

The first quarter of 2011 produced many significant geopolitical and other newsworthy events that affected financial markets around the world. The democratic movements that are spreading through the northern African countries of Tunisia, Egypt and Libya have been near term catalysts for significant increases in the price of oil, as Libya's civil conflict has disrupted the flow of nearly 2% of OPEC's oil exports. Although Libyan oil is primarily consumed in Europe, it has increased the world price by more than \$25 a barrel, in spite of recession-driven, decreased world demand and increased refined inventories. The financial weaknesses in the Irish, Portuguese and Spanish economies, as well as the natural disaster in Japan, have also cast a pall over markets worldwide. Indeed, the Dow Jones Industrial Average declined 6.5% between late February and mid-March, as a result of all of this news. In mid-March positive market momentum returned, as the news on the US economy turned a bit more positive. Weekly unemployment numbers have started to string together a series of consecutive improvements and retail sales figures also reflect surprising strength: economic indicators are coming in at levels indicative of a modestly expanding economy.

This past quarter was a period of both mild improvement in some, and it's not getting too much worse in other, economic news. Unemployment declined another to 8.8% with 131,000 fewer jobs lost and 291,000 jobs gained, in March alone. Housing remains a distressed sector particularly in the western US. The amount of bank owned real estate continues to grow in the west, while in the other three regions of the country, bank owned real estate has leveled off. Although the numbers for housing starts and existing home sales are still far from robust, there are definitive signs of improvement from the market nadir. Most economic indicators are exhibiting strong signs of an expanding economy. The ISM Non Manufacturing Index has been in a growth mode for 16 consecutive months, the most recent un-employment figure reflected another 0.1% decline in rate, auto sales are 11.8% above last year's level and retail sales continue strong. Consumers' debt service and other monthly payments are at the lowest percent of income since 1995. It is interesting that the most recent escalation of oil prices, with gasoline at \$3.86 to \$4.20 a gallon, has not yet had its traditional dampening effect on consumer confidence and confidence seems to be spreading through the economy with the pickup in employment (March marked the twelfth consecutive month of private sector job growth).

The budget woes of federal, state and local governments have added fuel to the inflationary fire. We attended a talk by Senator Alan Simpson and Erskine Bowles, during which they reviewed the findings of their highly regarded budget reform committee. Their talk was enlightening and modestly encouraging, while at the same time, rather frustrating. They presented a very well-researched and thought out plan, which seemed to lay out virtually all of the necessary governmental adjustments that would restore fiscal sanity to the Federal Government. Unfortunately, their work and findings seemed to have as much of an impact on Congress as "a hummingbird whistling into a hurricane" to quote Senator Simpson. Following up on their findings, Senator Paul Ryan of Wisconsin is currently attempting to instill a corrective budgetary

plan but is running into all kinds of resistance from our Congressional “leaders.” It certainly seems as if the government and anyone involved with government have lost touch with the present economic predicament of their constituents. Government leaders seem unable to adjust to the reality of the current economic environment where individuals have reduced their debt levels and may be working for wages that are significantly lower than they enjoyed prior to the recession. This type of reality has not yet worked its way into government thinking, nor action. There are, however, small signs of awakening as evidenced by the battle to make some preliminary changes leading to the last minute avoidance of a government shutdown. The \$38 billion reduction in the budget represents just a 0.25% decrease in spending however, it was at least a small step in the right direction.

The Federal Reserve’s policy of providing liquidity in the economy via mortgage purchases seems to have been rather effective in providing a measure of stability to the financial markets. We do not expect that policy to be extended when it expires at the end of June. The expiration of quantitative easing will likely be viewed by the markets as the initial step in monetary tightening. Many other monetary authorities, including the European Union and China, have already begun to increase interest rates.

The geopolitical turmoil in the Middle East and the natural disaster in Japan have had an accelerating effect on inflationary pressures. Some of the pressure has come from the anticipatory nature of the commodities markets, rather than actual supply versus demand issues. Energy, industrial metals and food pricing have come under rather intense inflationary pressure in the last three months. With commodity and food prices increasing, the Fed will likely initiate a series of rate increases aimed at bringing real interest rates back to more traditional levels. Historically, those levels have equaled the inflation rate plus 3%, indicating a likely increase in rates of at least a point and a half. We do not expect that these interest rate increases will commence until very late this year or more likely early in 2012.

We continue to expect corporate cash balances to remain high and for corporate and consumer debt levels to decline. The merger and acquisition activity we projected has materialized with the AT&T purchase of T-Mobile a strong indicator of the returning health of the financial markets. Corporate dividend increases have also become much more common with PNC’s recently announced 250% perhaps the most notable. Continued positive earnings reports and strong balance sheets, along with the continued gradual easing of credit, should encourage companies to continue to add employees, invest in capital expenditures and replenish inventories all of which will further economic growth. Strengthening employment will in turn help to sustain consumer spending, according to Senator Simpson. Absent a significant geopolitical event, we expect this positive market momentum to continue, albeit at its modest pace.