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The following contains a brief discussion of the equity markets and an outlook from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.

MARKET OVERVIEW

Macro concerns finally got the best of the market as we neared the midway point of 2011 and stalled the upward trajectory we had seen after a robust 2010.

The Arab Spring continued to cause unrest in the Middle East. Even with the conflict in Libya escalating and involving U.S. forces, in western media, it took a back seat to the nuclear crisis in Japan. By the end of the period however, most of the world was focused on the European debt crisis.

Greece is the word – the country continued to grapple with austerity plans, and Europe dealt with the bailout, hinting at the "Too Big to Fail" mantra. The contagion fears seem real as many European banks hold the Greek debt, and no one really knows who has the relevant credit default swap exposure. On top of that and adding to the list of PIGS (Portugal, Ireland, Greece, and Spain), the latest casualty seems to be Italy, experiencing debt problems of its own.

These foreign macro issues all impacted the risk appetite for equities here, but domestically we are dealing with endogenous problems as well. Unemployment data continues to disappoint, suggesting that all the stimulus and easy monetary policy hasn't done much to help the actual economy, although it may be boosting asset prices. The debt ceiling is the latest issue causing concern for investors.

Valuations for equities had become somewhat stretched. As we approach the halfway point of 2011, the Russell 2000 Growth Index had posted significant gains for six out of the last seven quarters – perhaps we needed to digest those valuations. Under the surface of the overall market, there was some divergence among individual stock performance, essentially a bias toward companies with organic growth, and those with consistent and defensible business models.

OUTLOOK

As it has been for the last three years or so, investors are focused on macroeconomic issues, and for good reason. There are some looming issues domestically and globally that could have significant impact on capital markets. We have addressed some of those issues in these reports before – inflation, an energy crisis, price shocks, geopolitical unrest, an overheated China, and the massive and growing U.S. debt.

Here is a simple tautology to consider: if something is not sustainable, it must come to an end. That sounds simple enough, but when we hear that the federal deficit spending is not sustainable, we must consider how this situation will come to an end. The combination of watching the figurative train wreck in Greece along with the political nightmare in the US on the debt ceiling and massive deficit should be a reminder of what is in store for us.

We know it must end or change somehow, but we can't know when or how. In the past, we spoke of hyperbolic discounting and the mismatched timing of costs and benefits providing an incentive to "kick the can down the road." So, what we also know is that as long as they are able, politicians will do everything in their power to avoid really addressing the long term issue. Additionally, as the debt grows, so too does the debt service.

The abnormally low interest rate environment has kept this problem from spiraling out of control. As the can gets kicked down the road, and the debt and interest payments mount, it will be critically important for interest rates to stay low. One of our research providers noted:

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> If interest rates normalize [thru the end of the decade] the added interest costs in 2021 alone will be $800 billion – more than 20 times the mere $37 billion in budget cuts that tore up Congress in March. It would take virtually all of the cuts in the Ryan budget to cover that added interest, much less to start bringing down the national debt.

As long as the Federal Reserve Bank and the government have the ability, they will keep interest rates low.

If nominal interest rates are being kept low, it is imperative that inflation be kept under control, else *real* interest rates would be negative. We quite possibly are in a negative real rate environment now, certainly for short term rates, because the current CPI calculations probably don't represent actual inflation. Negative real interest rates can generate perverse unintended consequences: discouraged savings, loss of confidence in the currency, and upward pressure on commodities, other assets, and even stocks.

The easy money was made long ago. The first stage of this recovery (expansion?) was *beta* – a broad market rally and growing valuations. The second stage is all about *alpha* – stock picking matters, and the fastest growing among them are justifying or overcoming the relatively lofty valuations. Clearly, there are problems looming on the horizon, but it is very difficult to predict the timeframe in which we will be forced to deal with them. Because of the many incentives to maintain accommodative monetary policy (and even creative policy moves like releasing oil from the SPR), we believe that this environment can persist for quite some time: where growth beats value and active beats passive.

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Alpha: An annualized return measure of how much better or worse a fund's performance is relative to an index of funds in the same category, after allowing for differences in risk. Beta measures the volatility of the fund, as compared to that of the overall market. The Market's beta is set at 1.00; a bête higher than 1.00 is considered to be more volatile than the market, while beta lower than 1.00 is considered to be less volatile.

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