

Market Review

US Equities

The US equity market extended its gains from last year with the **Russell 3000 Index** finishing the quarter up another 6.8%. The market is now up 94.7% from the March 2009 bottom, and is just 5% below the November 2007 peak. Concerns over events of the first quarter were evident in the monthly returns, however, with March's return coming in just above even at 0.45%.

Small company stocks outperformed large company stocks for the second quarter in a row with the **Russell 2000 Index** advancing more than 7.9% to the **Russell 1000 Index's** 6.2%. The Russell 2000 Index fully recovered from the losses from the broad market peak of November of 2007 in February, but as of the end of the quarter still sits 2.9% below its own high water mark in May 2007. The Russell 1000 has gained 76.9% from the March 2009 market bottom, but still remains close to 6% below the November 2007 high.

The biggest laggards in the US Equity Market remain the largest of the large. The **Russell Top 200 Index**, an index of the largest 200 companies traded in US exchanges, still languishing more than 10% below the November 2007 peak.

Value stocks slightly edged Growth stocks for the quarter, with the **Russell 3000 Value** Index posting a 6.47% return to the **Russell 3000 Growth's** 6.30%. Growth stocks still hold a considerable edge, however, having recovered completely from losses in 2008 and 2009, ending the quarter more than 1% above the 2007 peak, versus Value stocks which are still down more than 11%.

Dividend paying stocks, in a reversal of last quarter, underperformed Growth Stocks, Value Stocks and the Broad Market, with the **Dow Jones Select Dividend Index** posting a 5.7% return for the quarter.

Every sector of the US Equity Market rose in the first quarter, led, not surprisingly, by the Oil & Gas Sector which rose more than 17%. This was almost 8% higher than the second best sector, Industrials. Consumer goods brought up the rear with a respectable 3.2% gain.

International Equities

International equities continued to face headwinds in the first quarter relative to the US Market. The **MSCI ACWI (All-Country World Index) ex US** rose 3.4% over the quarter. Developed economies led the quarter, with the **MSCI World ex US Index** posting a 3.8% gain versus the **MSCI Emerging Markets Index** 2%. This is in spite of the considerable drag of Japan, the world's 3rd largest economy, and a considerable part of the MSCI World Index, down 4.9% as measure by the MSCI Japan Index.

Currency again played a large role in the first quarter. The dollar continued its slide against most foreign currencies, adding more than 2% to the return of the MSCI ACWI ex US Index when calculated in dollars versus local currency, more than 2.3% to the MSCI World ex US, and 1.4% to the MSCI Emerging Market Index. Again Japan was one of the only regions not to receive a boost due to currency, as money fled out of the Yen, with the MSCI Japan's return in dollars coming in more than 2% less than in Yen.

Within the developed markets, Europe was the best performer, with the **MSCI Europe Index** posting a 6.46% return. Europe was led by the EMU (European Monetary Union) countries, with the **MSCI EMU Index** posting a 9.78% return, and an impressive 10.69% when Germany is excluded. The **MSCI Pacific Index** fell well short of Europe, declining more than 2%. Even after excluding Japan, the **MSCI Pacific ex Japan** Index only rose 2.76%.

It was a similar story in the emerging markets, with the **MSCI EM Europe Index** rising 11.76% to the **MSCI EM Asia's** 1.42%. Latin American countries, however, were the biggest laggard, with the **MSCI EM Latin America Index** rising only 0.88% for the quarter. The largest emerging market economies of Brazil, Russia, India, and China, the so-called BRIC countries, collectively rose 3.24% in the first quarter, as measured by the **MSCI BRIC Index**, better than the broad index, but still well below the European countries.

Real Estate

Global REITs added to their gains of last year with the **Dow Jones Global Select REIT** Index posting a 5.69% gain in the first quarter. U.S. REITs outperformed International REITs, 6.7% to 4.17%, as measured by the **DJ Select US REIT** and **Global ex US REIT Indexes**. As was the case with international equities, Japan was a big detractor in international REITs, dropping 8.16% for the quarter. European REITs were the best regional performers, posting a 9.7% gain, while Asian/Pacific REITs lost 0.34%, dragged down by Japan.

Looking at REITs by type, Self Storage REITs posted the biggest gain of the quarter, up 10.46%, followed by Healthcare REITs, up 8.42%. Hotels, one of the best performers in 2010, posted the only loss for the quarter, dropping 1.54%.

Commodities

Commodities markets also extended their gains from last year, although at a less blistering pace in the broad market than we saw at the end of 2011. The **Dow Jones-UBS Commodity Index** rose 4.45% on a total return basis in the first quarter. In a complete reversal of 4th Quarter 2010, the gains were driven primarily by energy, up 6.92% and Livestock, up 7.17%. Agriculture, which rose more than 25% in the 4th quarter, rose a more modest 2.92%. Slightly more troubling for the economic outlook, Industrial Metals barely squeezed out a positive return for the quarter, up a slight 0.22%, primarily due to Copper dropping 3.31%. All of the loss was experienced in January, however, and prices seemed to stabilize in February and March, so it may not be cause for significant alarm.

Closely watched Gold, was mainly flat on the quarter, closing up just 0.68%, but another precious metal, Silver, posted a whopping 22.4% return, only bested by Cotton, up 40.55%, among the single commodities.

Most troubling to everyday consumers, however, was the spike in oil and petroleum prices. Crude Oil jumped close to 8% on the quarter, but much closer to home, Unleaded Gasoline and Heating Oil both surged over 20%.

US Taxable Fixed Income

The US investment-grade taxable fixed income market bounced back slightly from the losses in the 4th Quarter of 2010. Unrest in the Middle East, followed by the Tohoku earthquake in Japan, caused a flight to quality that held yields from increasing too rapidly. Long dated US Treasuries were still the worst performer, with the **BarCap LT Treasury Index** declining 1.01% for the quarter, but this was benign compared to the greater than 8% loss in 4th Quarter of last year. The flight to quality could be seen mainly in the 1.17% gain in February as concerns about the unrest in the Middle East were reaching a head. Corporate Bonds fared better for the quarter, the **BarCap Credit Index** gaining 0.89%. Mortgage-Backed Securities, the other large segment of the market, also posted a slight gain as measured by the **BarCap Mortgage-Backed Index**, up 0.58%.

Low grade US Bonds again posted large gains in the quarter, in spite of the flight to quality that occurred in February, unexpectedly driving prices down. The **Merrill Lynch US High Yield Master II** Index gained 3.9% in first quarter, as yield spreads, the amount the low grade bond must pay over comparable US Treasuries, narrowed to 4.77%, the lowest point since November 2007. US Leveraged, or floating-rate, loans, which adjust their income payments as interest rate rise, benefitted from the environment, with the **Credit Suisse Leveraged Loan Index** gaining 2.65%.

Municipal Bonds

The Municipal Bond Market in the first quarter was hampered by continuing concerns about the health of municipal finance in the US as well as extremely light new issuance and thin secondary market volume. The **Barclays Municipal Bond Index** posted a slight 0.51% return for the quarter, only kept in the black by a 1.59% return in February, as both January and March posted losses. Low issuance and thin trading volume had made for more volatility, as evidenced by February's sudden jump, as market participants find it difficult to determine where yields are headed in the short term.

Belle Haven Investment, one of our preferred municipal bonds managers, believes that the municipal market "will be able to withstand an increase in new issue supply" and, they also believe that "many underlying factors lay just off the radar screen that could work to increase the need for tax-free municipal bonds." These include potentially higher tax rates, as well as the resurrection of the Build America Bond program, which Congress failed to renew last year. They also believe that "investors' fears over credit concerns are overdone, especially by analysts unfamiliar with public finance. . . . fiscal

conservatism already underway is positive for municipal credits and we should see credit spreads tighten.”

One event at the end of the first quarter will certainly have an impact going into second quarter, the downgrade by Standard & Poor’s, of Dekalb County, Georgia’s general obligation bonds *five notches*, from AA- to BBB. S&P’s move took the market by surprise, and highlights a new era of rating responsiveness prompted by the 2008 credit crisis and Dodd-Frank reforms. Still, the decision to lower the rating so drastically signals a departure from previously more tolerant behavior with respect to weaker GO issuers.

International Bonds

Following the lead of the equity market, developed market international bonds outperformed emerging market bonds in the first quarter, with the **Merrill Lynch Global Broad Market ex US Index** gaining 1.97% to the **Merrill Lynch USD Emerging Market Sovereign & Corporate Index**’s 0.98%. Most of the underperformance came in January, however, as Emerging Market Bonds underperformed by more than 1%. By the end of the quarter the momentum seemed to be on the side of the emerging markets as they gained on their developed market counterparts each month, outperforming in March by 0.9%.