

### May 2011



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Vice President

Bond Rates	6/3/2011	12/31/2010
U.S. Federal Funds Target Rate	0.25%	0.25%
U.S. Two-Year Treasury Yield	0.43%	0.60%
U.S. Ten-Year Treasury Yield	3.00%	3.30%
U.S. Ten-Year Muni Yield	3.26%	3.75%
High Yield	6.95%	7.51%

Exchange Rates	6/3/2011	12/31/2010
\$ per €	1.46	1.34
\$ per £	1.64	1.57
¥ per \$	80.53	81.11

Latest Returns						
EQUITIES						
Index	May-11	3 months	YTD	1 Year	3 Years	5 Years
S&P 500	-1.13%	1.84%	7.82%	25.95%	0.91%	3.32%
S&P 400 Midcap	-1.35%	3.82%	10.82%	32.96%	5.95%	7.04%
S&P 600 Small Cap	-0.90%	4.73%	9.52%	29.69%	6.01%	5.00%
MSCI EAFE	-2.95%	0.54%	6.31%	30.69%	-4.12%	1.73%
MSCI Emerging Markets	-2.62%	6.30%	2.45%	28.84%	1.16%	11.72%
FIXED INCOME						
Index	May-11	3 months	YTD	1 Year	3 Years	5 Years
BC Aggregate Bond	1.31%	2.66%	3.04%	5.87%	6.55%	6.64%
BC Muni Bond 1-10 Yr	1.09%	2.28%	3.08%	3.82%	5.20%	5.12%
BC High Yield	0.49%	2.37%	6.01%	18.22%	11.98%	9.44%
BC Global Aggregate Bond	-0.08%	3.50%	4.30%	12.12%	6.16%	6.98%
CSFB Bank Loan Index	0.06%	0.80%	3.32%	9.78%	6.12%	4.47%
OTHER						
Index	May-11	3 months	YTD	1 Year	3 Years	5 Years
DJ UBS Commodity	-5.06%	6.10%	33.88%	73.56%	0.87%	6.18%
DJ Wilshire US REIT	1.55%	6.00%	14.78%	32.16%	1.85%	3.52%
S&P Developed World Property	0.30%	3.73%	8.62%	34.80%	-0.68%	2.66%
LPX 50 TR	-3.13%	3.77%	12.32%	48.83%	-7.45%	-2.62%
HFRI Fund of Funds Index	-1.46%	-0.36%	0.62%	6.71%	-1.79%	1.60%
3 Month T-Bills	0.01%	0.05%	0.08%	0.16%	0.48%	2.08%

\* Returns provided by outside vendor. Innovest not responsible for accuracy of numbers presented.

## The Economy

### The U.S.

Baseball season is upon us. Our beloved Colorado Rockies began the 2011 season with the best record in April, only to have the worst record in the majors in May. The Rockies have real potential but continue to struggle with a combination of low offensive production and mediocre pitching. The Rockies are not unlike the U.S. economy, where we see signs of improvement coupled with signs of economic weakness. We continue to cheer on both the U.S. economy and the Rockies, though outcomes for 2011 remain undecided.

We can now officially confirm a double dip in U.S. housing prices, according to Case Shiller data just released. In March, aggregate U.S. home prices fell below their April 2009 lows. Despite the best efforts of the U.S. government to reinvigorate the housing market, widespread weakness is likely to be our reality for at least the next year. The trickle-down effects of weak housing cannot be underestimated. Consumer spending drives 70% of U.S. economic activity. Homeowners who face negative home equity and the threat of unemployment are not spending money.

The latest consumer and manufacturing surveys provide further detail of economic water-treading. Consumer confidence in May fell to 60.8, surprising to the downside. Sustained high unemployment continues to weigh on the sentiment of the U.S. consumer. May's ISM Manufacturing survey was a disappointing 53.5 (readings above 50 indicate an expansion), indicating

economic expansion but at a slower pace than hoped for.

There is good news to report within the U.S. Inflation is still mild and monetary policy is highly accommodative. Productivity in the workforce is as high as it has ever been. U.S. companies are exceedingly profitable. Commercial banks are once again competing aggressively to loan money to cash flowing businesses. The Federal Reserve still sees GDP growth meeting 3% in 2011, though opinions are varied.

### The World

In Virgil's Aeneid, we are advised to "beware of Greeks bearing gifts." The advice pertains to the story of the Trojan Horse, in which the Greeks destroy the city of Troy. Perhaps we should also beware of Greeks bearing debt instruments. It has come to light over the past two years that Greece as a sovereign entity is essentially bankrupt and insolvent. Only with massive bailout packages from the European Union has the country stayed afloat financially.

The Greek crisis (and to a lesser extent financial crises in Portugal, Ireland and Spain) will continue to weigh on Europe for the rest of 2011. Greece will most likely have to write down some of its sovereign debt, creating widespread losses for those who hold exposure to its bonds. Commercial banks in Western Europe will survive, but damage will be done. The crisis will be a true test of Europe's Economic and Monetary Union (EMU).

China faces its own economic troubles. With inflation creeping to unacceptably high levels, the Chinese government is slamming on the brakes.

Commercial lending has been increasingly restricted. New regulations for mortgage lending are part of a larger effort to curtail the massive capital inflows to Chinese real estate. Make no mistake: China is very likely in a real estate bubble. No amount of clever central planning in Beijing can extricate China seamlessly from this situation. With the specter of a hard landing for their economy, the much touted positive demographic trends in China like urbanization and increased consumer spending will be put to the test.

Yet there are positives in the global economy as well. The economies of China and India are projected to grow 9%+ and 8%+ this year, respectively. These growth rates could hardly be considered recessionary. With the end of quantitative easing in the U.S. scheduled for June, inflationary pressures in emerging market economies will be moderated. Brazil, Russia and India have all taken steps to cool inflation in their economies, the results of which appear to be working as planned. Japan witnessed consumer prices rising for the first time in April in twenty five months—a positive development from a country fighting deflation.

## The Market

May was the toughest month in the U.S. stock market since last August. In the U.S., the S&P 500 dropped a modest 1.13%. Despite giving back some gains, the S&P 500 is still up 7% year-to-date. Over the last 52 weeks, the S&P 500 is up 25%. We've had quite a run in the equity markets since the end of last summer.

Global equity markets also suffered. The MSCI EAFE index was down nearly 3% for May. May's downward turn is unsurprising given the uncertainty surrounding debt markets in Europe. Emerging markets posted a 2.6% loss for the month. Fears of emerging market inflation, combined with countries whose fortunes are tied to commodity prices, provided the downward momentum.

Fixed income gained in May as investors took money out of equities and allocated more capital to bonds. The Barclays Aggregate Index was up 1.31% for the month. As greater perceived risk began to appear in global markets, the move toward fixed income was a natural consequence.

Other asset classes had mixed performances in May. Commodities suffered—the Dow Jones UBS Index dropped 5.06% in May, the largest decline since May 2010. As emerging market countries tightened monetary policy in response to inflation, commodities went down. Notably, commodities had been up every month since last August. A pause in commodity prices was to be expected. The Wilshire U.S. REIT Index was up 1.56% as yield hungry investors sought out alternatives to fixed income.

## Outlook

Winston Churchill once noted: “Americans can always be counted on to do the right thing, after they have exhausted every other alternative.” Thankfully, many of the alternatives for our elected officials in Washington have been exhausted. Private industry will continue to create the kind of jobs and economic growth in the United States that no amount of government spending can accomplish. We have seen the rebound of profits for large corporations in the U.S. Entrepreneurship is leading the economic growth engine for smaller companies as well.

We were heartened in May by the initial public offering of the social networking company, LinkedIn. The company's value nearly doubled on its first day of trading as a public company. (The stock's stratospheric valuation is a topic for another column.) Technological innovation and entrepreneurship are still alive and well in Silicon Valley; we are blessed as a country to have these types of creative risk takers.

So called small business “gazelles” have become an increasing focus for economists. A gazelle is defined as a small business with revenues of at least \$1 million and a four year compounded annual growth rate of 20%. According to the Kaufmann Foundation, gazelles in the United States account for less than 1% of businesses yet create over 10% of our new jobs. Entrepreneurship in the U.S. continues to create new gazelles and the economy grows healthier as a result.

Interest rates moved down in May, to the surprise of many. The end of quantitative easing hasn't been enough to drive down demand for U.S. Treasuries, as fears from Europe and the emerging markets have pushed risk capital here. Look for interest rates to rise gradually in the second half of 2011 as economic growth and inflation should eventually force the Fed's hand by 2012.

At the risk of trying to call a top in the commodity markets, commodities do seem rather richly priced. Should demand temporarily wane in places like China, energy and metal prices could experience a correction this summer. Legendary hedge fund manager George Soros sold all of his gold holdings in the first quarter of 2011, while Fox News' Glenn Beck continues to hawk gold on his radio show. Mr. Beck should probably stick to non-financial matters.

We will likely see more mixed headlines from the global economy. By their very nature, economies are cyclical creatures. A short-term pause in global industrial output growth and a correction in commodity prices could be a medium-term tailwind. Taking this all into account, we remain confident in our strategic investment allocations. We can only hope that the Colorado Rockies, and the U.S. economy, will get their act together this summer.