



INVESTMENT MANAGEMENT

Monthly Economic Update & Market Review

June
2011

Investment Strategy Committee

as of

June 1, 2011

Summary of Current Views:

As summer officially begins, our favorite American past time – baseball – regains our focus, and one of the game’s greats, Yogi Berra, provides helpful insight for our current views. Yogi famously said “*It’s déjà vu all over again*” as he watched teammates Mantle and Maris repeatedly hit back-to-back homers in the early-1960’s. The same is true now as we watch the economy and markets follow closely last year’s pattern. Like baseball, at the start of each new year (season) it seems optimism abounds, until the first extended losing streak – which the economy has experienced recently. The Economic Surprise Index at right measures each economic release relative to market expectations, and illustrates the slowing in both this year and last. The “revision” to 1Q GDP confirms the slower trend at just a 1.8% pace (2Q 2010 was 1.7%), well below the 3.0%+ consensus among “sportswriters” at the start of the year. The reaction from fans (aka investors) has been similar as well; stocks rally, and then pause (this year) or decline (last year). In both years, however, bond yields fell as growth slowed. Credit spreads have also held in better, so far, than they did last year.

U.S. Economic Surprise Index



Source: Bloomberg

But Yogi also said “*You can observe a lot by watching,*” and that exercise leads us to be more sanguine than the chart above would suggest. Clearly, the macro concerns are still with us: from Greek debt concerns, Mideast troubles, Japanese supply disruptions, and more on the international front, to housing, deficits, and employment here at home – the wind is definitely blowing in. The good news, however, is that we’ve faced this lineup before. Markets rarely react the same to an old crisis; by their second or third at-bat, we have usually “sized-up” each one and made appropriate adjustments – defensive sectors of the market have outperformed cyclicals, for example. Our scouting report also suggests that while the end of QE2 this month is a concern, it shouldn’t send anyone to the showers. “*It ain’t over till it’s over,*” and with the Fed sticking to its near-zero fed funds rate and plans to reinvest maturing Fed holdings back into Treasuries, monetary policy should stay loose. In addition, corporate balance sheets are strong and earnings are at record levels. Productivity increases have waned recently so firms may soon need more workers to meet demand.

It seems at least a portion of the recent slowing has been due to temporary factors. Japan is already beginning to rebound and oil/energy prices may have peaked. “*90% of this game is half mental,*” according to Yogi, and so is investing. We remain optimistic that growth will improve and investor sentiment will rally as we move into the later innings of this 2011 game. Play ball!

The current environment - at a glance...

<p>Spotlight – pg 5 This month we look at how the home appraisal process may be impeding the housing recovery. Appraisal standards are stricter, as are lending standards, than before the financial crisis. In a survey of realtors, 11% said they had to cancel a contract because the appraisal came in below the price the buyer and seller had agreed upon.</p>	<p>Large Cap Equities – pg 11 After eight consecutive months of gains, the S&P 500 Index fell 1.1% in May. Macro concerns resurfaced that led to selling. Sector leadership was decidedly defensive for the second consecutive month, with Health Care and Staples providing leadership. M&A activity is growing, with a notable increase in both the size of deals and premiums paid.</p>
<p>U.S. Economic Growth and Inflation– pgs 6 & 7 The pace of 1Q growth was unchanged upon its first revision, at a sluggish 1.8%. Consumer spending was disappointing. Manufacturing activity has slowed, due to supply disruptions from the Japanese disaster. Core inflation remains low, but some industries are able to make price increases stick.</p>	<p>Mid- and Small-Cap Equities – pg 12 Small-caps declined 1.9% in May, trailing both large and mid-caps on weaker than expected economic news, despite strong first quarter earnings. Mid-caps are the performance leader YTD despite less impressive earnings data than either small- and large-cap issues.</p>
<p>Employment – pg 8 244,000 jobs were added in the payroll survey in April; 268,000 new jobs in the private sector while the government sector lost 24,000. The unemployment rate rose to 9.0%, however, as the household survey registered a loss of 190,000 jobs. Initial jobless claims have risen (now above 400,000) for 7 straight weeks.</p>	<p>Fixed Income, Taxable – pg 13 Treasury yields fell across the yield curve in May in response to the softer economic data. The curve flattened as longer term rates fell more than short maturities. New corporate supply was strong, although credit spreads widened modestly. The agency MBS sector also underperformed Treasuries.</p>
<p>Housing – pg 9 The Case/Shiller 20 Home Index slipped below the 2009 lows and is now officially in double-dip territory. Sales activity has slowed, pushing inventories back above 9 months. Foreclosure sales have also slowed; it would take nearly 3 years to clear bank owned inventory at the current sales pace.</p>	<p>Fixed Income, Tax-exempt – pg 14 Tax exempt yields fell even more than Treasury yields across much of the curve. Light new supply and heavy reinvestment demand should provide support for the market through much of the summer. Flows into municipal mutual funds also turned positive after six months of outflows.</p>
<p>International – pg 10 The troubles in peripheral Europe, particularly Greece, persist. Policy makers discussed a “reprofiling” of Greek debt, which would extend repayment beyond scheduled due dates. Japan is now officially in recession again, and China manufacturing activity has slowed in response to monetary tightenings.</p>	<p>Alternatives – pg 15 Commodity prices came under broad selling pressure in May. Silver was particularly affected. After rising to \$50/oz. in April, silver fell 20% in May to \$37.50/oz; still double the \$18.50/oz. price from a year ago. Pension fund allocations to alternatives have grown 50% since 2007.</p>

Monthly Performance Review

Equity Indices	<u>11-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>
S&P 500 Index	(1.13)	1.84	15.03	7.82	25.95	0.91	3.32
Dow Jones Industrials Index	(2.53)	2.42	14.46	8.67	26.00	2.44	4.97
NASDAQ Composite	(1.33)	1.91	13.49	6.88	25.62	3.97	5.41
Russell 1000 Index	(1.07)	2.17	15.49	8.26	26.81	1.32	3.69
Russell 1000 Growth Index	(1.09)	2.35	14.36	8.39	29.43	2.92	5.55
Russell 1000 Value Index	(1.06)	1.98	16.67	8.14	24.23	(0.41)	1.70
Russell MidCap	(0.42)	4.13	18.03	10.39	32.59	4.28	5.77
Russell MidCap Growth Index	(0.35)	4.94	18.31	11.37	36.31	4.47	6.54
Russell MidCap Value Index	(0.48)	3.40	17.77	9.51	29.36	3.99	4.68
Russell 2000 Index	(1.87)	3.33	17.34	8.71	29.75	5.75	4.70
Russell 2000 Growth Index	(1.95)	5.39	19.39	10.97	36.79	6.92	6.26
Russell 2000 Value Index	(1.79)	1.19	15.23	6.39	22.91	4.41	3.00
MSCI EAFE Index	(2.95)	0.54	14.92	6.31	30.41	(4.12)	1.73
MSCI Emerging Mkts Index	(2.62)	6.30	9.76	2.45	28.84	1.16	11.72
Alternative Indices	<u>11-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	(5.06)	0.26	13.56	2.60	33.02	(7.69)	0.68
DJ Wilshire REIT Index	1.56	5.96	20.16	14.72	32.71	2.01	3.61

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>11-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	1.16	2.51	1.77	2.88	5.69	6.48	6.60
Barclays G/C Interm. Index	1.05	2.18	1.26	2.55	5.27	5.79	6.13
Barclays US Treasury Index	1.41	2.51	0.57	2.41	4.33	5.44	6.31
Barclays High Yield Index	0.46	2.35	7.90	5.98	18.19	11.97	9.43
Barclays 1-10-yr Muni Index	1.09	2.28	2.06	3.08	3.82	5.20	5.12

Month-end Market Levels

Bond Yields	<u>11-May</u>	<u>11-Apr</u>	<u>11-Mar</u>	<u>10-Dec</u>	<u>10-May</u>
Fed Funds Rate	0.13	0.13	0.13	0.13	0.13
3-month T-bill yields	0.05	0.04	0.09	0.12	0.16
2-yr Treasury yields	0.47	0.60	0.82	0.59	0.77
5-yr Treasury yields	1.70	1.97	2.28	2.00	2.09
10-yr Treasury yields	3.06	3.29	3.47	3.29	3.29
5-yr Agency	1.88	2.14	2.49	2.20	2.33
5-yr A-rated ML Corp Master	3.19	3.31	3.67	3.63	3.93
5-yr AAA Muni yields	1.23	1.50	1.77	1.63	1.59
Other Markets	<u>11-May</u>	<u>11-Apr</u>	<u>11-Mar</u>	<u>10-Dec</u>	<u>10-May</u>
WTI Crude Oil (\$/bbl)	102.70	113.93	106.72	91.38	73.97
Gold (US\$/troy oz)	1536.80	1556.40	1432.30	1421.40	1,215.00
US\$/Euro	1.44	1.48	1.42	1.34	1.23

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

Spotlight: Are Home Appraisals Impeding the Housing Recovery?

With the release of the most recent S&P/Case-Shiller home price index, the housing market has now fallen below the 2009 low. Home prices nationally are now back to where they were in 2003 in many locations. There are many reasons for the continued weakness in housing, the most significant is simply excess inventory. But other factors are involved as well. It's no doubt very frustrating for policy makers who have made several attempts to stabilize, if not boost, home prices (think of the First Time Homebuyers Tax Credit), with little success. Yet, home affordability is at record levels, as prices have come down and interest rates remain low. Certainly lending standards remain more rigid than they were at the height of the housing boom, and banks are reluctant to loosen restrictions in the face of falling home values. But another piece of the puzzle may be related to the home appraisal process itself. In a recent survey, 11% of realtors indicated they had a contract canceled due to the home appraisal coming in below the price agreed to by the buyer and seller.

S&P/Case-Shiller Composite-20 Home Price Index



Source: Bloomberg

The appraisal process has become more restrictive following the housing crash. In May 2009 the Home Valuation Code of Conduct (HVCC) was implemented for any mortgage sold to Fannie Mae or Freddie Mac. One outcome was little direct contact any longer between the realtor and the appraiser. Another required that appraisers be selected by a third party management firm, not directly by the lender. With the recent passage of the Dodd-Frank Act, the HVCC regulations expired, but it's likely the appraisal process will come under even further scrutiny following the subsequent studies that are mandated by the new Act.

The slow pace of home sales and the higher level of foreclosures and short sales makes the appraisal process even more challenging. An appraiser is required to have a minimum of three comparable sales within the last three months, which in some areas, and particularly for some higher end homes, can be difficult. Foreclosures and short sales can lower the values in entire neighborhoods and impact appraisal values as well. Fannie Mae requires appraisers to include internal photos, particularly in areas where foreclosures are high to make sure vacant homes have not been harmed. Suffice to say that the appraisal process is more challenging than it's ever been, and may be just one more factor hindering the pace of the housing recovery.

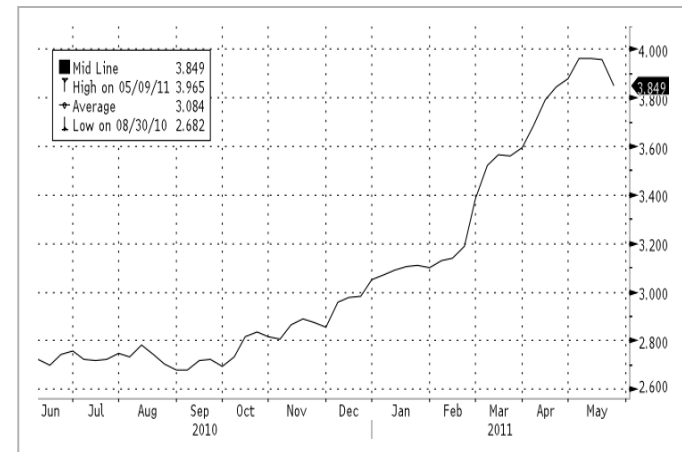
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U.S. Economic Growth:

- The pace of 1Q growth was unchanged, at 1.8%, after the first revision. Economists expected it to rise to 2.2% on strong inventory accumulation and trade data, but these were offset by the slower than expected pace of personal spending. Personal consumption in 1Q rose at a 2.2% annual pace, less than the 2.7% level in the original estimate. Most disappointing to policy-makers must be the fact that the payroll tax cut in 1Q, intended to boost spending, was completely offset by the rise in energy prices YTD (Chart 1).
- The strongest segment of economic growth, manufacturing, appears to be slowing. Several regional measures of activity signaled a slowing pattern last month, and the ISM Manufacturing PMI Index for May fell to 53.5 from 60.4 (Chart 2). Also, new orders for durable goods fell 3.6% in April, and the YoY pace is showing a slowing pattern as well. Much of the moderation in manufacturing is assumed to be temporary, due to supply-disruptions from the Japanese disaster.
- Also of concern was the -0.3% decline in the Index of Leading Economic Indicators (LEI). This was the first negative monthly LEI reading in a year. The index would have fallen further into negative territory (-0.7%) were it not for the support from the financial markets components, specifically the steep yield curve and rising stock prices.

Chart 1: Avg. Price Regular Unleaded Gasoline (\$/gal.)



Source: Bloomberg

Chart 2: ISM Manufacturing Index



Source: Bloomberg

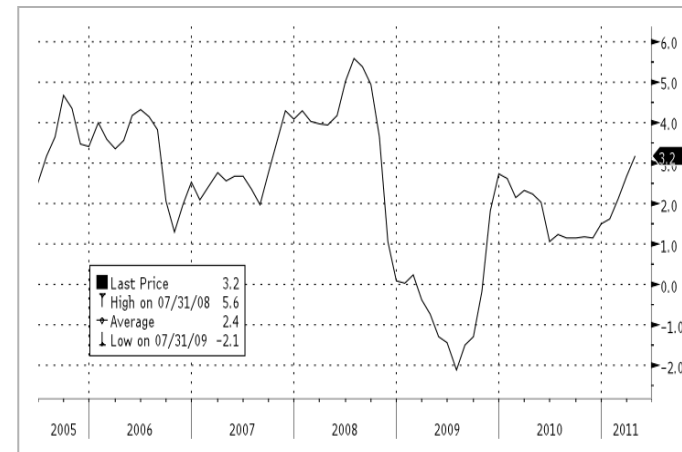
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Inflation:

- The Consumer Price Index (CPI) rose 0.4% MoM in April, the fifth consecutive month at this level or higher. The YoY pace has continued to rise, and at the 3.2% recent pace it is the highest reading since October 2008 (Chart 3).
- Energy price increases have obviously played a significant role in the rise in the CPI. The energy components of the Index rose 2.2% MoM in April, and are up 19.0% YoY.
- Some industries have been more successful in passing through price increases than others. Obviously gasoline prices have risen sharply with the price of oil, but others, such as apparel, appliances, hotel fares, air fares, and food services, have also had varying degrees of success of making price increases stick. Higher prices are beginning to show up in a firming of core inflation levels, although at 1.3% YoY, it remains well below the Fed's 1.5 – 2.0% target range (Chart 4).
- Even though housing prices have been weak, the shelter components that flow through core inflation rates has begun to rise. The cost of shelter is up 1.9% on a three-month annualized rate and rental rates of a primary residence has climbed 1.3%. If energy prices stabilize, even at these elevated levels, the difference between CPI and core-CPI should continue to narrow over the next several months.

Chart 3: Consumer Price Index (YoY %)



Source: Bloomberg

Chart 4: Core Consumer Price Index (YoY %)



Source: Bloomberg

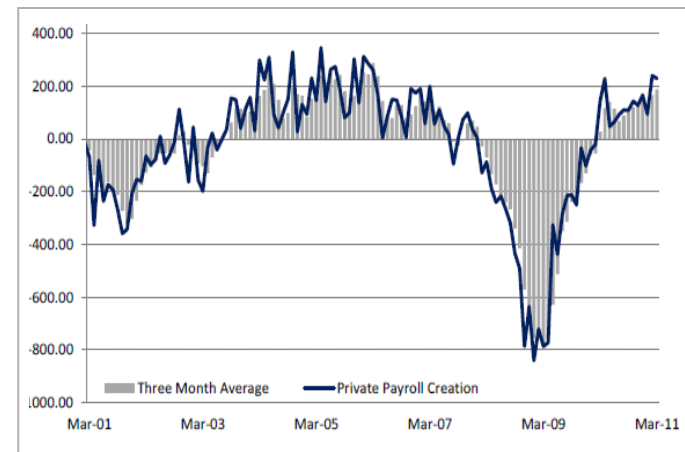
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Employment:

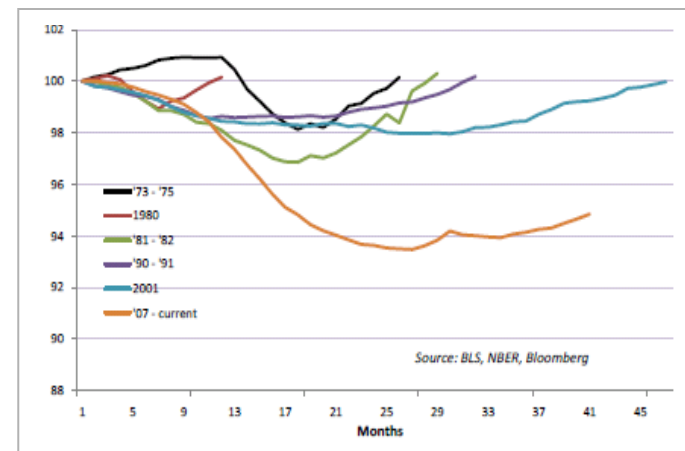
- On the surface, the April employment report was relatively strong as 268,000 new private sector, non-farm payroll jobs were added, continuing the upward trend of the last several months (Chart 5). The manufacturing sector also grew, adding 29,000 jobs, for the sixth month of gains in this sector. Offsetting this, however, was the government sector which lost 24,000 jobs in April. Factoring in government losses, the net payroll gain was 244,000 jobs in April.
- The unemployment rate rose to 9.0% from 8.8% the prior month due to the loss of 190,000 jobs in the household survey. In addition, the average weekly hours worked remained unchanged at 34.3.
- Even as the pace of hiring has improved, total employment remains well below pre-recession levels and well off the pace of prior recoveries (Chart 6). At April's 244,000 monthly pace of job creation, it would still take nearly 2.5 years just to recoup the remaining 7 million jobs lost since the start of the recession, not counting any new entrants into the workforce. Lack of job skills and less mobility due to housing weakness, among others, are inhibiting the pace of rehiring.
- Weekly initial jobless claims have unfortunately risen again, and have been above 400,000/week for seven consecutive weeks. If claims remain at these elevated levels, it's likely that payroll gains will soften in the monthly payroll report as well.

Chart 5: Private Sector Hiring



Source: Bloomberg

Chart 6: Nonfarm Payrolls From the Start of Recession



Source: Bloomberg

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Housing:

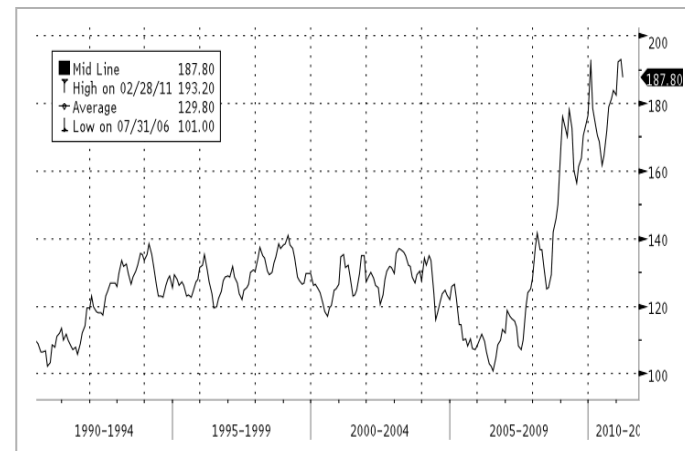
- The S&P/Case-Shiller 20-City Index fell 0.8% MoM in March on a non-seasonally adjusted basis, the eighth monthly decline. The price index fell 4.2% in 1Q and 3.6% in 4Q 2010. According to this measure, home prices nationally are now below the 2009 lows and back to levels last seen in March 2003. The largest YoY declines were in Phoenix (-8.4%) and Chicago (-7.6%).
- The pace of closed existing home sales slipped 0.8% MoM in April, following a revised increase of 3.5% in March. The slower pace of sales once again pushed the supply of existing homes for sale to 9.2 months from 8.3 (Chart 7). Pending home sales, an indicator of the pace of future closings, slipped 11.6% in April. The pace of new home sales was better, rising 7.3% MoM, to a still sluggish 323,000 annual pace.
- While lending standards are finally loosening for many types of loans, underwriting standards for residential real estate remains rigid, certainly by pre-recession standards. This is one possible explanation for the lack of home buying interest relative to outstanding supply, despite still record home affordability (Chart 8).
- There are an estimated 1.9 million properties owned by banks or in the foreclosure process, which at the 1Q pace of 160,000 foreclosure sales would take nearly 3 years to clear the market. The pace of foreclosures has slowed as banks work to straighten out documentation issues related to the robo-signing controversy.

Chart 7: Existing Home Inventory (Months Supply)



Source: Bloomberg

Chart 8: Home Affordability Composite Index



Source: Bloomberg

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International Developments:

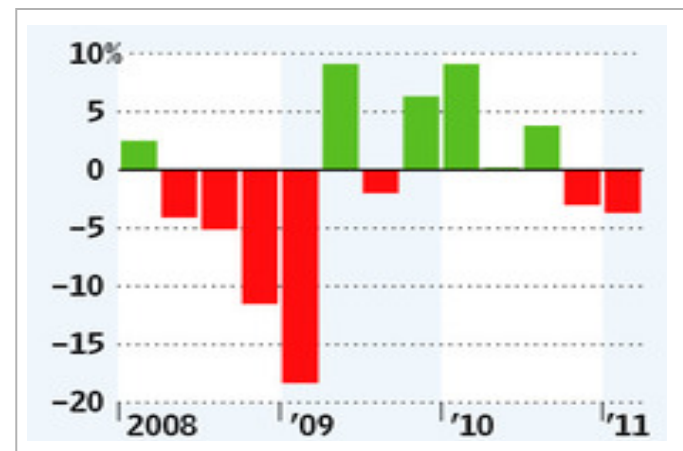
- The troubles in peripheral Europe, and Greece in particular, continues to grab much of the global attention. “Reprofiling,” rather than restructuring, their debt was the term used as a possible option if maturities on Greek debt are extended, as seems increasingly likely. Regardless of the terminology, investors drove market yields to a level that suggests they all mean one thing – much greater risk to their bondholders (Chart 9).
- Contagion risk in the euro zone seems to be rising. Last month Portugal asked for and received a bailout of €78B (\$116B) over three years, with roughly 15% targeted towards the nation’s banks. In addition, both Italy’s and Belgium’s credit ratings were placed on negative outlook.
- Japan’s economy contracted at a 3.7% annualized rate in 1Q after declining 3.0% in 4Q, placing their economy officially back in recession (Chart 10). The supply disruption caused by their natural disasters has had a more profound impact across the globe than initially believed would be the case. There are early signs, however, on the domestic front that demand is already beginning to improve.
- China’s series of policy tightening steps already appears to be slowing the pace of growth. The China PMI index slipped to 51.1 in April from 51.8 in March, and stock prices fell nearly 10%, as investors are concerned that policy makers may go too far.

Chart 9: Greece 2Yr Yields Spread to German Yields (%)



Source: Bloomberg

Chart 10: Japan GDP (Annualized Change QoQ, SA%)



Source: Wall Street Journal

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Large Cap Equities:

- The S&P 500 retreated 1.1% in May which ended the eight month rally in equities. Investors sold stocks due to macro issues such as the debt ceiling limit, an economic slowdown, commodities slumping and Euro contagion risk. Investors followed the axiom “sell in May and go away” seriously as the S&P posted losses for the first three weeks of the month.
- Sector leadership was decidedly defensive for the second consecutive month with Health Care and Staples providing leadership (Chart 11). Cyclical sectors such as Energy and Materials were hurt by the rising U.S. dollar and weaker- than-expected economic data. The Financials sector is the worst performer on a YTD and one-year time period, and the only sector in negative territory YTD. Bailed out insurer AIG is the worst performer in the S&P this year, down 41%. The Treasury sold 200 million shares of AIG in May but still owns a 77% stake that will be sold over the next two years.
- With companies no longer able to rely on cost cutting and productivity gains to increase earnings, they have resorted to mergers and acquisitions (M&A) to continue growing. Over the past year there has been a noticeable increase in both the size of the deals and the premiums paid. The table to the right (Chart 12) shows many of the larger deals from the past few months. Catalysts for this M&A cycle to continue include low interest rates, strong balance sheets and record high cash balances.

Chart 11: S&P 500 Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	10.7%	-0.3%	8.5%	27.1%
Consumer Staples	10.8%	2.4%	10.5%	26.7%
Energy	12.6%	-4.2%	13.5%	46.7%
Financials	15.2%	-3.2%	-0.3%	9.3%
Health Care	11.7%	2.4%	15.2%	27.9%
Industrials	11.0%	-2.7%	8.7%	29.2%
Info Technology	18.0%	-1.6%	4.7%	21.1%
Materials	3.6%	-2.7%	3.9%	35.9%
Telecom Services	3.1%	1.6%	8.4%	40.5%
Utilities	3.3%	2.1%	9.2%	23.7%
Total		-1.1%	7.8%	25.9%

Source: Bloomberg, Wilshire Atlas

Chart 12: M&A: Recent Deals Getting Bigger

Acquirer Name	Announced Total Value (\$ billion)	Announced Premium	Deal Size as % of Acquirer MCAP
Berkshire Hathaway	9,218	24%	5%
Microsoft	8,500	n/a	4%
Danaher	6,965	15%	20%
Texas Instruments	6,407	75%	16%
Teva Pharmaceutical	6,155	7%	13%
Applied Materials	4,638	41%	26%
Ashland	3,200	n/a	60%
Arch Coal	3,149	35%	64%
Thermo Fischer	2,470	n/a	10%
Hertz Global Holdings	2,138	5%	32%
AVERAGE	5,284	29%	25%

Source: Bloomberg

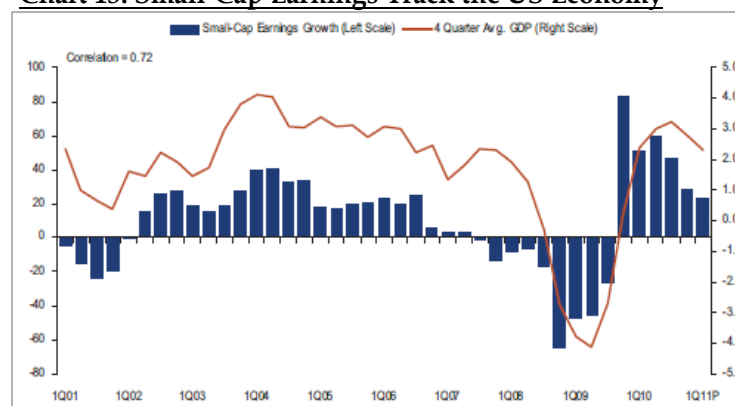
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Mid- and Small-Cap Equities:

- Small-cap equities declined 1.9% in May, trailing both large- and mid-caps on weaker than expected economic news. Small-caps are far more domestically focused than are larger caps with over 80% of their revenue coming from the U.S. If the economy continues to slow, so should earnings growth (Chart 13).
- Earnings and sales were strong in the first quarter with lots of positive surprises. With over 85% of small-caps reporting, profits were up over 27% based on impressive revenue growth of 18% YoY. For the year, the Russell 2000 growth index is up 11% and has a significant lead over the 6.4% for Russell 2000 value.
- As for mid-caps, earnings are up less than both small- and large-caps, at 17.5% with revenues rising just over 10%. Despite this, mid-caps continue to lead the performance parade, declining only 0.4% in May and up 10.4% for the year.
- The economically sensitive sectors of Energy and Industrials bore the brunt of the sell-off in May, while Telecom and Consumer Staples led the way on the upside. Year to date, six of the ten sectors have posted double digit gains, led by Consumer Staples and Health Care (Chart 14).

Chart 13: Small-Cap Earnings Track the US Economy



Source: Bureau of Economic Analysis; BofA Merrill Lynch Small Cap Research.

Chart 14: Russell Mid Cap Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	15.6%	1.7%	13.2%	37.2%
Consumer Staples	6.2%	3.7%	17.6%	37.7%
Energy	8.7%	-4.5%	10.7%	47.8%
Financials	18.6%	-1.2%	6.7%	22.9%
Health Care	6.4%	0.3%	17.1%	34.0%
Industrials	12.8%	-3.0%	6.7%	32.2%
Info Technology	14.1%	-0.5%	8.9%	31.7%
Materials	6.1%	-0.2%	10.4%	35.2%
Telecom Services	1.9%	4.9%	1.0%	27.7%
Utilities	6.6%	1.6%	12.5%	29.0%
Total		-0.4%	10.4%	32.6%

Source: Bloomberg, Wilshire Atlas

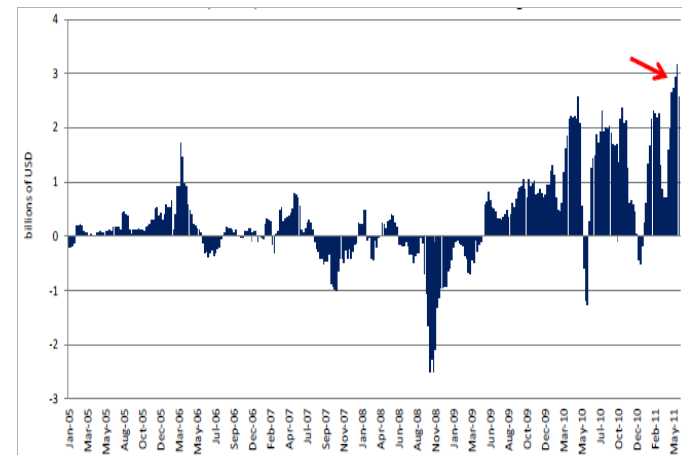
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Fixed Income Market – Taxable:

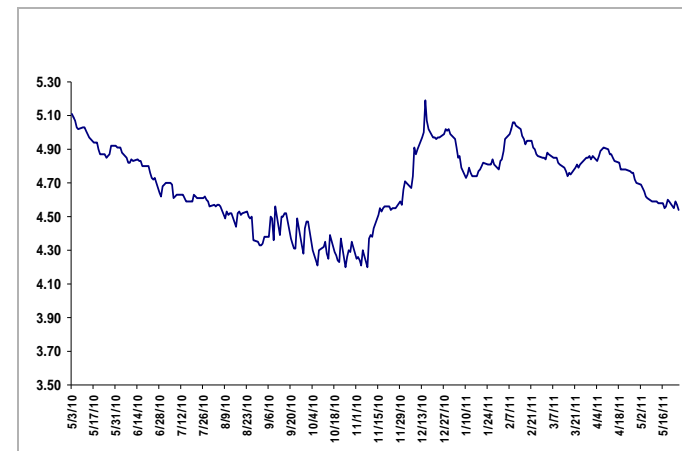
- Treasuries rallied strongly from early April throughout the month of May. Over the month, the 5yr, 10yr and 30yr Treasuries rallied 22, 15 and 20bp, respectively. The 2s-to-10s curve flattened modestly by 9bp while the 10s-to-30s curve steepened 6bp. This rally was primarily driven by softer economic data as well as a flight to quality into the dollar, which rallied approximately 3% in May. Despite the recent dollar rebound, inflows into global bond funds are hitting record levels as investors attempt to diversify their bond holdings outside the U.S.(Chart 15).
- Investment grade (IG) corporate supply in May was very strong at \$106B, up from \$55B in April, as firms took advantage of the low nominal yields. 15% of issuance was floating rate. IG spreads increased 7bp over the month while high yield (HY) spreads increased 27bp. The total return for IG corporates was 1.35% in May (4.15% YTD); HY was 0.3% (5.89% YTD), as both underperformed the Treasury market.
- The agency mortgage-backed securities (MBS) market also underperformed US Treasuries by about 13bp for the month of May. MBS lagged early in the month as market participants took profits but moved in line with Treasuries for the balance of the month. Potential refinancing activity has gone up due to lower rates, although rates might have to fall further before refinancing increases meaningfully (Chart 16).

Chart 15: Net New Assets at Global Total Return Funds



Source: Deutsche Bank

Chart 16: US 30yr Fixed Rate Mortgage (%)



Source: Bankrate.com

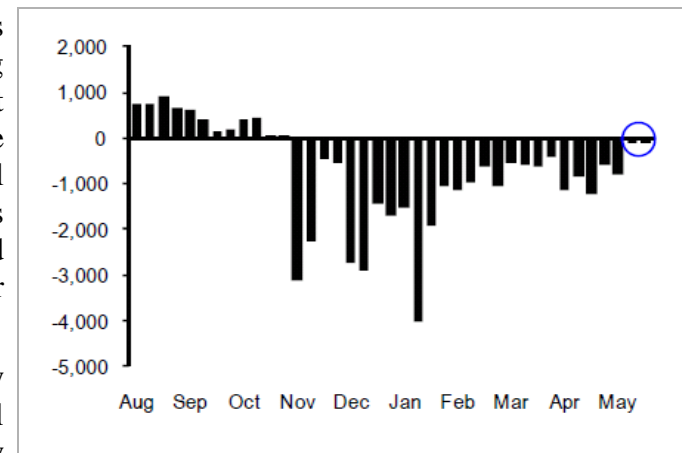
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Fixed Income Market – Tax-exempt:

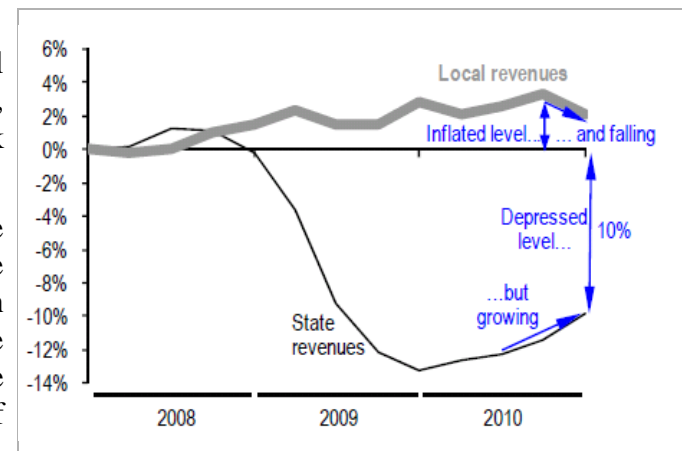
- The municipal market had a strong month of returns as yields fell across the board, even outperforming Treasuries in nearly all maturity segments. The market is entering a very favorable technical period where coupon reinvestment and reinvestment demand will significantly outpace new issue volume. Buyers attempted to get ahead of this imbalance and pushed yields to relatively rich levels, particularly for the 5-year segment of the yield curve.
- Some believe municipal supply could remain relatively low for an extended period as state and local governments have embraced a new level of austerity regarding spending and borrowing. Many intend to defer issuing new debt until absolutely necessary. Some are now estimating new supply for 2011 will be less than \$200B, after more than \$400B was issued last year.
- Also supporting municipal prices is improving mutual fund flows (Chart 17). For the first time in six months, tax-exempt funds finally had their first net inflow week in May.
- Tax revenues in 1Q across states rose 9.1% YoY, the fifth consecutive quarterly gain. Despite that, total state tax revenues are still nearly 10% below pre-recession levels, and local revenues, primarily property taxes, are rolling over (Chart 18). Nonetheless, in states like California tax revenues are running \$6.6B ahead of budget, easing near-term pressures somewhat.

Chart 17: Tax-Exempt Weekly Bond Fund Flows (\$M)



Source: JP Morgan Research

Chart 18: Cumulative Change in Tax Revenue (annualized)



Source: JP Morgan Research

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Alternative Markets:

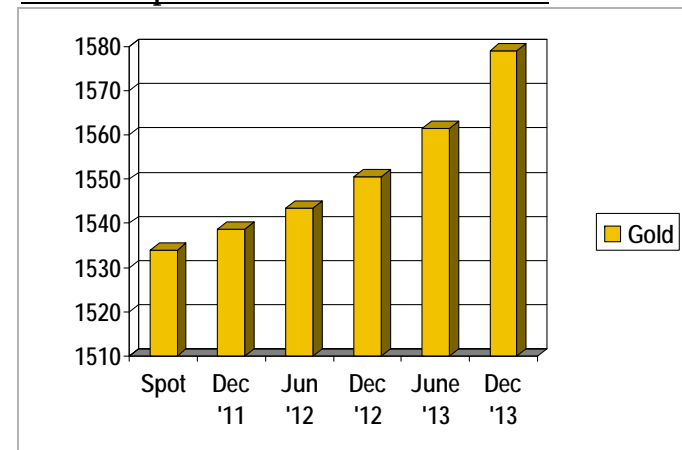
- Though commodity prices are much higher than they were a year ago, market corrections are bound to occur, as happened last month. The DJ UBS Commodity index posted its first monthly loss in 2011, falling by (-5.1%), and leaving the YTD return at a modestly positive 2.5%.
- Silver was particularly vulnerable to a correction. After rising to \$50/oz in April, it fell intra-month by nearly 30% before settling with a 20% loss. Yet, at \$37.50 silver is still more than double its \$18.50 price of a year ago (Chart 19).
- A condition called “contango” occurs in the futures market when prices rise among longer dated contracts, as is the case with gold (Chart 20). Contango can negatively affect performance of commodity investors as they roll from one contract to the next. Often, contango conditions suggest excessive speculation by market players unable to take physical delivery.
- Pension fund allocations to alternative managers have grown 50% since 2007 according to London based research firm Prequin, as the trend toward more diversification in institutional portfolios continues. Wilshire Associates reports that large retirement plans have benefited from private equity (+6.7%), and hedge fund (+6.8%) annualized median performance relative to stocks (+5.7%) over the last ten years.

Chart 19: Silver Spot Price (\$/oz.)



Source: Bloomberg

Chart 20: Spot Gold vs. Gold Futures Prices



Source: Bloomberg

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