



INVESTMENT MANAGEMENT

Monthly Economic Update & Market Review

September
2010

Investment Strategy Committee

as of

September 1, 2010

Summary of Current Views

In June, the Administration announced the beginning of the “Recovery Summer” tour. According to The White House press release it was to be “a six-week-long focus on the surge in Recovery Act infrastructure projects...and the jobs they’ll create...” Unfortunately, like those who bought tickets with great anticipation to see such entertainment icons as, Lady GaGa, Bret Michaels, The Jonas Brothers, or Rihanna, in concert this summer, the “Recovery Summer” tour was just one more in the long list of those cancelled due to lack of interest – or so it appears based recent economic data. The revision to 2Q growth, from 2.4% to 1.6%, perhaps best sums up the slowing trend, and more recent data points to more of the same. The probability of the economy falling back into recession has risen, as has the risk of deflation. We would now place the odds of U.S. growth of 1.0% or less in the second half of 2010 to be greater than growth surprising to the upside, exceeding 2.5% - a still relatively subpar pace at this stage of recovery. **U.S. GDP growth between 1.0% - 2.5% through 1Q 2011 remains our base case scenario, but it’s the rising probability of the fat tail risk to the downside that makes us, and the markets, uncomfortable.**

Are asset prices priced for such a slow growth scenario? Based on the decline in bond yields last month, we would argue that Treasuries are well on their way, if not already there. Clearly, there is still room for yields to move lower if core inflation also declines further, as it appears poised to do. With the recent Fed decision to purchase 2- to 10-year Treasuries with the cash flow from their huge mortgage portfolio, who knows how low yields may fall? Chairman Bernanke, in his speech to fellow economists at Jackson Hole, WY said the Fed stands ready to take additional steps to boost growth if necessary. The decline in equity prices in August, trading off the weaker macro backdrop, suggests that stocks may suffer under additional pressure if growth falls below our base case range.

While the Fed has done a lot, and stands ready to do more, their ability to boost growth up to an acceptable speed – a pace at which hiring picks up, unemployment declines, and confidence returns – is unlikely. To achieve that wish list requires a coordinated effort from policy makers and industry, as occurred in the depths of the recent financial crisis. It will require a balance of monetary and fiscal stimulus, wrapped in a credible long-term deficit reduction package; a thorough, coordinated policy response, equal in scope to the magnitude of headwinds we face. We’re hopeful, but not optimistic near-term, with the pending elections. Partisan politics is the more likely path as we head into November, the opposite of what’s needed at this point.

Most importantly, however, consumers, investors and businesses need confidence. It’s apparent to us that the lingering effects of the financial crisis remain. Personal savings rates remain closer to 6% than 1%, as consumers rebuild savings and reduce debt. Investor cash flows continue to favor safety and income over risk and growth by a wide margin. Businesses that are profitable, and quarterly earnings reports suggest many are, prefer to remain very cautious with their cash. They prefer to seek strategic mergers and acquisitions which, while perhaps wise at the company level, often lead to consolidation and layoffs, rather than expansion and hiring. Yet, even adolescent concert-goers know that cancelled concerts aren’t the end of the world. Seasons change, and the warmth of summer will soon shift to fall, perhaps bringing with it a new, fresh, perspective on the structural headwinds we face.

The current environment - at a glance...

<p>Spotlight – pg 5 Change is in the air in the world of politics, not just in the U.S., but around the globe. In various European countries in particular, the electorate has forced a series of changes in policy, if not personnel among their political leaders. The same appears likely in the November elections here. If so, the result may have both policy and, potentially, investment implications.</p>	<p>Large Cap Equities – pg 10 The S&P 500 declined 4.5% in August, with the Financial sector as the worst performer. Stocks did get a boost from increased M&A activity as companies found value and began to put cash to work. Macro concerns continue to outweigh fundamentals, including uncertainty over future tax policy. High single stock correlation continued its recent pattern.</p>
<p>U.S. Economic Growth and Inflation– pg 6 Second quarter GDP growth was revised down to 1.6% from 2.4% primarily due to a widening trade deficit and less inventory build. The majority of economic data has been below market expectations and the markets have responded accordingly. The manufacturing data has been more mixed.</p>	<p>Mid- and Small-Cap Equities – pg 11 The Russell 2000 Index fell 7.4% in August, and small caps are off roughly 19% since their April peak. The Financial sector has held in the best, but this is skewed by REITs which are up 9.1% YTD. Mid-caps outperformed small and remains modestly positive YTD.</p>
<p>Employment – pg 7 The July payroll report showed that just 71,000 new private sector jobs were created even as the unemployment rate held steady. Recent increases in initial jobless claims is also cause for concern. In place of new jobs, employers have lengthened the workweek, a positive sign for future job creation.</p>	<p>Fixed Income, Taxable – pg 12 Treasury yields fell last month and the yield curve flattened with long rates falling more than short. Weak data, combined with the Fed’s decision to buy Treasuries with the cash rolling off from their large MBS portfolio, was the cause. Corporate spreads held steady even as yields declined.</p>
<p>Housing – pg 8 There has been very little to like in the recent housing data. Sales activity has plunged and inventory levels are high and rising. There has been little improvement on the foreclosure front as well. The data suggests that further downward pressure on home prices could be forthcoming.</p>	<p>Fixed Income, Tax-exempt – pg 13 The tax-exempt market had a very good month as it attempted to keep pace with falling Treasury yields. The municipal curve also flattened, yet intermediate and long maturity yield ratios are still attractive relative to Treasuries. The California budget remains in limbo, as opposing sides in the legislature sit idle.</p>
<p>International – pg 9 China officially overtook Japan as the second largest global economy in 2Q, and is unlikely to relinquish the position. Japan’s economy is sputtering and the yen is rising, hurting imports and growth even more. Stress remains on many euro zone countries, but Germany remains the stronghold.</p>	<p>Alternatives – pg 14 The new financial regulation bill is resulting in less appetite for risk in the derivatives market, and lower trading activity – as designed. Some hedge funds are closing as a result. Oil prices fell and inventories are high, suggesting more downside risk is possible. Gold continued its steady climb higher.</p>

Monthly Performance Review

Equity Indices	<u>10-Aug</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	(4.51)	(3.17)	(4.04)	(4.62)	4.91	(8.66)	(0.91)
Dow Jones Industrials Index	(3.91)	(0.50)	(1.65)	(2.11)	8.39	(6.47)	1.77
NASDAQ Composite	(6.24)	(6.34)	(5.55)	(6.84)	5.22	(6.62)	(0.36)
Russell 1000 Index	(4.47)	(3.52)	(3.97)	(4.37)	5.55	(8.34)	(0.71)
Russell 1000 Growth Index	(4.67)	(3.49)	(4.65)	(5.68)	6.14	(6.26)	0.10
Russell 1000 Value Index	(4.28)	(3.55)	(3.28)	(3.03)	4.96	(10.61)	(1.69)
Russell MidCap	(4.40)	(3.93)	(1.12)	0.35	12.32	(6.32)	0.82
Russell MidCap Growth Index	(4.30)	(4.22)	(1.87)	(1.10)	11.58	(6.29)	0.80
Russell MidCap Value Index	(4.48)	(3.67)	(0.44)	1.73	13.01	(6.79)	0.45
Russell 2000 Index	(7.40)	(8.71)	(3.60)	(2.97)	6.60	(7.44)	(0.69)
Russell 2000 Growth Index	(7.29)	(7.79)	(3.14)	(3.44)	7.16	(7.02)	(0.17)
Russell 2000 Value Index	(7.52)	(9.57)	(4.05)	(2.54)	6.06	(8.03)	(1.33)
MSCI EAFE Index	(3.10)	5.03	(3.04)	(7.95)	(2.34)	(10.75)	0.96
MSCI Emerging Mkts Index	(1.94)	5.44	5.19	(0.32)	18.02	(1.50)	12.38
Alternative Indices	<u>10-Aug</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	(2.54)	4.39	(2.18)	(5.93)	4.17	(6.62)	(2.83)
DJ Wilshire REIT Index	(1.32)	2.58	14.37	14.03	33.30	(7.13)	0.58

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-Aug</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	1.29	3.97	5.81	7.83	9.18	7.65	5.96
Barclays G/C Interm. Index	1.17	3.67	5.01	6.94	8.18	7.01	5.67
Barclays US Treasury Index	2.01	4.61	6.60	8.72	8.13	7.62	5.90
Barclays High Yield Index	0.04	4.88	6.73	8.27	21.52	8.61	7.51
Barclays 1-10-yr Muni Index	1.58	3.14	4.08	5.61	7.43	6.64	5.12

Month-end Market Levels

Bond Yields	<u>10-Aug</u>	<u>10-Jul</u>	<u>10-Jun</u>	<u>09-Dec</u>	<u>09-Aug</u>
Fed Funds Rate	0.13	0.13	0.13	0.13	0.13
3-month T-bill yields	0.13	0.14	0.16	0.05	0.13
2-yr Treasury yields	0.47	0.55	0.77	1.14	0.97
5-yr Treasury yields	1.33	1.60	2.09	2.68	2.39
10-yr Treasury yields	2.47	2.91	3.29	3.84	3.40
5-yr Agency	1.60	1.81	2.33	2.95	2.76
5-yr A-rated ML Corp Master	3.06	3.33	3.93	4.50	4.72
5-yr AAA Muni yields	1.06	1.29	1.59	1.57	1.81
Other Markets	<u>10-Aug</u>	<u>10-Jul</u>	<u>10-Jun</u>	<u>09-Dec</u>	<u>09-Aug</u>
WTI Crude Oil (\$/bbl)	71.92	78.95	73.97	79.36	69.96
Gold (US\$/troy oz)	1250.30	1186.20	1,215.00	1,096.95	951.25
US\$/Euro	1.28	1.31	1.23	1.43	1.43

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

Spotlight: Global Political Changes

As American voters prepare to be inundated with political campaign advertisements for the November midterm elections, it's easy to focus solely on the potential changes that occur in the U.S. Congress and many state governorships. However, this year has already seen a number of governments around the globe that have faced angry electorates. Combinations of austerity measures, high unemployment and government debt, and corruption scandals have led to a wave of changes. We list a few examples below.

In Germany, Chancellor Angela Merkel's moves to assist in the rescue of the Greek crisis has weakened her Christian Democratic party-led coalition, and the loss of a majority in the upper house of parliament.

In France, President Nicolas Sarkozy has implemented an unpopular austerity economic program; endured global criticism for his government's policy to deport large groups of illegal immigrants; and faces a campaign finance scandal with increasing investigations.

In Italy, new elections are likely after Prime Minister Silvio Berlusconi has lost his parliamentary majority after the defection of a group of his coalition. This was precipitated over corruption by a member of his cabinet. A vote of confidence may occur this month.

In Spain, Prime Minister Jose Luis Rodriguez Zapatero faces a rupture in his coalition, as two nationalist parties are gaining public popularity for reforms of labor laws and social programs.

In Great Britain, a tenuous coalition of the Tory and Liberal Democrat parties with an agreement to last one year has moved to put David Cameron as its Prime Minister. Many issues determined the May election, but most urgent were discussion on fiscal policy and government handling of the financial crisis.

In Australia, the Labor and Coalition parties are still negotiating through a hung parliament after elections held on August 21 yielded 72 seats for each party, short of the 76 needed for a majority. Among the key factors was a proposal to tax the resource and mining sector in an economy highly dependent on these industries.

Back here in America, current predictions by political analysts would suggest that the House is likely to change control, with the Senate on the precipice of potential change. Such a result would have significant macro policy implications on taxes, fiscal policy, trade agreements, and effects on monetary policy and its control by the Federal Reserve. A return of business and consumer confidence, necessary to accelerate the economic recovery, may only result from a shift of political power.

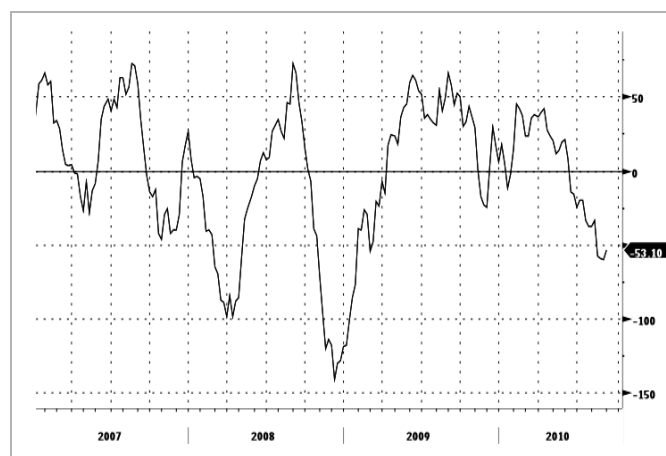
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U.S. Economic Growth and Inflation:

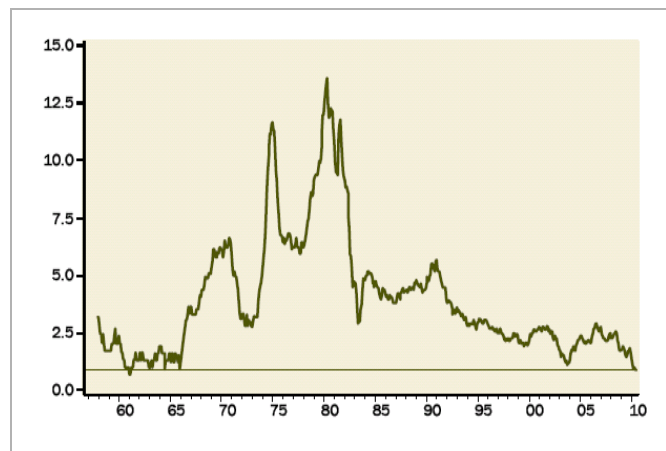
- 2Q GDP growth was revised lower to 1.6% from the initial estimate of 2.4%. A wider trade deficit combined with less inventory rebuild led to the downward revision. Favorably, however, the pace of consumer spending was revised up to a 2.0% annual rate from 1.6% initially.
- The Citi Economic Surprise Index tracks economic data relative to consensus estimates. Since April the trend has been disappointing and is now more than one standard deviation from the mean of zero, illustrating how persistent the weakening trend has been (Chart 1).
- The Quarterly Survey of Senior Bank Lending Officers showed that, for the first time since 2006, large banks eased credit standards for small businesses in 2Q. It was a very modest change, but may signal a critical component in sustaining growth. Weak loan demand persists, however, as the deleveraging process continues.
- The manufacturing sector is sending mixed signals. The the ISM Manufacturing Index rose to 56.2 from 55.5 in July. This is in contrast to weaker surveys from recent regional manufacturing data from the Philadelphia Fed and Kansas City Fed, among others.
- As growth slows, deflation fears have risen. Core-CPI held at 0.9% YoY for the fourth consecutive month in July, the slowest pace since March 1961 (Chart 2).

Chart 1: Citi U.S. Economic Surprise Index



Source: Bloomberg

Chart 2: Core Consumer Price Index (YoY %)



Source: Gluskin Sheff

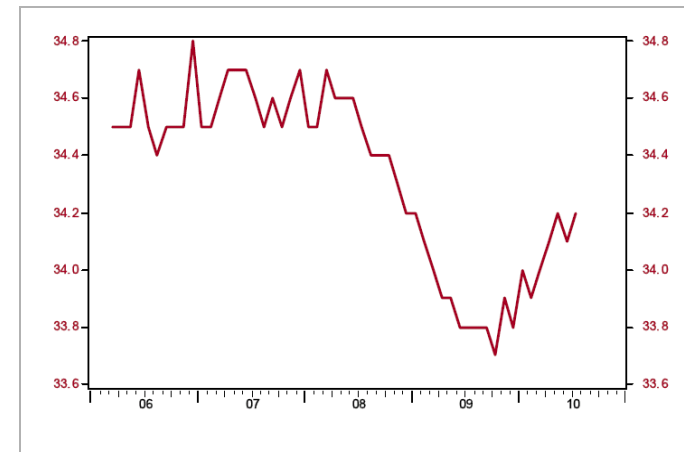
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Employment:

- July's payroll number was disappointing on many fronts. Just 71,000 private sector jobs were created and the three prior monthly reports were revised lower. The unemployment rate did hold steady at 9.5%, but would have risen were it not for the third consecutive monthly decline in the labor force. Nearly 1.2 million workers have stopped looking for work over the last three months; if added back in, the unemployment rate would be 10.4% instead of 9.5% today. The unemployment rate is expected to inch up to 9.6% in the August report when released.
- Both the household employment survey (-159,000) and the payroll survey (-131,000) shrank, reflecting the termination of census workers as well as the general decline in government payrolls that continued in July.
- Partially offsetting the weakness was a 36,000 increase in manufacturing jobs and a lengthening of the average workweek by 0.1 hours to 34.2. It's estimated that each 0.1 hour worked increase is equivalent to an additional 400,000 jobs in terms of total production.
- Initial jobless claims resumed their upward trend once again. After hovering near 450,000 weekly claims since May, claims jumped to 504,000 before falling near month-end. The four-week moving average, which helps smooth the week-to-week volatility, is now back over 486,000, implying little if any new job growth in the payroll report (Chart 4).

Chart 3: Average Weekly Hours Worked - Private Industries



Source: Strategas Research

Chart 4: Initial Jobless Claims (000's)



Source: Bloomberg

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Housing:

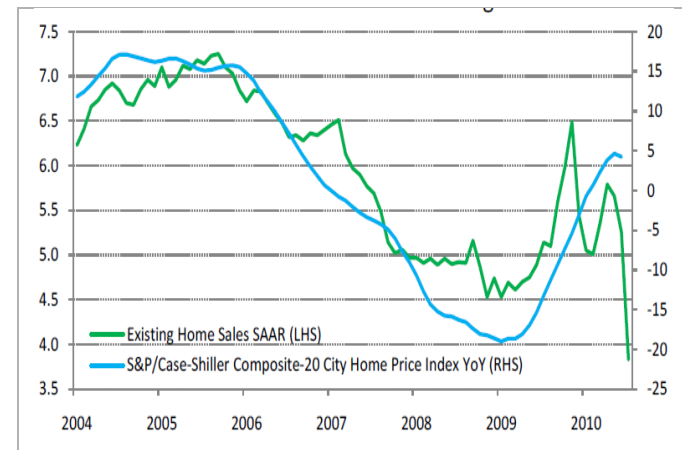
- Existing home sales plunged 27.2% in July, to an annual pace of just 3.83 million homes; less than one-half the 7.25 million annual pace at the peak in September 2005 (Chart 5). New homes sales fell 12% MoM, to an annual pace of 276,000, the lowest level of new property sales since records were compiled starting in 1963.
- At the same time that sales activity has fallen, inventory available for sale increased 3%. Considering just listed homes, at the current pace of sales there were 12.5 months of existing home supply and 9.1 months of new home inventory at the end of July. Rising inventories and slowing sales suggests the recent stability in home prices may not last (Chart 6).
- Foreclosure activity also remains high, adding to already abundant property sitting on bank balance sheets. An estimated five million homeowners are now either in the foreclosure process or more than 90 days delinquent. In addition, roughly one-quarter of homeowners with a mortgage are in a negative equity position.
- The Obama Administration hosted a summit on “The Future of Housing Finance,” in Washington in mid-August. Invited were a cross-section of housing industry leaders to provide thoughts and ideas. Despite rumors and anticipation to the contrary, no major policy decisions were announced, leaving the market, it appears, to find its own equilibrium level at which more homes will clear.

Chart 5: Existing Home Sales (SA, 000's)



Source: Bloomberg

Chart 6: Home Prices and Existing Home Sales



Source: Bloomberg

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International Developments:

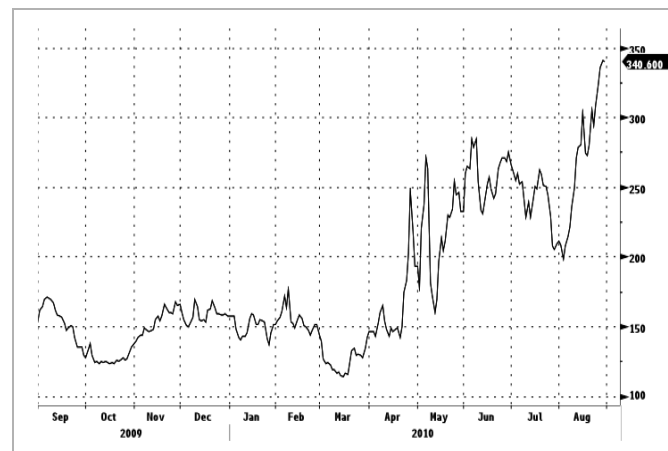
- China's GDP exceeded that of Japan's in 2Q making it once again the world's second largest economy, a position it's unlikely to relinquish again. In nominal terms China's GDP was \$1.337 trillion in the quarter vs. Japan's \$1.288 trillion.
- Japan's 2Q GDP advanced just 0.4%, well below the 2.3% consensus estimate. Confirming the weakness, the Nikkei 225 Index has fallen 20% from its April peak, placing it in/near bear market territory. Yet, the yen continues to rise and is at a 15-year high relative to the U.S. dollar (Chart 7), hurting export growth. In late-August the Bank of Japan held an emergency meeting, unveiling fresh stimulus via expansion of a special bank lending program. The market was unimpressed as the yen continued to rise further against the dollar.
- Renewed concerns regarding the deficits and debt of some euro-zone countries resurfaced, pressuring sovereign credit spreads wider. In Ireland, for example, S&P downgraded the country's debt to AA- (negative outlook) from AA on fear the Irish government may need to provide more capital to shore up Irish banks. Ireland's CDS are trading wider than before the EU/IMF stabilization package was announced in May (Chart 8).
- Germany remains the European stronghold. 2Q GDP exceeded expectations at 2.2%, the fastest pace in 20 years. Germany's economy is largely export driven, which has been helped by the euro weakness.

Chart 7: Yen Spot Price in U.S. Dollars (FX)



Source: Bloomberg

Chart 8: Ireland CDS spreads (bps)



Source: Bloomberg

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Large-Cap Equities:

- The S&P declined 4.5% in August as disappointing economic data including housing, employment and regional Fed surveys caused investors to favor defensive, lower-beta stocks. The Financial sector was the worst performer as it traded lower off of the slowing economic data and weak loan demand (Chart 9). However, the stocks got a boost from increased M&A activity. Although a lagging indicator, it is encouraging to see companies are finding values and putting their record cash balances to use. Activity was strong within the information technology sector as Intel, Hewlett Packard, Dell and IBM all pursued acquisitions.
- Macro concerns intensified during the month as investors worried over issues ranging from monetary and fiscal policy, global growth slowdown and high debt levels of governments. These macro concerns are illustrated by the near record level of single stock correlation where stocks trade with a similar pattern and it is hard for investors to add value through stock selection (Chart 10).
- Recent polls show that a majority of Congressional members (60% Republican, 75% Democrat) do not believe a deal to preserve the Bush tax cuts can be reached. The equity markets, however, appear to be pricing in a compromise as 70% of investors believe Congress will be able to keep the dividend tax rate below 30% (currently 15%) versus an expected dividend tax rate reset to 40%. If Congress fails to act and the tax cuts are allowed to expire, investors could view the inaction as a downside surprise.

Chart 9: S&P 500 Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	10.3%	-3.9%	2.0%	17.3%
Consumer Staples	11.8%	-1.5%	1.6%	10.7%
Energy	10.9%	-4.3%	-9.2%	0.3%
Financials	15.9%	-7.8%	-5.3%	-6.5%
Health Care	11.7%	-1.5%	-8.9%	0.4%
Industrials	10.5%	-7.0%	1.7%	14.4%
Info Technology	18.3%	-7.0%	-10.9%	3.1%
Materials	3.6%	-2.6%	-4.8%	7.3%
Telecom Services	3.3%	2.3%	2.5%	13.4%
Utilities	3.9%	1.5%	1.4%	10.2%
Total	0.0%	-4.5%	-4.6%	4.9%

Source: Bloomberg, Wilshire Atlas

Chart 10: High Correlations influenced by macro concerns



Source: Credit-Suisse

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Mid- and Small-Cap Equities:

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- The Russell 2000 index suffered a drop of 7.4% last month, the fourth worst August on record. Since the peak on April 23rd, small-cap stocks have slumped almost 19% and appear to be tracking the persistently weaker U.S. economic data given their largely domestic focus.
- Consumer Discretionary has given back all earlier gains with the worst monthly decline of 10.8% (Chart 11). The more defensive sectors of Consumer Staples and Utilities are the only sectors in the black year-to-date. Financials are skewed by REITs which only declined 3% during the month and are up 9.1% year-to-date.
- Quality and growth have held up better as the low quality rally has long faded. Non-earnings companies lost 10.8% last month, 16.9% the past three months and have now declined 13.8% year-to-date. Conversely, stocks with long-term earnings growth over 20% declined just 5.1% over the past three months and have lost just 1.5% year-to-date.
- The Russell Mid Cap index continues to be in the sweet spot domestically, holding up best this past month. They're modestly positive year-to-date and are up about double that of small-caps and triple the returns of large-caps over the past year. Only the energy sector has failed to post double digit gains.

Chart 11: Russell 2000 Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	13.3%	-10.8%	-1.6%	8.3%
Consumer Staples	3.2%	-7.0%	0.8%	12.4%
Energy	5.4%	-7.5%	-10.3%	10.1%
Financials	21.8%	-6.9%	-0.8%	3.2%
Health Care	13.0%	-6.2%	-6.9%	-0.3%
Industrials	15.3%	-10.4%	-4.8%	4.4%
Info Technology	18.1%	-6.2%	-1.9%	11.2%
Materials	5.3%	-3.3%	-2.6%	15.3%
Telecom Services	1.0%	-7.6%	-10.8%	-0.2%
Utilities	3.5%	-0.2%	5.7%	14.8%
Total		-7.4%	-3.0%	6.6%

Source: Bloomberg, Wilshire Atlas

Chart 12: Russell Mid Cap Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	16.1%	-5.4%	3.2%	14.4%
Consumer Staples	6.5%	-1.7%	7.5%	16.0%
Energy	7.1%	-5.7%	-6.5%	9.1%
Financials	19.6%	-4.8%	4.6%	10.2%
Health Care	8.7%	-2.5%	-2.4%	11.2%
Industrials	12.9%	-7.6%	-1.1%	10.7%
Info Technology	14.5%	-4.7%	-5.1%	11.7%
Materials	6.3%	-4.1%	0.1%	15.1%
Telecom Services	1.7%	-0.8%	5.3%	35.1%
Utilities	6.7%	0.6%	0.9%	11.5%
Total		-4.4%	0.4%	12.3%

Source: Bloomberg, Wilshire Atlas

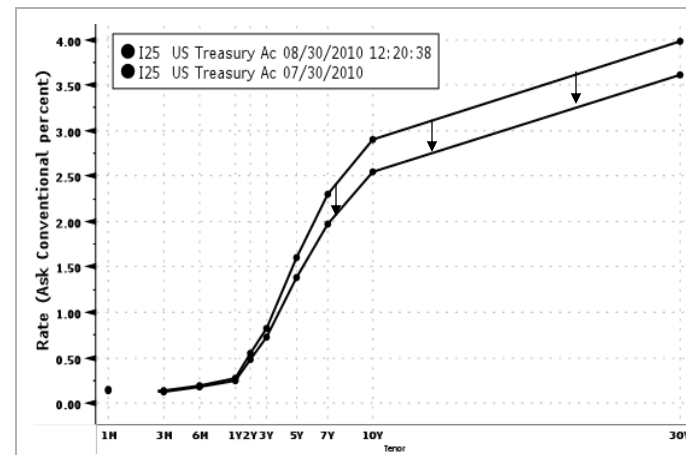
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Fixed Income Market – Taxable:

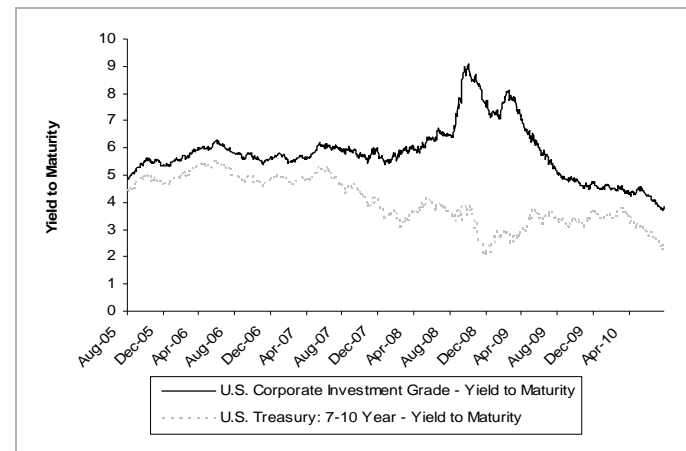
- Treasury yields continue to decline (Chart 13) with the 2yr bouncing around record low territory. The Fed recently stated an intention to reinvest roll-off from its mortgage portfolio into additional Treasury securities – holding their balance sheet steady at \$2.0 trillion. The steep intermediate maturity segment of the yield curve continues to present roll opportunities. The 2s to 10s portion of the curve flattened 37bps in August but remains very steep on a historical basis at nearly 200 bps spread. The 10s to 30s portion of the curve flattened modestly (2bp) but also remains steep.
- Investment grade corporate bonds outperformed high yield, Treasuries and stocks in August and YTD with returns of 2.5% and 11%, respectively. Technical factors contributed to the performance with strong fund inflows combined with modest new issuance. Many companies continue to take advantage of the low rates, including Johnson & Johnson, which issued a 2.95% 10yr bond (a record low for corporate 10yr issuance). IBM issued a 3-year bond with a coupon at just 1.0%.
- Corporate yields are declining alongside Treasury yields (Chart 14). The spread on corporate bonds is a growing proportion of the total return as yields decline overall. In recent history low interest rates driven by economic weakness tend to lead to wider credit spreads, but a longer-term perspective suggests a more mixed credit spread trend in similar low rate environments.

Chart 13: Treasury Yield Curve 7/30/2010 & 8/30/2010



Source: Bloomberg

Chart 14: Corporate Yield versus Treasury Yield



Source: Barclays Capital Live

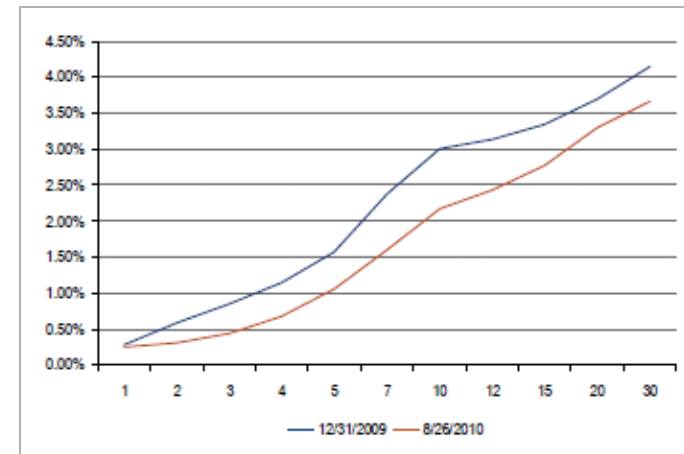
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Fixed Income Market – Tax-exempt:

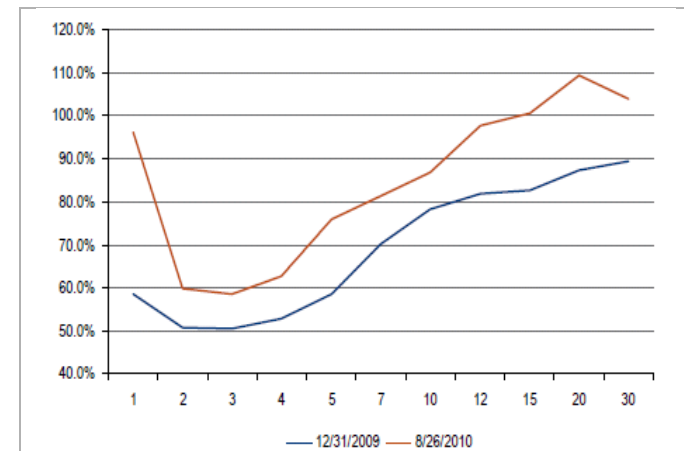
- Tax-exempt yields moved sharply lower in August as it attempted to keep pace with the Treasury market rally. The yield curve flattened as 10-year yields fell by 38 bps while 2-year issues fell just 4 bps. The yield curve is both lower and flatter than where it began the year as seen in Chart 15.
- Despite the lower tax-exempt yields, relative to Treasuries they remain attractive on an historic basis, particularly if marginal income tax rates rise in 2011 as is currently expected. The 5-, 10-, and 30-year muni/Treasury yield ratio is 80%, 90%, and 110% respectively, all of which are higher ratios than when the year began (Chart 16).
- Despite the strong flows into the tax-exempt sector for more than a year, it does not appear that the lower yields have slowed investor demand; the prospect of higher taxes, low money market yields, a steep yield curve, and a secular demand for income all remain in place.
- California has been without a budget since July 1. The legislature remains at odds over how to close the \$19B deficit, battling over spending cuts or tax hikes. In addition, Governor Schwarzenegger has threatened to let his term expire without a budget unless further progress is made on pension benefit reform. Soon, the state may issue IOUs to conserve cash for the second consecutive year.

Chart 15: AAA Municipal Yield Curve



Source: BofA/Merrill Lynch

Chart 16: Muni/Treasury Yield Ratio Curve



Source: BofA/Merrill Lynch

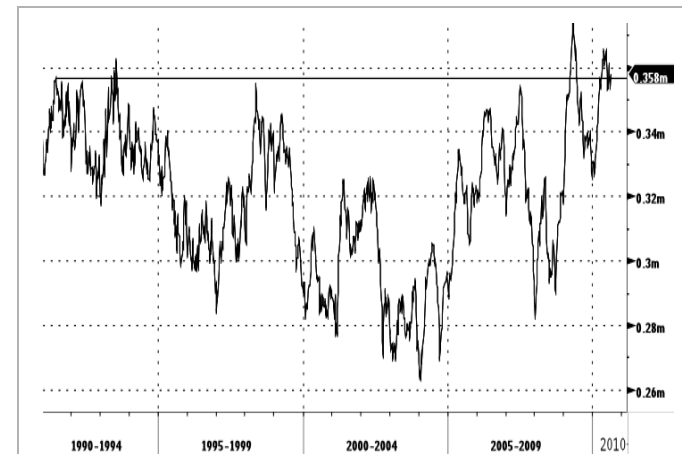
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Alternative Markets

- The passage of the Dodd-Frank financial regulation bill will likely result in less appetite for risk in the derivatives markets and lower trading activity. The new regulatory regime requires counterparties to derivative trades to reserve enough excess cash collateral to meet unforeseen market dislocations. The cash remains uninvested, earning little, on the sidelines in excess bank reserves.
- The ramifications for hedge funds, and nearly all participants that use derivatives markets are substantial. The new regulations make hedging intentionally more expensive, serving as a de-risking mechanism through the cash collateral requirements. This may have played a role in the announcement that Stanley Druckenmiller, a well-known, 30-year veteran hedge fund manager, will close his fund strategies and return cash to investors.
- Oil prices fell nearly \$7.50/bbl in August, or 9.4%, on the weaker global economic data. Oil inventories are at elevated levels and, should the economic growth remain sluggish, it would appear that additional downward pressure is possible (Chart 17).
- Gold continued to defy gravity, rising another 5.6% MoM and is up 11.3% YTD (Chart 18). While gold is increasingly viewed more as a currency trade, rather than a commodity, in August it rose despite the increase in the U.S. Dollar Index. Demand for the precious metal appears to be broadening out, but the dominant source of new purchases remains by investors via gold ETFs.

Chart 17: Crude Oil (\$)



Source: Bloomberg

Chart 18: Gold (\$)



Source: Bloomberg

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