MARKET COMMENTARY

First Quarter, 2011

Two years after the U.S. stock market hit rock bottom, the economy appears to be on the verge of what Fed Chairman Bernanke referred to as a 'self-sustaining' recovery. While a great deal of upheaval has recently enveloped much of the globe, it appears that, at least for now, the uncertainty will most likely have a limited impact upon the pace of our economic recovery. We believe embedded in this capital markets cycle is a higher than normal level of risk, and we have a robust collection of hedging tools available to mitigate related volatility.

Healthy Roots?

One week after the market's bottom in March of 2009 Federal Reserve Chairman Ben Bernanke used the term "green shoots" to describe the early signs he saw of a potential turn in the economy and improved confidence in the capital markets, at least partly as a result of the quantitative easing program engineered by the Fed. Two years later, the Fed's second round of easing (QE2) is more than halfway complete and investors are starting to anticipate how the market might respond to its end in June. Investors are also faced with a growing list of concerns that include sharply higher crude oil prices, the Japanese earthquake and its aftermath, Middle East uprisings, and continued sovereign debt problems in Europe. In the U.S, issues include persistently high unemployment, weak housing, and the prospect of inflation.

Yet, despite these uncertainties, after a sell-off in early March, the S&P 500 index recovered lost ground. By the end of the first quarter, the index was barely under its mid-February high, with a total return of 5.9%. Given the long list of potential problems, how is this possible? We believe the economy may be progressing towards the self-sustaining level described by the Fed and that in addition to green shoots we are also starting to see some healthy roots establish themselves in the soil of our economy, fertilized by the liquidity from QE1 and QE2.

On a particularly upbeat note, growth in capital spending is now at one of the highest levels on record, indicating confidence among management teams. Such spending is typically a leading indicator of hiring activity. In fact, in a recent Business Roundtable survey, **52% of CEOs from 200 of the largest U.S. companies said they were planning to increase hiring over the next six months**, the highest reading since the survey began back in 2002. As another benefit from increased corporate confidence, we are also seeing new demand trends develop for bank loans, and this lending activity is also likely to help stimulate economic growth. Another sign of confidence is the recent pickup in M&A activity, most notably the AT&T/T-Mobile $39 billion transaction.

Given the domestic economy's strength and the global rise in oil prices due to the turmoil in the Middle East, inflation could be seen as a potential concern. However, inflation expectations, (as measured by the five year TIPS breakeven rate) are currently 2.2%, a level that the Fed does not consider problematic. In addition, Chairman Bernanke recently said the elevated prices of commodities were unlikely to create more than a temporary increase in the inflation rate, and because the unemployment rate remains elevated and manufacturing capacity utilization remains at moderate levels, the Fed sees no signs that inflation will become a problem in the near term.

Another area of concern is Japan, the third largest economy, accounting for 9% of global GDP. The country's second quarter economic growth may slip into negative territory as a result of the recent disaster, but its historic economic resilience aided by large injections of liquidity by the Bank of Japan and the boost it will receive later this year from reconstruction activity should result in a relatively quick recovery. **We do not anticipate that the catastrophe in Japan will put much of a dent in global economic growth.**

Europe represents another low-impact area of concern despite recent headlines about Portugal. Of the so-called PIIGS countries in Europe, Greece and Ireland are now in deep trouble, and Portugal has now asked for a bailout. This leaves Spain and Italy as the remaining members of this cohort. However, it is possible that from this point onward the news about sovereign debt problems in Europe may only improve. Spain and Italy are much larger, more diversified economies than Ireland, Greece, and Portugal, and therefore the odds of their economies reaching a critical state appear quite low as reflected in the recent prices of credit default swaps (CDS) on the debt of Spain and Italy. Moreover, the European Central Bank has created special financial entities such as the European Financial Stability Facility, a special purpose vehicle which can issue bonds to raise funds with the purpose of lending to troubled European countries, recapitalizing banks, or purchasing sovereign debt. Despite the implosion of the smaller PIIGS economies, U.S. investors seem to have reached the opinion that sovereign debt issues are no longer a critical concern.

As the first quarter progressed stock market volatility spiked in late February in response to developments in the Middle East and spiked again in March due to the earthquake and tsunami in Japan. There was also a sharp rise in food-related commodities which impacted emerging market inflation rates, since food is a much larger component of spending in those locales. We believe that ongoing inflation and related pressures are likely to depress valuations in the developing world, and as a result we sold our emerging market ADRs during the quarter. However, their performance prior to their sale weighed on our portfolio. Consumer stocks also hurt the performance of the portfolio early in the quarter as several companies issued guarded outlooks for 2011. In the energy sector, not owning a number of mega cap stocks which performed well also hurt us relative to the benchmark index. Overall, technology was the biggest positive contributor to performance during the quarter.

The All-Cap Core portfolio is currently positioned to benefit from higher energy prices, both directly and secondarily through clean energy-related companies which see higher demand in response to high energy prices. The energy weighting may also help act as a hedge if the situation in the Middle East deteriorates further. Our materials sector weight and our ‘Pricing Power’ theme should hold us in good stead if input cost pressures intensify. We have also added two new themes in recent weeks, ‘Mobile Wallet’ and ‘Japanese Renewal.’ The first theme, which is now the third largest in the portfolio, focuses on companies which are poised to enable the concept of a mobile wallet where a smartphone can be used to pay for goods and services by holding the phone near a point-of-sale device. Partly as a result of this theme, the portfolio’s weighting in technology has increased substantially since year end.

We believe the economy continues to be on solid footing. Economic data in general continues to be positive and inflation risks still appear low in the U.S. Despite the list of exogenous events that have occurred so far this year, we find the current market environment favorable for equities.

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