Economic & Market Commentary

The first quarter of 2012 was the best first quarter for stocks since 1998. Virtually all indices of US equity performance were up double digits, led by the NASDAQ composite, up 18.7%. This was true globally as well, with all but a small handful of country markets (Spain, Portugal, The Philippines and Indonesia) performing well. Capitalization size differentiation was not a major factor in the quarter, unlike past periods, as companies of all sizes performed roughly in line. Continuing the recent trend, growth did better than value, and stocks did better than bonds.

The most notable aspect of the quarter's equity performance was the fact that the character of the market turned upside down compared to recent periods. It was clearly a "risk-on" market with low quality, higher beta issues well outpacing high quality. According to Merrill Lynch's quality rankings, low outperformed high by 40% or more. Also contrary to recent periods, dividend yield was no help in the performance game. Merrill's work indicates that issues with a yield in excess of the market were at the bottom of the quarter's performance rankings. The only sectors to outperform the aggregate were financials, information technology, and consumer discretionary, while energy, healthcare and consumer staples were stuck at single digits and utilities produced a negative return.

The other notable aspect of the quarter was the impact of a single stock – Apple Inc. AAPL is now the largest company in the S&P 500; carrying a 4.6% weight (Exxon Mobil is next at 3.2%). AAPL was up 48% during the quarter, so it's impact on the S&P quarterly return was close to 2 percentage points out of the 12.0% quarter.

The point of this discussion is to emphasize the fact that, while the quarter was a good one, the performance was not broad. The high correlation of the past, between stock's returns was not there and a narrow list of issues produced the best results.

At the end of last year we believed the equity market was about fair value and, given the circumstances at the time, felt that we could see an upside of about 1350 for the S&P 500 over the coming months. With the results of the first quarter we would say we've had a good "year" already. The consensus assumptions underlying this performance seem a little rosy. The U.S. economy is getting better, but as The Economist recently wrote "the economy is not a lot better, it is just not getting a lot worse." Since the recovery began in 2009, the U.S. economy has grown about 2.4%/year. Had we remained on a trend growth path, it is estimated that the economy would be at 12% larger than it is today. The components of the economy are performing about as would be expected in this slow growth world. Consumer spending has held up. The employment picture has gotten better, in spite of what appears to be a disappointing March report. In the prior 3 months about 734,000 jobs were added (the best since April 2006) and the unemployment rate has declined from 9.0% to 8.2%, although much of the drop in the official unemployment rate is a result of people dropping out of the work force as opposed to job creation. As we have said before, to have a significant impact on the economy we need a long string of monthly job additions in the area of 250,000 or more. That would ensure growth in personal incomes and sustain a healthy consumer. At the moment, consumer spending is being fueled more by savings (the savings rate is back to 3.5% from a peak of 8.5%), renewed debt accumulation and government entitlements. These sources are neither sustainable nor healthy which is why the employment picture is crucial. This is particularly true as we look out 12 months and see transfer

payments declining and taxes, in all likelihood, rising.

Corporate spending could be better. Corporations are sitting on this huge pile of cash, which Barron's has estimated at $1.7 trillion at year end. They continue to be reluctant to spend on either labor or capital goods, due to uncertainty in both economic outlook and regulatory outlook. With a stronger dollar, the prospect for exports is modest at best, particularly with the European markets in recession. Housing on the other hand, has begun to show some positive signs after a long period of dormancy (some of this may be due to the unseasonably mild winter in the northern tier). These ingredients lead to an expectation of first quarter U.S. GDP growth of 1.5%-2.0%. This seems reasonable to us, and is in keeping with our long held view that a +2%-2.5% trend rate of real GDP growth is the new norm for some time to come. We are not ready to ratchet our growth assumption higher, in spite of the fact that the U.S. economy is more likely on a recovery path than appeared the case in the fall. Numerous potential problems still exist which we discuss below. While the U.S. consumer has begun the deleveraging process and brought household debt from 100% of GDP to about 80%, there is still more to go. In addition, whatever household debt reduction has taken place, has been more than supplanted by increased government debt. So net/net, we still have not started the deleveraging process which will take years to complete. The surge in federal debt and an extraordinarily accommodative Federal Reserve runs the risk of high inflation providing the bulk of the deleveraging in the future. The risk of this outcome has increased dramatically over the past year with the collapse of Simpson Bowles, The Super Committee and the Ryan Budget proposal.

In addition there are the federal budgetary/deficit issues that have been present for a long time, with no prospect of dealing with them until after this November's elections. Speaking of the election, InTrade (a prediction platform) has President Obama with a 60% probability of reelection. This is a reversal of recent trends and is no doubt the result of the improved economic outlook and the dysfunctional Republican primary process. Looking out into next year, we are faced with expiration of federal stimulus programs and the Bush tax cuts, as well as the beginning of sequestration. The effect of these actions could create a fiscal drag of approximately 1.5 to 3.0% on GDP, depending on election outcomes and which of the items are enacted. So while the current environment looks better, there are potholes lurking in the future.

The European situation is also looking better – at least in the near term. The European Central Bank's (ECB) Long-Term Refinancing Operation (LTRO) program seems to have done what we suggested it would do in our year end outlook – that is it has bought time. Greece has gone through its credit event, triggering the Credit Default Swaps (CDS), without a significant fall out. Others in the southern tier have begun austerity programs, which are not being received with open arms. Many European countries are either in or close to recession, with unemployment at high levels. Social unrest lies just beneath the surface, so they are far from out of the woods yet, and Portugal and Spain may be the next Greece. In addition France, the second largest economy in Euroland, is in midst of a presidential election campaign. It appears that François Hollande, the Socialist candidate, is ahead of incumbent Nicholas Sarkozy. In a country where public debt is 90% of GDP (and rising), and public spending is 55% of GDP (compared with an OECD average of 43%), the prospect of a socialist leader could be chilling.

Finally China is still in a softening economic mode but, according to most observers, the odds favor a

"soft landing". The central bank has cut reserve requirements several times, with probably more to come. This is good news, as a soft landing for China most likely means GDP growth slows from 9% to 6-7% - not a big hurt for the rest of the world economy.

So while the U.S. economic landscape looks better that it did 6 months ago, there are still many landmines that could upset this year's brightened path, and certainly do so next year. The Economist recently ran a cartoon that captures this feeling well.

Last year the story with stocks was earnings growth. Recall that nominal U.S. GDP growth of 5% produced S&P 500 earnings growth of 17% as margins expanded to unprecedented levels. This occurred in an uncertain world, where heightened risks caused the equity risk premium (ERP) to rise and conversely price/earnings (P/E) multiples to fall. This quarter the reverse took place. The landscape looked better, ERP fell and multiples expanded. As was said earlier, it was truly a 'risk-on' quarter. We are again about to start earnings reporting season, which will set the tone for the rest of the year. As we pointed out at year end, the tailwinds that produced good earnings last year could become headwinds this year:

- slowing growth in China and Europe could offset improvement here.
- dollar strength which should continue
- operating margins that are at all-time highs could begin to mean revert

The rate of change in aggregate earnings has been coming down over the past year, and the expectation for this quarter is for a flattish aggregate report. Interestingly, Barclays calculates that, excluding Apple, the quarterly report would show a decline in earnings. We will obviously watch these earnings reports with great interest. For the year, our expectation is for minor growth in earnings. As long as the economy produces nominal growth we would expect earnings to grow, but at a slow pace. For the S&P 500, a figure of $100 seems reasonable.

Using that figure the equity market is currently selling at close to 14x forward earnings. With the ERP having declined, this is a reasonable valuation – neither cheap nor dear. It is hardly a valuation level that calls for adding significant risk to a portfolio, however. Given the valuation level, and the attendant economy and political risks, we prefer to retain a balanced portfolio position, and look for good businesses at cheap prices.

Fixed Income Review and Outlook

As was the case with equities, the fixed income market was in a 'risk-on' mode for the quarter, a reversal of what had been the case for most of 2011. The majority of fixed income sectors produced positive return, except for long dated Treasuries. Holding spread product (non-Treasury assets) was rewarded, and the Barclays Aggregate eked out a 0.30% return.

Treasuries returned - 1.29% in the first quarter, after the strong showing in 2011. Treasury rates, especially those at the front end of the yield curve, are influenced by Federal Reserve actions. Monetary policy remains accommodative as the Fed holds its overnight borrowing rate near zero. In January, the Fed Governors extended from mid-2013 until late 2014 the timing of any expected tightening of the borrowing rate. When it became clear that the Fed intends to keep short term rates low, investors exited the front end of the Treasury curve in favor of intermediate paper. Further upward pressure on rates came in the form of the Fed's revised assessment of the economy in March, which suggested the expansion is getting stronger. For the quarter, the yield on the two year note rose 8 basis points to 0.33%, while the thirty year bond, which trades more on inflation expectations than Fed action, rose 44 basis points.

We expect that Treasury rates will continue to rise modestly. They are just too low. At the end of 1Q2011, the ten year note yielded 3.47%. At that time the economy had added 450,000 jobs in the previous three months; unemployment was 8.9% and the year over year measure of the CPI was 2.7%. At March 31, 2012, the economy has added 734,000 jobs in the last three months; unemployment is 8.3% and year over year CPI is 2.9%. Yet the ten year yields 2.21%! It is for this reason that we expect to maintain an underweight position in Treasuries.

Could the ten year yield return to last year's 3.47% level? It can and it will, but we do not think that will happen anytime soon. Basel III, new regulations designed to ensure capital adequacy at the banks worldwide, will provide incentives for banks to hold more Treasuries. Basel III establishes Liquidity Coverage Ratios that call for banks to have sufficient high-quality assets to "survive a significant stress scenario" lasting for one month. Those high quality assets will be comprised of Level 1 and Level 2 assets. There are no limits on Level 1 assets and they are not subject to a haircut. Treasuries and Ginnie Mae mortgage-backed securities (MBS) that have an explicit government guarantee are the only Level 1 assets. We think adoption of Basel III will encourage additional purchases of Treasuries by banks and keep a lid on yields.

U.S. government agency bonds returned 0.24% during the quarter. Much of this return can be attributed to the tightening of agency spreads relative to Treasuries and the positioning of agency paper in the short end of the curve, which is less susceptible to negative returns. Demand should remain strong for agencies as investors who require highly rated securities will continue to provide a market for this asset class. In addition, agencies will continue to benefit from the market perception that Fannie Mae and Freddie Mac are backstopped by the Government.

While we expect that bulleted agencies will continue to benefit from scarcity value, we believe that spreads are too tight relative to Treasuries and prefer to use callable agencies with final maturities of 2016 and earlier as a yield- enhancing strategy.

Corporate bonds offered investors 2.04% and had their best three-month return relative to Treasuries since 2009 and third best three-month return relative to Treasuries EVER. Lower quality was the best performer on an absolute and relative basis. BBB-rated corporates returned 2.52% and 4.33% respectively.

Corporates remain the investment vehicle of choice for many investors in this low-yield, slow growth environment. Despite record earnings, high cash balances and the return of the S&P 500 index to early 2008 levels, corporate spreads over Treasuries remain wide to historical values. The combination of relative wide spreads and low all-in yields available in Treasuries and agencies have encouraged additional investment in corporates.

We subscribe to this train of thought and will continue to overweight corporate bonds. However, after such a strong run we are approaching the asset class with more caution. As the availability of many high-quality pieces of corporate bonds evaporates and the relative value of corporates over other fixed income asset classes has diminished, opportunities to go up in quality and increase yield have presented themselves. We are looking to exit those names that, like bullet agencies, are trading too tight relative to Treasuries. We intend to swap those corporates into callable agencies that offer greater yield without a large increase in duration or similarly-rated corporates that offer more yield.

Mortgages beat the overall index to start the year, returning 0.57%. Mortgages have benefited from both the investment community's desire for yield and the assumption that further monetary easing (the much-debated Quantitative Easing or QE3) would involve the purchase of MBS by the Federal Reserve. We currently do not support the view that the Fed will embark on a QE3. Mortgages, in our view, have gotten close to fair value and we are not looking to add exposure at this time.

Municipal returns trounced those of the Barclays Aggregate, returning 1.75%. Positive technical factors contributed to the rally as traditional municipal buyers needed to reinvest coupons paid at year end. Heavy inflows by retail investors also added to the reach for municipal bonds. These technicals will dissipate to some extent in the coming months, as retail investors often sell munis to fund tax payments and the new issue calendar hits a seasonal lull.

While concerns about "billions of dollars of defaults" have receded from the forefront of municipal investors' minds, a new one could be on the horizon. Tax reform that would limit the ability to deduct interest paid on municipals is being talked about in Washington. States and municipalities have voiced their objections, as it would raise their funding costs as investors demanded higher yields. It would conceivably create two classes of municipals: the pre- and post-reform class. Pre-reform bonds would continue to benefit from tax exemption (the indentures of a bond cannot be changed without bondholder approval) while post-reform bond interest would be potentially taxable depending on income. Given the complexities of the proposal and the expected contentious nature of the November elections, we do not see this change as an issue this year.

High yield bonds posted a 5.3% return to start the year. As was the case in the investment grade sector, lower quality bested higher quality. The Caa sleeve returned 8.1% while Ba bonds offered 4.4%.

What drove the "risk-on" trade to start 2012? A big factor in the move to "risk-on" was the European Central Bank's Long-Term Refinancing Operation (LTRO). This program, introduced in November and

implemented on December 21 and utilized again on February 29, lets the ECB provide three-year collateralized loans to European Banks at 1%. The intention was that banks would borrow at low rates and buy higher yielding securities, capturing the spread to shore up their balance sheets. Rather than buying bonds, banks have chosen to take the loans and hold cash. This action both lessened the banks' liquidity concerns and may have avoided a solvency crisis. As the perception of the European banks improved, investors' risk appetite increased as well.

In the United States, the Federal Reserve gave the 19 largest U.S. banks a passing grade in their annual stress tests, which are designed to test for capital adequacy under duress. The Fed does not want a repeat of the seizure in the credit markets similar to the one that followed the collapse of Lehman in 2008. These tests examine the value of bank assets assuming a 50% drop in the stock market, 13% unemployment and another 20% drop in home values. An overwhelming majority were found to have enough capital to survive those conditions. Almost 80% of those tested would be able to continue to return capital to shareholders in the form of dividends or share repurchases even under those circumstances.

We think the best of the "risk-on" trade in bonds is behind us for the moment. Given the low absolute yield of most fixed income sectors (the Barclays Credit Index hit its 30 year low in March); we favor strategies that enhance income. An underweight in Treasuries and an overweight in corporate bonds should continue to benefit the portfolios. Slow, steady economic growth in the 2-2.5% range will benefit spread product. We see the best value in high quality financials and those companies with pricing power. Higher coupon mortgages that are less prone to extension risk and callable agencies that provide yields comparable to high quality corporates round out our preferred investments.