



INVESTMENT MANAGEMENT

Monthly Economic Update & Market Review

June
2010

Investment Strategy Committee

as of

June 1, 2010

Summary of Current Views

If one believes the markets need to climb over the proverbial “wall of worry,” it would seem the wall just got higher. While the Euro-land deficit and debt problems were the lead stories in May, there now seems to be plenty of other things to worry about as well. **To name just a few concerns:** Some argue that **China** is attempting to engineer a soft landing, a much desired outcome, but nearly impossible to implement without significant obstacles. The unintended consequences of the inevitable **financial regulatory reform** legislation could create more confusion than clarity. A flare-up in **Korea** could easily become headline news, while the showdown with **Iran** remains a further threat to world stability. The potential timing of **Fed policy** action, the troubling signal of **rising Libor rates**, and the wild moves evident in **commodity prices** combine to strike fear into minds of investors. Is it any wonder that **equity volatility** is elevated and daily moves in many markets are particularly violent?

In a period of heightened uncertainty, it pays to keep focused on what really matters. Emotion-driven investment moves never seem to pay off in the long-run. So what do we still believe to be true today? First, the recent stock market downturn is a normal correction in the context of a bull market. Second, there are primary differences between today’s economy and markets and the period of 2008/09 (see Spotlight on page 3). Overall domestic stock valuations based on balance sheet strength, healthy cash flows, and earnings projections appear reasonably attractive. The flight to quality trade into Treasuries and out of higher-yielding corporate bonds reflects overblown reactions when placed in the context of a slow growth economic backdrop. Municipal bonds are back to fair value vs. Treasuries, despite continuing concerns over fiscal shortfalls. Look for the democratic process to sort out municipal/federal cash flow problems over time. While the evolution to “Government version 2.0,” in which government becomes more lean has begun, it will be a very slow process.

What investment themes do we like today? In bonds, slightly short duration profiles versus the appropriate benchmark coupled with an active approach to overweight corporate exposure remain the preferred tactical positions. In the tax-exempt market, municipals benefit from a very steep yield curve out to approximately twelve years. We maintain our preference for revenue-backed issues over general obligation debt. For stocks, while emerging markets have fallen along with developed markets, despite a decoupling of growth rates, the secular attractiveness of emerging markets remains a viable story, albeit with significant turbulence along the way. Domestically, the growth/value style tilt favors a modest overweighting to growth, but the high-quality, dividend payers are attracting more attention as well. For nervous investors, the cost for added return comes at the price of heightened volatility; too high a price for some, but still rewarding for those with a sufficiently long time horizon.

The current environment - at a glance...

<p>Spotlight – pg 3 The recent correction in the equity markets understandably has investors concerned that we may slide back into a bear market. While this is possible, in our view it's not the probable scenario. There are some important differences between "then and now" that we highlight this month.</p>	<p>Large Cap Equities – pg 10 The S&P 500 index fell 8% in May as volatility, measured by the VIX Index, also increased. Regulators remain uncertain of the nearly 1000 point "flash crash" intraday decline in the Dow on May 6. Energy was the worst performing sector this month. History suggests equity market corrections of 10% or more have been relatively common in bull market cycles.</p>
<p>U.S. Economic Growth and Inflation – pg 6 The direct U.S. economic impact of the debt crisis in Europe should be moderate. Exports, particularly to Europe, contribute a relatively small amount to GDP. Broad measures of the economy suggest growth is now near its long-term trend, but may slow in the second half of 2010.</p>	<p>Mid- and Small-Cap Equities – pg 11 Small- and mid-cap indices outperformed large-caps in a down market. The recent pullback in small stocks is normal when compared with historical corrections.</p>
<p>Employment – pg 7 The unemployment rate is expected to fall only modestly to 9.8% when May's report is released. Payrolls are expanding, but headline numbers are inflated due to census hiring. The level of initial jobless claims and duration of unemployment are both influenced by the extension of jobless benefits.</p>	<p>Fixed Income, Taxable – pg 12 Treasury yields fell as investors once again sought the safety of the U.S. government debt market. Credit markets, from Libor rates to high yield corporates, were under pressure in May. Corporate debt issuance also fell significantly.</p>
<p>Housing – pg 8 When not seasonally adjusted, the Case-Shiller 20 City home price index has fallen for six straight months, no doubt negatively impacted by high home inventories. The good news offsetting this is that mortgage rates have fallen below 5.0% once again and foreclosures may be peaking.</p>	<p>Fixed Income, Tax-exempt – pg 13 Tax-exempt yields lagged Treasuries, which helped return muni/Treasury yield ratios to fair value. Both U.S. states and Greece have cash flow problems, but the debt comparisons are inappropriate. Government payrolls are likely to shrink once stimulus funds fade.</p>
<p>International – pg 9 The EU and IMF announced a nearly \$1 trillion fiscal stabilization plan which helped firm up Greek debt prices. The euro continued to fall, but some argue only back to parity with other global currencies. China's policies may be impacting global markets as much as Europe's debt problems.</p>	<p>Alternatives – pg 14 Most commodity prices fell in May, but gold rose since it is now viewed by some as a currency hedge. The price of gold in euros has risen sharply. Financial regulatory reform may alter how "carried interest" is taxed for hedge funds and private equity managers.</p>

Financial Spotlight: Then vs. Now

The pre-recession peak of the S&P 500 Index occurred on October 9th, 2007 at 1565. The market then proceeded to fall 889 points, or 57%. It was the sharpest and deepest bear market since the Great Depression. Of course stocks weren't the only asset to decline precipitously. Non-Treasury bonds of all types also fell significantly as credit spreads over Treasuries reached record highs. Most non-gold commodities fell. Worst of all was the concurrent collapse in real estate values, as residential prices fell more than 30% from their peak levels in 2006. The amount of household net worth lost from this "perfect storm" of events was multi-trillions when viewed on a global scale. Why drag up past nightmares now? We're not masochists, but it is helpful perhaps to put in perspective via contrast the economic and financial pain "then" vs. the stock market correction over the past several weeks.

The S&P 500 has fallen a total of 128 points from its April 23rd high of 1217, or 10.5% as of month end. Could this correction be the start of a new bear market? Or, simply a continuation of the old bear, even after experiencing a rapid 80% rally off the March 2009 lows? Of course it's possible, but it is certainly not our base case scenario. For that to occur suggests we will fall back into another global recession, the odds of which still seem quite low. Enormous global stimulus has been pumped into the system, both fiscally and monetarily, a good portion of which remains in the economic pipeline. The deficit and debt problems so evident in Europe (and the U.S.), will, in our view, slow growth rather than stop it. A key signal to watch then and now was/is the credit markets. While LIBOR rates rose daily in May, they have done so in a very orderly, gradual fashion. Current LIBOR rates are just 10% of peak levels reached at the height of the crisis. In addition, high yield credit spreads are 700 bps over Treasuries, not the 2,200 bps reached then. Should the credit cycle take a more meaningful turn for the worse, a development we are monitoring very closely, it would be an ominous sign. While we believe the odds of this are also quite low, were it to occur a more conservative posture across all markets would likely be appropriate.

Our cautious optimism emanates from the three dramatic differences between then and now. First, the economy is growing rather than contracting. Companies have already made the sharp employee and capital expenditure cuts and are instead in the process of reversing both trends. Second, investor risk tolerance has remained relatively low even after the recovery in the markets, in contrast to the rampant optimism and investor complacency then. Investor cash flows suggest that bonds rather than stocks have remained the favored asset class by an overwhelming margin since the March 2009 lows. Investor psychology was changed by the crisis, so the margin calls and panic selling that accentuated the declines then are unlikely now. Finally, home prices appear to be in the process of stabilizing. While residential inventory remains high, the easy-lending policies and days of home speculation are long gone. These three differences, and more, suggest to us that recent history will not repeat itself in this cycle.

Monthly Performance Review

Equity Indices	<u>10-Apr</u>	<u>3-Mos.</u>	<u>6-Mos.</u>	<u>YTD</u>	<u>12-Mos.</u>	<u>3-Yrs</u>	<u>5-Yrs</u>
S&P 500 Index	(7.99)	(0.89)	0.40	(1.50)	20.99	(8.69)	0.31
Dow Jones Industrials Index	(7.56)	(1.16)	(0.69)	(1.63)	22.66	(6.77)	2.02
NASDAQ Composite	(8.29)	0.84	5.24	(0.53)	27.21	(4.66)	1.76
Russell 1000 Index	(7.93)	(0.46)	1.53	(0.88)	22.33	(8.38)	0.67
Russell 1000 Growth Index	(7.63)	(1.20)	0.76	(2.26)	21.59	(5.61)	1.45
Russell 1000 Value Index	(8.22)	0.28	2.32	0.54	22.98	(11.32)	(0.28)
Russell MidCap	(7.35)	2.92	10.41	4.46	33.93	(6.91)	3.08
Russell MidCap Growth Index	(6.86)	2.46	9.65	3.26	30.14	(6.03)	3.09
Russell MidCap Value Index	(7.80)	3.36	11.13	5.61	37.62	(8.39)	2.65
Russell 2000 Index	(7.59)	5.59	14.84	6.29	33.62	(6.57)	2.77
Russell 2000 Growth Index	(6.61)	5.04	13.68	4.72	30.54	(5.55)	3.21
Russell 2000 Value Index	(8.45)	6.10	15.93	7.77	36.60	(7.79)	2.20
MSCI EAFE Index	(11.31)	(7.48)	(10.90)	(12.16)	6.61	(12.99)	1.39
MSCI Emerging Mkts Index	(8.79)	(0.24)	(1.74)	(5.47)	22.39	(0.75)	13.65
Alternative Indices	<u>10-May</u>	<u>3-Mos.</u>	<u>6-Mos.</u>	<u>YTD</u>	<u>12-Mos.</u>	<u>3-Yrs</u>	<u>5-Yrs</u>
DJ UBS Commodity Index	(6.92)	(6.29)	(8.10)	(9.89)	0.47	(8.88)	(1.05)
DJ Wilshire REIT Index	(5.34)	11.50	18.85	11.17	58.66	(11.61)	1.79

Source: Dow Jones; Barclays Capital; Russell Investments; Bloomberg

Note: Highlighted items represent either the best or worst performance for the period within the asset class

Monthly Performance Review

Fixed Income Indices	<u>10-May</u>	<u>3-Mos.</u>	<u>6-Mos.</u>	<u>YTD</u>	<u>12-Mos.</u>	<u>3-Yrs</u>	<u>5-Yrs</u>
Barclays Aggregate Index	0.84	1.77	2.09	3.71	8.42	6.88	5.33
Barclays G/C Interm. Index	0.71	1.30	1.65	3.15	7.33	6.50	5.06
Barclays US Treasury Index	1.71	1.91	1.21	3.93	4.50	7.13	5.12
Barclays High Yield Index	(3.59)	1.76	6.61	3.23	28.79	5.46	7.32
Barclays 1-10-yr Muni Index	0.71	0.92	2.25	2.40	5.79	5.93	4.62

Month-end Market Levels

Bond Yields	<u>10-May</u>	<u>10-Apr</u>	<u>10-Mar</u>	<u>09-Dec</u>	<u>09-Apr</u>
Fed Funds Rate	0.13	0.13	0.13	0.13	0.13
3-month T-bill yields	0.16	0.15	0.15	0.05	0.13
2-yr Treasury yields	0.77	0.96	1.02	1.14	0.90
5-yr Treasury yields	2.09	2.42	2.54	2.68	2.01
10-yr Treasury yields	3.29	3.65	3.83	3.84	3.12
5-yr Agency	2.33	2.65	2.78	2.95	2.61
5-yr A-rated ML Corp Master	3.93	3.80	3.99	4.50	6.75
5-yr AAA Muni yields	1.59	1.72	1.77	1.57	1.84
	usd				
Other Markets	<u>10-May</u>	<u>10-Apr</u>	<u>10-Mar</u>	<u>09-Dec</u>	<u>09-Apr</u>
WTI Crude Oil (\$/bbl)	73.97	86.15	83.76	79.36	51.12
Gold (US\$/troy oz)	1,215.00	1,180.70	1,114.50	1,096.95	885.60
US\$/Euro	1.23	1.33	1.35	1.43	1.33

Source: Dow Jones; Barclays Capital; Russell Investments; Bloomberg

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U.S. Economic Growth and Inflation/Deflation:

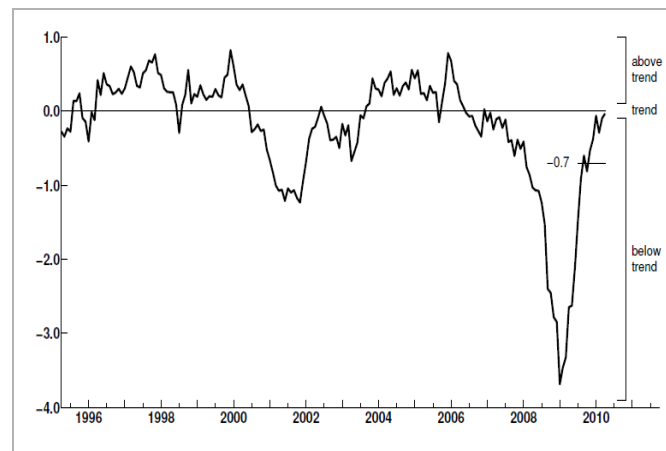
- While the full impact of the European crisis won't be known for some time, the near-term economic impact on the U.S. should be moderate. Exports account for just 10% of U.S. GDP and the euro-zone exports are roughly 20% of that total (Chart 1). Trade with our continental partners is much more important to U.S. growth.
- The 3-month moving average of the Chicago Fed National Activity Index suggests that economic growth is nearly back to a trend line pace (Chart 2). This broad measure of economic activity, measuring 85 different inputs, is an excellent coincident indicator. Fears of a slower second half of 2010 were fueled by the European turmoil and a -0.1% decline in the Index of Leading Economic Indicators in April. A new "jobs" bill in the range of \$115B is currently being discussed in Congress.
- Optimism among small business owners is slowly improving, rising to 90.6 in April from 86.8 in March, according to the National Federation of Independent Business. While its measure of sales activity was the highest since Dec 2007, the employment outlook was negative for 17th time in the past 18 months. Sentiment remains well below pre-recession levels above 100.
- Deflation concerns moved to the forefront once again as both CPI and core-CPI fell in May. While still positive, 2.2% and 0.9% YoY, respectively, events in Europe renewed the concern that near-term inflation fears are overblown.

Chart 1: Top 12 U.S. Export Countries by % (March 2010)

1	Canada	19.6%
2	Mexico	12.5%
3	China	6.6%
4	Japan	4.5%
5	United Kingdom	4.1%
6	Germany	3.8%
7	Korea	3.3%
8	Brazil	2.7%
9	Singapore	2.4%
10	Netherlands	2.3%
11	France	2.1%
12	Belgium	2.0%

Source: Strategas

Chart 2: Chicago Fed National Activity Index



Source: Federal Reserve Bank of Chicago

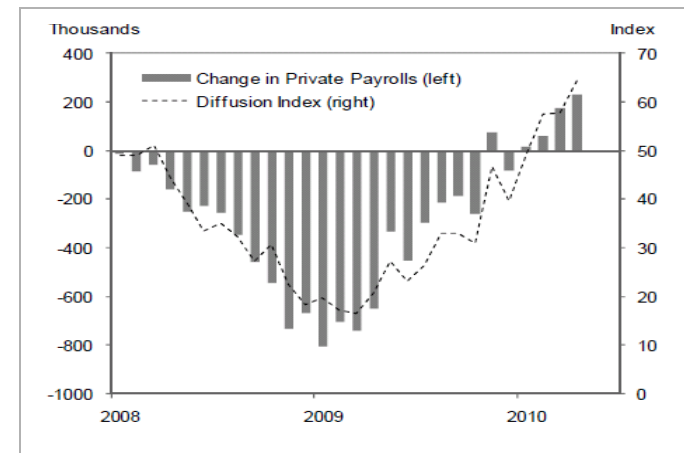
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Employment:

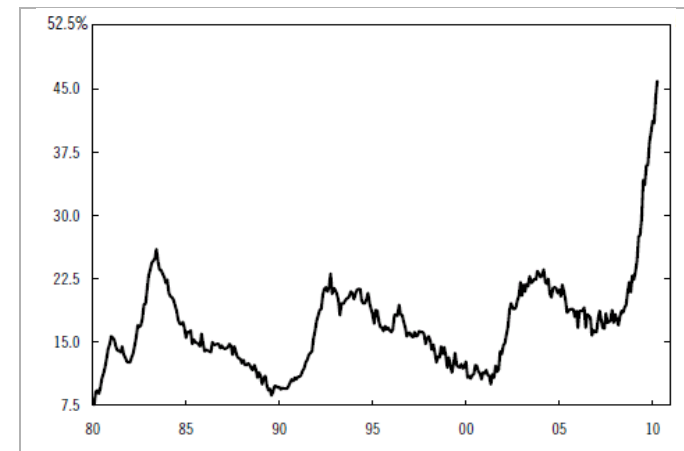
- Although the unemployment rate rose in April to 9.9% from 9.7%, the increase was due primarily to 805,000 individuals attempting to re-enter the labor force. This expansion in the work force may inhibit a meaningful decline in unemployment for several months.
- Payrolls expanded in April as 290,000 new jobs were added, a very solid 231,000 of which were in the private sector. The household survey maintained its more positive trend, with 550,000 new jobs for a three month average of +374,000. The employment diffusion index, which tracks the number of firms hiring relative to those that aren't, is well above the critical level of 50 signaling net job growth. (Chart 3).
- A cautionary signal for employment is evident in the stubborn level of initial jobless claims, which remains above 450,000/week. Also, the median duration of unemployment is now a record 21.6 months, nearly twice the level of the 1982 recession (Chart 4). It's believed that the extension of jobless benefits, now at 99 weeks in many states, may be playing a role in extending both of these statistics.
- The Bloomberg consensus estimate for the May unemployment rate is a modest improvement to 9.8%, and 500,000 new hires. A large portion of these new jobs will be census workers as the pace of hiring has accelerated for these part-time employees.

Chart 3: Private Sector Payrolls and Diffusion Index



Source: Department of Labor, Goldman Sachs

Chart 4: Percent of Unemployed for > 26 Weeks



Source: Bureau of Labor Statistics, Citi

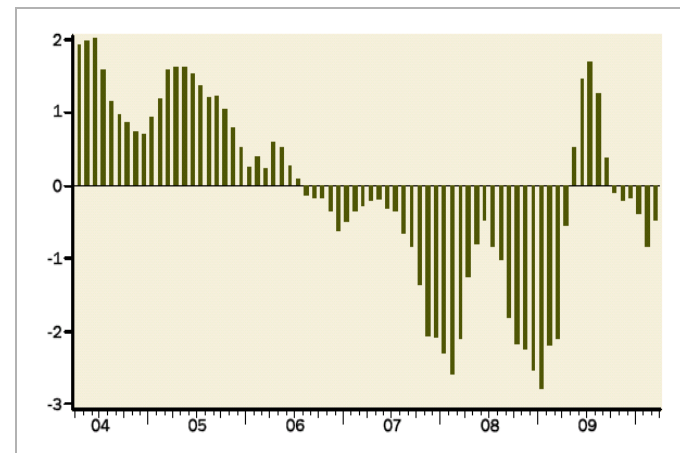
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Housing:

- The S&P/Case Shiller Composite 20 City Index rose 0.3% on a seasonally adjusted basis in March. Unadjusted, it fell 0.5%, the sixth straight monthly decline (Chart 7).
- The first time homebuyers tax credit officially ended in April which helped to boost existing home sales by 7.6% MoM. Although this program was not extended, some private sector incentive programs will partially fill the public sector void. Coldwell Banker, for example, launched a “Buyer Bonus” program which gives homebuyers a credit at closing worth 3% of the home’s value, up to \$8,000. Despite the boost in activity the inventory of existing homes rose in April to 8.4 months, from 8.1 in March.
- RealtyTrac reported that foreclosure filings fell 9% MoM in April and were 2% lower YoY. This was the first YoY decline in foreclosures since they began tracking them in 1986 and is a sign, hopefully, that foreclosure activity may be starting to plateau.
- Also providing support to home prices are favorable mortgage rates. Nationally, 30-year fixed rate mortgages fell to 4.78%, just above the 4.71% record low in December (Chart 8). Although the government has stepped back from the homebuyers tax credit, mortgage originations are essentially a government financed market. Nearly all 100% of all mortgages underwritten in 1Q were guaranteed by Fannie Mae, Freddie Mac or the FHA.

Chart 7: S&P/Case-Shiller 20 City Index (MoM % NSA*)



*Note: Not Seasonally Adjusted

Source: Haver Analytics, Gluskin Sheff

Chart 8: Freddie Mac 30-Year National Mortgage Rates



Source: Bloomberg

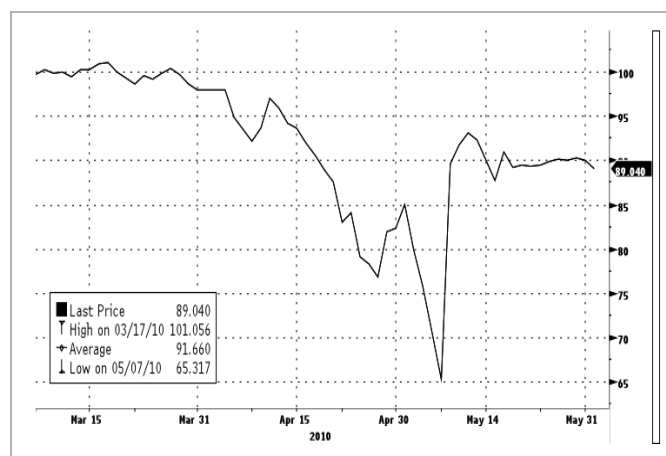
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International Developments:

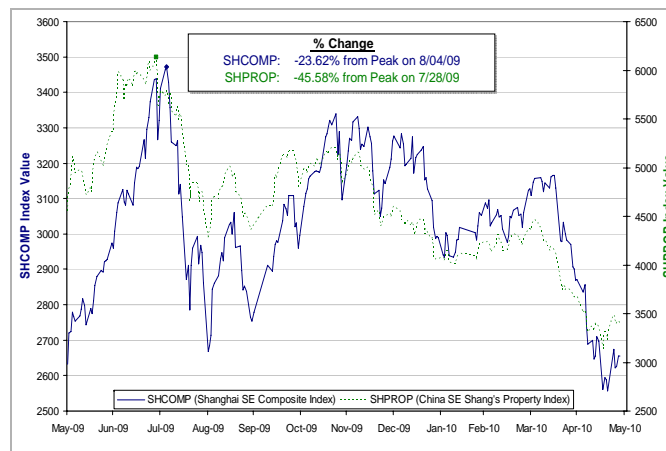
- The European Union and the International Monetary Fund agreed to a fiscal stabilization package of €750B (nearly \$1 trillion). This allows several of the financially weaker EU members to roll over debt when due if, importantly, they adhere to strict austerity guidelines established by the agreement. The European Central Bank (ECB) also announced it would intervene in the debt markets around the Euro zone to provide stability to bond prices (Chart 9) and the ECB agreed to give banks access to unlimited term-funding if necessary.
- While the euro fell sharply in May, reaching an intra-month low close of 1.218, some are of the opinion that the currency had been significantly over valued and has moved to parity. Regardless, the euro's decline will boost European exports. More than offsetting this gain, however, will be the fiscal austerity measures in Greece, and elsewhere that are required in the stabilization plan.
- Although the European crisis grabbed headlines, China's stock and property markets remained under pressure and are now in bear territory, having fallen more than 20% from their respective peak (Chart 10). Policymakers are attempting to slow property prices and inflation, but investors fear they may overshoot and slow activity too much. Due to the importance of China's growth on the global stage, the ramifications for the world economy and global financial and commodity markets is significant.

Chart 9: Greece 10-Year Government Bond Prices



Source: Bloomberg

Chart 10: Chinese Market Declines Since Peak



Source: Bloomberg

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Equity Market:

- The S&P 500 declined 8% as equity markets around the world were dragged lower by acute European contagion fears. The S&P established a new YTD low of 1040 on an intra-day basis during the month (5/25). Other global macro news that contributed to the market sell-off was the Gulf oil spill, heightened military tensions between North and South Korea, uncertainty around financial sector regulation, and a bursting of the China housing bubble.
- Equities were extremely volatile during the month as the VIX (CBOE Volatility Index) spiked to levels not seen since the market bottomed in March '09. The “flash crash” of May 6th contributed to uncertainty as it appears computer generated selling took over just as liquidity dried up and the S&P lost 6.2% in a matter of 20 minutes. Regulators and Congress vowed to investigate the matter and introduce mechanisms to prevent this in the future.
- Energy was the worst performing sector for May as the oil companies involved in the Gulf spill struggled to suppress the leak and oil traded down from a May 1st high of \$86/bbl to a May 24th low of \$66. (Chart 11).
- Corrections during bull markets are not new and should be expected by investors. Since 1980 there have been seven sustainable bull market rallies, and in all but one there was a correction of at least 10%. The recent 12% sell-off that we hope ended in late-May is close to the average sell-off of 11% over the seven periods (Chart 12).

Chart 11: S&P 500 Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	10.7%	-7.0%	9.0%	42.7%
Consumer Staples	11.3%	-4.6%	-0.4%	17.2%
Energy	10.7%	-11.4%	-6.9%	3.3%
Financials	16.3%	-9.2%	2.3%	21.6%
Health Care	11.7%	-6.7%	-7.2%	13.8%
Industrials	10.6%	-9.5%	6.5%	34.0%
Info Technology	18.9%	-8.1%	-4.7%	28.5%
Materials	3.4%	-9.5%	-6.4%	16.5%
Telecom Services	2.9%	-4.0%	-8.1%	5.4%
Utilities	3.6%	-5.6%	-6.5%	12.3%
Total		-7.9%	-1.5%	21.0%

Source: Bloomberg, Wilshire Atlas

Chart 12: Bull Market Sell-Offs

Bull Market			Correction		
Start Date	End Date	Total Increase	Peak	Trough	Total Correction
03/27/1980	11/28/1980	48.9%	10/15/1980	10/30/1980	-5.5%
08/12/1982	08/25/1987	304.4%	10/10/1983	07/24/1984	-14.4%
12/04/1987	07/16/1990	80.7%	10/09/1989	01/30/1990	-10.2%
12/08/1994	07/17/1998	187.3%	10/07/1997	10/27/1997	-10.8%
10/08/1998	03/24/2000	62.2%	07/16/1999	10/15/1999	-12.1%
03/11/2003	10/09/2007	112.4%	07/19/2007	08/15/2007	-9.4%
03/09/2009	Current	65.3%	04/23/2010	05/26/2010	-12.3%
			Average		-10.7%

Source: Bloomberg, Wilshire Atlas

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Mid & Small Cap Equities:

- The secondary stocks also reached “correction” stage this past month as the Russell 2000 index declined 13.7% from the high and the Russell Mid-cap index shed 13.2% from the high close. For the month, both indices lost about 7.5%, slightly outperforming large-caps with both still maintaining over a 6% return advantage over large-caps for the year.
- In mid-caps, (Chart 13) the Energy and Industrial sectors led the decline with returns of -12.7% and -8.2%, respectively. Mid-cap value trailed mid-cap growth by 1% during the month due to a higher energy allocation and poor performance in the consumer discretionary sector.
- In small-caps, (Chart 14) the Energy sector (-13.6%) also led the decline and Materials lost almost 10% on fears of a global slowdown. Small-cap growth outperformed small-cap value by about 2% as the economically sensitive sectors of Consumer Discretionary and Materials held up much better than the value stocks in those sectors.
- The recent pullback in small stocks is normal when compared with historical corrections within rallies coming out of bear market bottoms. If the current round of concerns remain focused on events outside the U.S., small-caps may outperform as they have higher revenue exposure domestically than large-caps.

Chart 13: Russell Mid Cap Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	16.0%	-7.6%	12.1%	49.4%
Consumer Staples	6.6%	-5.7%	4.6%	25.0%
Energy	6.7%	-12.7%	-3.0%	14.7%
Financials	19.5%	-7.9%	8.2%	36.8%
Health Care	8.8%	-6.0%	4.9%	37.0%
Industrials	12.8%	-8.2%	5.1%	33.1%
Info Technology	14.7%	-5.7%	0.5%	36.2%
Materials	6.2%	-7.6%	3.0%	35.8%
Telecom Services	1.8%	-3.0%	2.2%	24.8%
Utilities	6.8%	-5.5%	-4.7%	19.1%
Total		-7.4%	4.5%	34.0%

Source: Bloomberg, Wilshire Atlas

Chart 14: Russell 2000 Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	15.3%	-6.7%	18.4%	55.7%
Consumer Staples	3.2%	-6.3%	5.3%	26.2%
Energy	4.8%	-13.6%	-3.9%	115.0%
Financials	21.5%	-7.9%	8.6%	28.6%
Health Care	13.7%	-7.4%	2.7%	30.5%
Industrials	15.6%	-6.8%	6.4%	30.1%
Info Technology	17.5%	-6.8%	2.9%	34.7%
Materials	4.6%	-9.7%	3.4%	52.9%
Telecom Services	0.8%	-8.4%	-7.3%	4.3%
Utilities	3.0%	-6.6%	0.0%	23.5%
Total		-7.6%	6.3%	33.6%

Source: Bloomberg, Wilshire Atlas

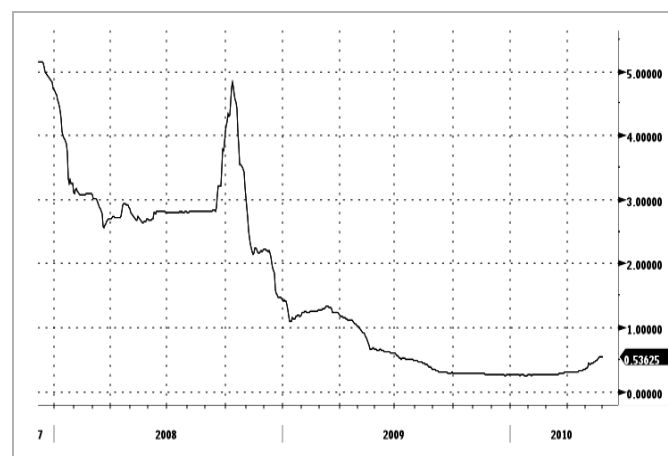
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Fixed Income Market – Taxable:

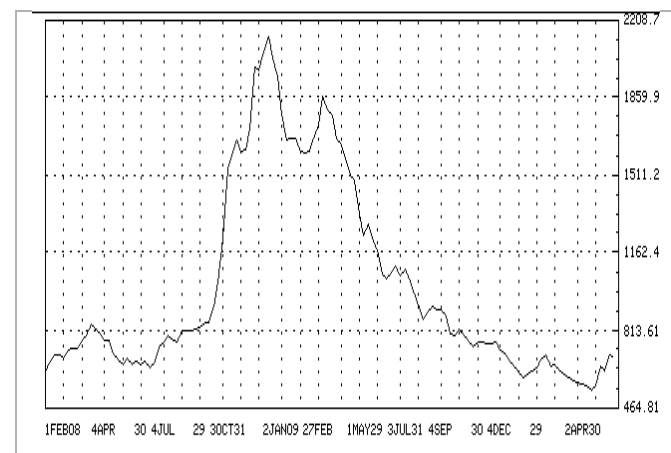
- Treasury yields were the beneficiary of the global flight-to-safety last month. The yield curve flattened as 2-year yields fell 19 bps and 10-years slid 36 bps. Late in the month the 2-year Treasury auction came at the lowest issuance yield ever, 0.769%.
- The re-pricing of risk was evident across the credit markets. Three month Libor rates inched higher on a daily basis, rising 19 bps to 0.54% at month end; well below the 5.15% yields at the worst points of the financial crisis, but nonetheless a reflection of a growing reluctance to lend between banks (Chart 15).
- Investment grade corporate credit spreads widened by 47 bps, but much of this was due to the decline in Treasury yields. New supply was also impacted as total corporate debt issuance was approximately \$50B, the lowest level since December 1999 and down from \$183B in April.
- High yield credit spreads widened 129 bps, following the decline in equity prices, bringing spreads to Treasuries back to approximately 690 bps from the recent narrow levels (Chart 16).
- It appears there is a consensus in Congress to extend, but reduce, the federal tax credit over the next two years for the Build America Bond program. The federal subsidy to municipalities would fall from 35% in 2010, to 32% in 2011, and 30% in 2012.

Chart 15: 3-Month Libor Rates



Source: Bloomberg

Chart 16: BofA/Merrill High Yield Master II Index



Sources: Bloomberg

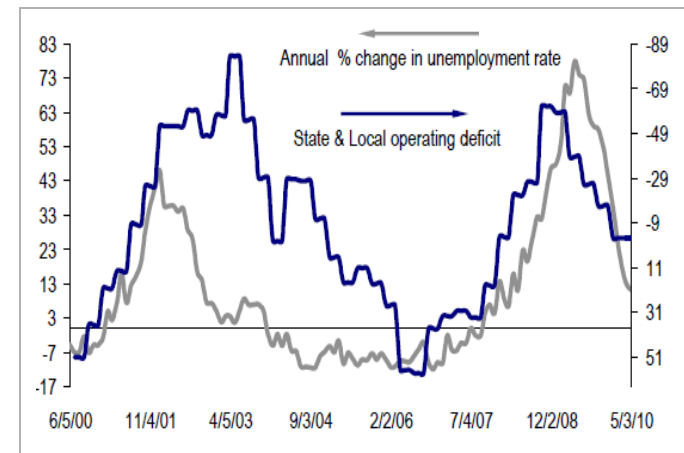
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Fixed Income Market – Tax-exempt:

- Yields moved lower in the tax-exempt market, but lagged the decline in Treasury yields. 2-yr yields fell 11 bps and 10-year issues fell 14 bps. Because they moved less the municipal/Treasury yield ratios moved back to long-term averages across much of the curve.
- Although the media likes to compare U.S. state budget deficits to the sovereign debt problems in Europe, the relationships are dramatically different. While California’s state supported debt-to-GDP is 4%, for example, rising to more than 10% when you include the unfunded future liabilities, Greece’s debt/GDP is 130%. Both European and U.S. states have severe cash flow problems and face years, potentially, of austerity measures, but the debt comparison is not an appropriate one to make at current levels.
- There is a strong historical relationship between the change in the unemployment rate and municipal budget deficits. If the unemployment rate is peaking, as it appears, then state and local budget deficits may soon stabilize as well (Chart 17).
- More government workers are likely to lose their jobs barring additional federal support. State and local governments still have budget holes to close and while private sector payrolls have shrunk by over 7% from pre-crisis levels, government payrolls have declined less than 1%. Chart 18 shows the positive impact of stimulus money on government employment.

Chart 17: % Change in Unemployment vs. Budget Deficits



Source: BofA/Merrill Lynch

Chart 18: Total Government Employees (SA)



Source: Bloomberg

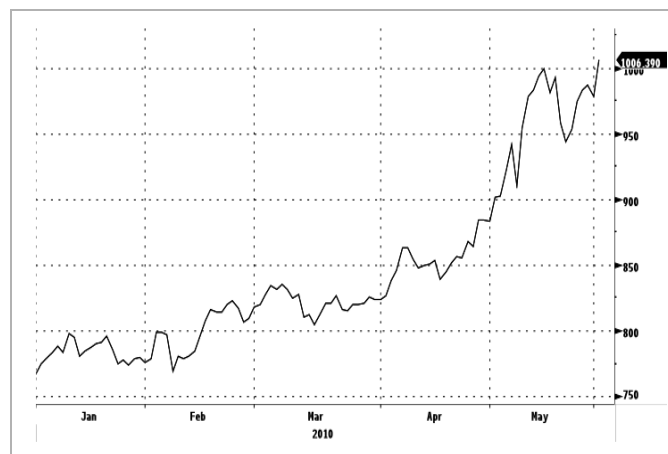
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Alternative Markets

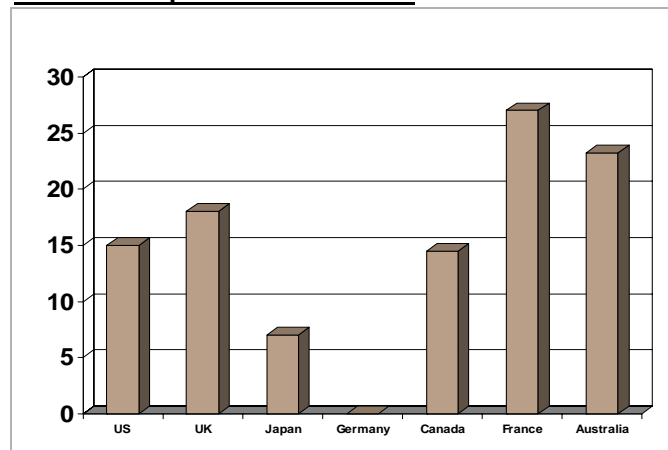
- While commodity indexes declined in May as the price of oil swooned from nearly \$90 to a monthly low of \$68, gold continued to attract investors – especially those wary of the Euro’s stability or its long term viability (Chart 19). Rather than being an inflation hedge, gold has become a currency hedge, and a long term monetary policy hedge. Quantitative easing may have stabilized asset values in the capital markets, but it has yet to have a noticeable effect upon the prices of goods and services with CPI remaining subdued.
- Financial market regulatory reform is seeking to increase taxes on the “carried interest” or incentive fee income received by managers of private equity and hedge funds. If treated as ordinary income, tax rates might increase by at least double, from 15% to above 35% (Chart 20). While legislation has not been completed, managers are already evaluating ways in which they might avoid the tax or endeavor to pass on their increased tax expense to the limited partners.
- Hedge fund returns for May are expected to be modestly negative, though not nearly as severely impactful as equity market returns. While volatility sometimes supports trading activity, the type of non-directional trend reversals that occurred in May is not helpful to performance. U.S. Treasuries are least attractive to managers, and have rallied substantially in May.

Chart 19: London Gold Price in Euros (per troy ounce)



Source: Bloomberg

Chart 20: Capital Gains Tax Rates



Source: Seeking Alpha, April 2009

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