

## MARKET COMMENTARY

June 8, 2011

Heightened levels of uncertainty on the macro front combined with the imminent conclusion of QE2 have led us to believe that a conservative tilt to the portfolio, with an elevated level of risk tools, is an appropriate stance.

Over the past month U.S. macroeconomic data turned decidedly less positive, and the market responded by dropping nearly 4.5% for the five week period ended June 3. During May, investors gravitated towards more defensive sectors, notably healthcare, consumer staples, and utilities, and shifted out of materials, industrials, and technology. While the stock market looked through many of the exogenous shocks that occurred during the first quarter (Middle East events, crude oil spike, Japanese earthquake/tsunami, and sovereign debt issues in Europe), it proved less resilient to events in April and May, which included heightened sovereign debt concerns regarding Greece, and notably weaker economic data in the U.S. Greece has now fallen short of its fiscal restructuring plans from 2010, and its bonds are now pricing in 50% or greater probability of default. The broader issue here is a risk of contagion with other weak sovereign debtors such as Portugal and Ireland, and to a lesser degree Spain and Italy, and the impact a default might have on the European banking sector given that so many banks hold sovereign debt on their balance sheets.

Investors are wondering if current events are a replay of the so-called ‘soft patch’ that began to unfold in May/June of 2010, roughly coincident with the end of the first round of quantitative easing. At the time, we had the BP oil spill, the flash crash, the Turkish-sponsored flotilla to Gaza, and fears of an economic slowdown in China. The market was also troubled by European sovereign debt problems in May 2010, and those concerns were eventually alleviated by way of financial stability packages and austerity budgets. US employment data began to weaken as well, and investors responded by de-risking their portfolios. While the list of exogenous concerns today bears only a slight resemblance to last year’s list, common themes remain Mideast instability as well as a resurgence of anxiety over European sovereign debt. We have also received incrementally weaker US economic data, although it remains an open question how much of the weakness can be attributed to supply-chain problems emanating from the Japanese earthquake and tsunami, as well as significant weather issues impacting the U.S. (flooding, tornadoes).

The imminent end of QE2 raises other questions about asset price levels, which have benefited significantly from the implementation of the program beginning last fall. Some commodity prices have rolled over, perhaps in response to the end of the Federal Reserve’s extraordinary measures.

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Noteworthy data from the past month include:

- \* Industrial production stalled in April, led by a drop in auto production, and consumer spending climbed less than expected as fuel and food prices rose.
- \* U.S. gasoline prices, averaging \$3.78 in the most recent week, have dropped only slightly from peak levels and remain more than 30% higher than this time last year.
- \* In May, US employers added the fewest number of workers in eight months.
- \* Consumer confidence climbed more than expected in May (according to the University of Michigan survey) to a three-month high. Index of consumer expectations six months into the future also climbed to the highest level since September 2010.
- \* April housing starts and permits were significantly below consensus.
- \* Credit is expanding – C&I loans from banks have increased six months in a row, as has consumer installment debt. To some degree this will help to offset the liquidity withdrawn with the end of QE2.
- \* According to ISI Research, third quarter schedules for US automobile production indicate a 100% increase in units produced over what was produced in Q2 as typical summer production hiatus is shifted forward into June. This hints at the potential for improved manufacturing data in July. May auto sales were weak relative to expectations.
- \* While the ISM manufacturing survey disappointed relative to expectations, May's non-manufacturing ISM survey, which reflects a much larger portion of our economy's output, was better than expected.

The All-Cap Core portfolio's loss of 4.3% (gross) during May trailed the 1.1% loss of the broader market. The market reversal accelerated throughout the month, and a few of our themes and sector overweights negatively impacted our performance. Our "Mobile Wallet" theme gave up the performance it had gained earlier in the year. Underweights in healthcare and consumer staples detracted from performance, while materials and industrials overweights also detracted. We have reduced our underweight in staples, our overweight in materials, and have added a hedge for our

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remaining materials exposure since we believe the broader sector may be at risk of underperforming in the current investment climate even though we retain what we believe are very attractive positions in the sector.

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