

Quarterly Market Letter



First Quarter 2012

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Highlights:

- European fears recede, not gone
- Earnings better than expected for 11 quarters
- Longer term bond yields up
- U.S. economy firm with modest growth

Introduction

U.S. equity markets continued on a roll in the 1st quarter. Many of the European fears have now receded and worries about a global growth slowdown have diminished. U.S. corporate earnings have now been better than expected for 11 quarters in a row. So the twin engines of reduced fear and positive surprises fired up a big rally for U.S. equities. These same factors led fixed income investors to reassess the attractiveness of U.S. Treasury securities. The absolute safety of Treasuries was no longer needed as a haven from the storm, and with yields under 2%, money began to flow towards equities to capture earnings momentum. So despite reassurances from the Fed that they would extend the period of ultra-low short-term rates into 2014, longer term yields moved up slowly in January and February, but then gapped higher in March. Broad fixed income indices eked out a positive return of around 0.5% for the quarter with most Treasuries declining while corporate bonds posted solid positive returns of 1-3%.

International markets also responded to the perceived improvements in the global outlook. Most markets were up close to 10%, with China and the UK the two notable major market laggards, up less than 5%. Expectations for 2012 global economic growth continued to taper off a bit, as the southern European economies continue to suffer. But the U.S. outlook remains firm, and China also looks fine even though it is deliberately slowing its expansion from 10% down to 7-8% per annum. Investors' worries were quieted by a continuing stream of good news, especially improving employment and output statistics. This led to an increase in the S&P (Standard & Poors) 500 index for 12 out of 13 weeks in a row. Only in late March did the market seem to reach a new near term equilibrium. But given our outlook for continued modest GDP growth of 2.0% - 2.5%, we still see room for additional albeit modest near-term equity gains over the rest of the year.

Domestic Economy

The domestic economy finished 2011 on a high note with 4th quarter real GDP (Gross Domestic Product) growing at a healthy 3%. However, this figure was positively impacted by a sizable boost in inventories as businesses replenished depleted stocks in order to meet demand. In the 1st quarter of 2012 growth has slowed to a more tepid 2%. The inability for the economy to build sustained momentum quarter over quarter is symptomatic of the uneven and subpar trajectory of this recovery, which is now in its third year. The message is that those who expect smoother sailing for the economy this year may well be disappointed. We expect to see sharp swings in a number of economic data points resulting in some irregularity in quarter-to-quarter GDP similar to what occurred last year.

One compelling reason for our forecast for further expansion, albeit uneven, is the steadily improving job market. For the past three months, the economy has added more than 200,000 jobs per month. In addition, initial unemployment claims have fallen over the past several months to a recent four-year low and are supportive of further labor market improvement. With more people getting back to work, it is no surprise that retail sales surged 1.1% in February, led by car sales that increased a solid 16% versus a year ago. Consumers, a very important and necessary aspect of GDP, remain resilient and are further encouraged by modest gains in personal income and a rising wealth effect from a surging stock market. Consumer confidence measures have risen to their highest levels since the end of the recession implying a continued positive consumption pattern.

Another positive impact of a slowly healing labor market has been some modest improvement in housing fundamentals. Both housing starts and existing home sales have shown recent signs of life due in part to an unusually warm winter as well as historically low mortgage rates. Low rates plus slumping home prices have propelled the affordability index to an all-time high, giving some credence to the notion that housing has turned the corner. As the labor market continues to improve, household formation should increase. This should help to stimulate home purchases, eventually leading to firmer home prices. While the housing sector accounts for only around 4% of GDP, housing has an outsized impact on the economy due to associated demand for consumer durable goods including furniture and appliances. Improvement in residential construction, while not considered a lynchpin to the sustainability of this economic recovery, could certainly provide a boost to growth in the second half.

While we believe that there will be modest growth in the economy of just above 2% for the year, there are some risks to this forecast. First, a sharp rise in oil prices has already taken average gas prices at the pump to nearly \$4.00 per gallon nationwide. As a rule of thumb, every \$10 per barrel increase in crude oil price raises the price of gasoline by \$0.25 per gallon, which creates a drag on disposable personal income of some \$35 billion annually. To put this all in perspective, the current year-over-year increase in gas prices may end up costing the average consumer an additional \$500. In our opinion, while certainly a drag on consumer spending, this is not nearly enough to derail the economy. But, should oil prices spike from here due to a Middle East conflict, then a much larger gas price shock could indeed destabilize the economy.

Second, the recent European sovereign debt crisis with particular focus on Greece, seems to have abated. The ECB's (European Central Bank) infusion of much needed liquidity into the Euro banking system has quieted concerns over any incipient financial crisis. The bailout of Greece has proceeded including forcing creditors to agree to reduce the face value of its sovereign debt by 50% and to extend maturities on new loans out to 30 years. While these moves have provided a reprieve to the immediate crisis, the Eurozone is far from being out of the woods. Europe is currently falling into recession, and other heavily indebted Southern European nations such as Spain and Portugal could go down the same path as Greece and bring the Eurozone situation once again to the forefront with difficult consequences for both the U.S. economy, as well as, the financial markets.

Third, an even greater risk to the economy is the twin fiscal impact of large spending cuts along with tax increases scheduled for January 2013. A "do nothing" Congress that becomes deadlocked in addressing these issues during a presidential election year could well erode confidence and delay spending decisions by both businesses and consumers. The expiration of the Bush era tax cuts at the end of 2012, and a new tax on investment income next year will lead to much higher taxes on dividends and capital gains. These additional taxes, combined with the expiration of the payroll tax cut and emergency unemployment benefits will serve as significant headwinds to economic growth. Even if cooler heads prevail and some degree of compromise is reached, there will be a decided fiscal drag on the economy both psychologically in the 2nd half of this year and potentially a reduction in growth next year. If all the proposed tax increases are enacted and if the automatic spending cuts occur, then GDP growth for next year could fall precipitously.

Given the ongoing unresolved problems in Europe, the potential for further increases in critical commodity prices, especially oil, and the possibility of major fiscal tightening in 2013, the future durability of this recovery is far from assured. On the brighter side, consumer inflation or headline inflation, as measured by the CPI (Consumer Price Index), after surging to 3% last year on the heels of much higher food and energy prices, looks to moderate this year to around 2%. Core inflation (absent food and energy) is expected to also converge towards headline at about 2%. Moderate but not strong economic growth accompanied by modest inflation should allow the Fed to remain on the sidelines and refrain from raising rates for at least 12–18 months. The 2012 outlook for financial markets, especially equities should continue to be favorable against a backdrop of moderate economic growth along with benign inflation and low interest rates.

Fixed Income

Investors in U.S. Treasury securities experienced some stormy weather during the latter part of the quarter. Basically the uncertainties that had been driving the yields lower finally reversed direction on these government issues. While there were multiple drivers, the primary factor was what we consider to be another temporary solution to the sovereign debt crisis in Europe with the round two bailout of Greece. Frankly it was an effort to buy more time and avoid a potential domino effect from occurring near-term. In addition, the release of the Fed's extreme stress test on large domestic financial institutions revealed lower risk levels on capital and a heightened ability to weather another substantial economic downturn without government assistance. Also, while key economic statistics continued to remain mixed, there was a decided general improvement in the rate of job growth that has now expanded nationally for 17 consecutive months.

The combination of all these factors led to improving investor sentiment and declining expectations for further quantitative easing. Also, it caused investors to be more aggressive and a return to "risk-on" market conditions. We believe this is what the Fed in their massive easing policy has been hoping for. As a result, equities rallied and interest rate spreads on corporate bonds compressed, while the yield on the safe haven treasury securities rose in a steepening fashion, as longer maturities rose more than shorter ones.

As measured by the Treasury 2, 5, 10 and 30-year maturities, yields were higher by the end of the quarter by 9bp, 21bp, 33bp, and 44bp, respectively, although the setback was even more pronounced prior to March 30th. As measured by the

10-year Treasury issue, yields at one point were higher by 50bp (basis points). Of course the compression in risk premium spreads on corporate issues caused the representative Barclays Credit Index OAS (Option Adjusted Spread) to narrow 57bp from +218bp to +161bp, thereby more than offsetting the price declines experienced in coupon treasury securities. Furthermore as inflation expectations rose, it increased the 10-year TIPS (Treasury Inflation Protected Securities) breakeven inflation rate by +34bp, which benefitted our portfolios.

Unfortunately, rising core interest rates and increased inflation expectations are not a favorable event for most fixed income investors. However, we were structured for this type of occurrence in our various fixed income styles and were well-positioned to take advantage of the market conditions experienced during the 1st quarter. Also, despite the turmoil in treasury securities, the well-followed Barclays Government/Credit Intermediate Index still managed to garner a positive return for the quarter at +0.61%. The longer maturity Barclays Government/Credit Index managed to stay above the zero mark with a +0.08% return.

Looking Forward

Even though the relief from adverse economic conditions was welcome during the first quarter of 2012, it is important to remember that many of the problems affecting the global economies are far from resolved. Due to the effects from the efforts of the Euro LTRO (Long Term Refinancing Operation), Greek sovereign debt fears are out of the spotlight for now. But Portugal, Spain and Italy are now center stage with austerity programs being thrust on their already weak economies. So, investors continue to question how long the European Union can survive. In addition, a new risk that the bond market will have to contend with is the potential for a conflict between Israel and Iran and the resulting fallout from an oil price spike.

While domestic employment and housing related statistics continue to improve, we would not describe the numbers reported as being either good or healthy. In fact, the level of job growth and the quality of jobs being created continues to be subpar. On the housing front, despite tentative signs of a bottom, the most recent S&P/Case-Shiller 20 City index statistic reported a new low in prices nationally. Furthermore, millions of households continue to be hobbled by negative equity in their homes. In other words, we are still far from experiencing normal conditions, and "events" are still an issue. The effects of deleveraging will be with us for some time.

So, we still believe the prevailing conditions will cap the potential for interest rates to rise significantly this year. If the European contagion reasserts itself, this could bring yields on Treasury securities back down to the lows reflected at the end of the 3rd quarter of 2011. As a result, we have not changed our interest rate forecast from the previous quarter and expect interest rate volatility to remain high.

Taxable Strategy

Somewhat like our equity counterparts, most of our entire year's expected market move occurred in one quarter. We believe that the shift to higher yields was too much too soon. As a result, we tactically repositioned our portfolio styles at the end of March with a change from a conservative duration bias to a neutral stance. We feel this portfolio restructuring will benefit our clients as questions still remain about China's hard/soft landing, continued European concerns with Spain as the next target and our domestic economy's sustained growth prospects still in doubt.

We completed several swaps to effect this change. Near-term, we think the 10-year Treasury should trade in a narrower range of 2.1-2.4%. However, our expectation for the balance of the year continues to be a broader 1.6% to 2.6% range. Of course as market impacting news and statistics vacillate between positive and negative outcomes, we will adjust portfolio durations accordingly.

We still favor overweighting corporate bonds given generally improving financial conditions, supply/demand factors and attractive spreads. Also, we will maintain our overweight position in TIPS, since the statistics driving the headline CPI rate should remain at fairly elevated levels for the time being. We carry an underweight exposure to government agencies based on the narrow yield spreads available and the continued headline issues associated with the GSEs (Government Sponsored Enterprise). Finally, our coupon treasury securities will be held for liquidity purposes and, as always, as a hedge against future uncertainty related to domestic and global events.

Municipal Summary

This year, new issue tax-exempt supply has been below normal while demand has remained vibrant. The favorable supply/demand factor was more pronounced during the first two months of the year resulting in a significant rally. However, the Ides of March took treasury yields to new heights, while new issuance surged, causing a fairly good sell-off in the middle of the month. A slight rally that ensued at the end of March helped to ease some of the pain. As the quarter closed, there were slightly positive returns for our clients and the representative Barclays Municipal Indices. The 5-Year Index nominal return was a positive 0.58%. Fortunately, our focus on higher quality issuers and structures proved beneficial and insulated us from the mini-carnage of those investors that chased maximum yield.

For the full quarter, primary supply surged over 60% year-over-year with \$78 billion in underwritings. Of course, the 2011 statistic was suppressed by the excess issuance from the prior year due to the expiration of the taxable, but federally subsidized, Build America Bond (BAB) program. While the year-over-year comparison may be impressive, the amount is just below the longer term norm. Although supply was digested by investors, it occurred in a somewhat disorderly fashion that left "Aaa" yields higher in the belly by up to 20bp, while the wings were lower from -1 to -10bp compared to year end statistics. The higher yields and good relative value in the 7 to 10-year maturity range is now providing us opportunities to increase yield meaningfully with curve roll strategies, while only slightly increasing durations. In addition to a slightly steeper municipal yield curve, yield ratios were either slightly above or below 100% of treasury securities, ranging from 97% to 114% of that taxable counterpart. These relatively attractive ratios have kept crossover buyers in the market and we expect those factors will remain in place near-term.

In spite of the quarter's modest positive returns, headline risks remain an issue. The real threat is longer-term and is associated with the surging costs from pensions and OPEB (Other Post-Employment Benefits). Unfortunately an unintended consequence of a lower interest rate environment has been an increase to the present value of these future liabilities. As a result, near-term costs are rising and headlines associated with the problem increase. This has resulted in a material widening in credit spreads for lower tiered structures and securities near the bottom end of the investment grade tiers. Our styles focus on liquidity and quality factors that result in a high average credit rating which is presently "Aa". Therefore, the effects of spread widening have been muted in client portfolios.

Fortunately not all the news is gloomy in the municipal sector. Preliminary data just released by the Rockefeller Institute for the 4th quarter of 2011 reflects a general but slow improvement in state tax collections. Revenues were up on average by 2.7% year-over-year. Although the gains are modest, it is reflective of a slow economic recovery. We are also beginning to see concessions from public unions that were initially vocally against any change. According to the National Conference of State Legislators, pension benefits for U.S. public workers have been reduced by 43 states over the last 3 years. While the magnitude of reduced benefits is small, at least it is a step in the right direction. Unfortunately the excess liabilities are still significant and will continue to challenge state and local governments and their respective agencies.

A potential positive development on the ratings front was S&P's announcement of a recalibration of their ratings, which will now just focus on quantitative data. As you may recall Moody's and Fitch recalibrated their ratings system in 2010 to give investors a global ratings approach based on default probability, resulting in sweeping ratings upgrades for credits across the board. The move did initially help allay fears that investors had at the time. S & P estimates that 32% of local government GO (General Obligation) ratings could increase. We believe that this move could provide a short-term boost to select issuers with lower yield levels on their securities, but not so significant as to capture additional return potential.

However, we are concerned with the timing of this methodology change, which we view as inappropriate in the present environment. In addition, taking out the subjective component in the review of various entities is basically removing what we consider to be the important political factors involved in each community. The change to a quantitative-only methodology parallels their state rating criteria implemented late last year. As you may recall, S&P upgraded the outlook of the state of California late last year and one could argue it has been our best performer in the 1st quarter of this year for our clients. It is important to note that there will now be divergence between S&P ratings and the other NRSROs (Nationally Recognized Rating Organization). Therefore, while S&P is looking to upgrade more issues than those downgraded, the opposite is occurring for Moody's and Fitch. In this environment we would embrace the latter as being more responsive to the prevailing problems.

Outlook and Strategy

We remain in an event-laden environment, where negative and positive headlines will continue to provide volatility and opportunity at the same time. The steepening of the yield curve especially in the 7 to 14 year area has provided opportunities for us to move out the curve modestly and still increase yield meaningfully. As an example, the increase in yield based on "Aaa" rated credits between 1 and 10-years is nearly 200bp. As we look to increase duration somewhat, we view the 7 to 14 year area of the curve as an attractive maneuvering point with swap transactions. Also, an investor can now capture 90% of the 30-year "Aaa" yield at 15 years. With the latest round of negative headlines, credit spreads have also widened in the "Aa" to "A" rating categories. We also view this as an opportunity to capture additional yield without significantly increasing credit risk on select issuers.

In addition, we anticipate that more local governments and their agencies will utilize the threat of bankruptcy, coupled with cuts in service and layoffs as a way to address budgetary issues. As a result of the above factors, we continue to de-emphasize smaller local GOs with poor and declining demographic trends as well as entities without viable options in dealing with pension and OPEB issues. Furthermore, we will slightly reduce our emphasis on liquid pre-refunded securities in favor of the wider yield spreads now available in select lower investment grade rated credits.

Equity Outlook and Strategy

With the economy now running at a near normal rate, we do not expect any big swings in the earnings or performance of the major market sectors. This will be a stock pickers market. We will seek those companies that can stand out in a slow growth environment. Sector shifts in the portfolio, if any, will be to where P/E (Price to Earnings) ratios are low, looking for a rebound in subsequent periods.

As we expected in our last letter, the utility sector was overpriced and has lagged badly. It was the only sector in the first quarter with a negative return. But even now, priced at a more modest relative P/E, but with no significant growth and yields still only in the 3-5% range, we will wait for a better opportunity.

We also anticipated that banks would eventually be allowed to increase dividends. When the Fed finally gave its blessing in early March, the whole sector rallied almost 5% in one day. We think their outlook is steadily improving after the shellacking they took over the last three years from

bad loans, faulty mortgages and cumbersome new regulations. A good earnings year for all banks is virtually guaranteed, as funding costs continue to decline and loan loss rates improve. Longer term we expect these stocks to continue to trade at a significant discount to the rest of the market, at only 8-10x P/Es, due to increased lending regulation, very modest growth and the need to keep larger reserves due to the implementation of new global banking regulations, Basel III. We will be price sensitive and look for shareholder friendly actions with improving cash flow.

One surprising thing is that energy stocks have lagged despite a +10% run up in the price of Brent crude oil. While Brent oil may be the global standard, for U.S. producers the WTI (West Texas Intermediate grade) is more relevant. WTI only advanced about 3%, as U.S. oil supplies surged and there is not enough capacity to carry it to where it can be refined. Another, perhaps bigger part, of the performance lag can be explained by the more than 25% decline in the price of natural gas, the other major source of earnings for these stocks. So while we do not think that oil prices are likely to go much higher, except in the case of a Middle East imbroglio, these companies are now selling at low P/Es and aggressively seeking major new finds both domestically and abroad. As a result, our portfolios will remain at about the same weighting as our benchmark index. We may not be facing the end of the carbon era quite yet, at least not because we are running out of oil and gas.

Germany, the linchpin of Europe, has now had four consecutive quarters of flat to lower industrial production. At some point their slow down/recession will run its course, and later this year we anticipate investment opportunities opening up as the cycle starts to turn upward. U.S. industrial conglomerates would be one of the beneficiaries, as would transportation companies with major links to the EU. Currently we have a modest commitment to this area, so we have plenty of room to expand when we gain some conviction that their economy has bottomed and will be getting better in the near term.

In the meantime, weak European demand and the slowing Chinese economy will keep commodity prices under pressure. As noted previously, if more fighting broke out in the Middle East, oil would be an exception, as would gold. But construction and industrial-production oriented chemicals, metals and other materials, even cotton, now appear to be in plentiful supply while global demand is somewhat subdued. Our holdings in these areas will continue to be quite modest and oriented to company specific developments or smaller industry niches. China has begun to transform its economy by de-emphasizing large

infrastructure spending in favor of driving broader based consumer spending growth. U.S. multinational companies that have exposure to this favorable shift are sure to benefit from those tens of millions of new customers.

As we have noted earlier, employment and income are now finally growing. This leads us to look more favorably on health care stocks that provide services to an expanding workforce. Even without gains in coverage from Obamacare programs, these stocks should have the wind at their back. They sell at low multiples and many pay good dividends of 3-4%. But we will continue to move slowly in this area until the Supreme Court ruling regarding the entire Obama health plan comes down at the end of the second quarter.

Even in the technology area, which we have liked for several years, we are starting to cut back a bit. Semiconductor companies are up 25-50% since the market bottom last September. Business remains good, but growth will be single digit and some companies are reaching our price targets. So we will shift back towards the index weight in this sector and look for better returns from individual companies that are driving their development and earnings faster than the market.

Conclusion

While the equity market based upon historical standards is still undervalued, we believe that with a slow growth economy and the overhang of international contagions, the market will continue to trade at a discount to long-term average valuations. We feel that the market's current P/E ratio of 13x based upon 2012 projected earnings is fairly to slightly undervalued and is likely to stay in a near-term trading range while assessing future earnings growth. This is the ray of sunshine because, though P/E expansion will be hard to come by, earnings growth is positive and in a slow growth, low inflation, low interest rate environment there is no reason for sustained P/E multiple contraction. Therefore between now and the end of the year we should be able to track earnings, possibly have a small multiple expansion and collect generous dividends. Dividends and earnings are the ammunition needed to hit the target as the year progresses. This double barrel approach will provide the formula for modest share price advancement and strong predictable current cash flow to supplement returns. Though returns for the remainder of the year will be more muted than the strength we saw in the first quarter, they should still be positive and continue to advance with the improving economic conditions.