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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

The stock market returned impressive gains in the first quarter of 2012. This should not be a surprise. Last summer's poor market performance was the surprise. While the stock market swooned, due to volatility created by the unrestrained trading activities of high frequency traders, corporations continued to produce profits. Indeed, while stock prices were flat to down last year, earnings were up about 10%. **This led to a situation where stocks represented better value at the end of 2011 than at the beginning of 2011**.

A useful valuation metric is called earnings yield, the reciprocal of the price earnings ratio, which allows the comparison of stock to bond valuations. Over time, the equity earnings yield tracks the ten year U.S. Treasury yield with a fairly narrow spread. **When the spread between the two yields widens, it is an indication of an opportunity; either equities are too cheap, or bonds are too expensive** or vise versa, depending on the direction of the spread. Towards year end, the equity yield spread to the ten year Treasury had widened to about 6%, a level so extreme, it had not occurred since 1974.

What does this mean? Is it that stocks are cheap, or bonds are expensive, or both. We think both. As the markets corrected the implied inefficiencies of the earnings yield valuation spread in 1974, stocks delivered above average returns while bonds barely kept pace with inflation.

With the expectation for continued earnings growth in 2012, the stock market was poised for a rally; so far, it has been a healthy rally. Market pundits say the "market climbs a wall of worry". **There has been plenty to worry about, whether from Iran, North Korea or higher gasoline prices. But, so far the market has ignored these obstacles.**

As we have noted, during this past year, there are two reasons for market volatility, a change in economic fundamentals, and unrestrained trading activities. We are confident that fundamentals are sound, with the pieces in place for an extended, albeit slow, recovery. On the basis of sound fundamentals, and with the equity markets at attractive valuation levels, **we are fairly confident that this market rally has the potential to continue.**

Our concern, however, is the ongoing threat posed by unrestrained trading strategies. In 2007, the SEC eliminated the uptick rule which prevents short sellers from adding to the downward momentum when the price of a security is already in decline. While some provisions of the rule have been reinstated, the strategy, used by high frequency traders, of aggressively driving securities prices lower through short sales, is at the core of the recent disruptions the market has experienced. While we think markets are still vulnerable to this type of manipulation, the positive is that, since this volatility is not based on fundamentals, the markets tend to recover quickly.

As we write this newsletter, the Supreme Court is considering the provisions of President Obama's healthcare overhaul. Specifically, the court has been asked to decide whether Congress exceeded its powers by requiring most Americans to obtain health insurance by 2014 or face a penalty. Further, the Court has been asked to consider whether provisions of the law can stand even if the Court decides the individual mandate which requires most to buy insurance is unconstitutional. The Court will also review whether Congress violated the Constitution by coercing the states to expand Medicaid healthcare for the poor, providing coverage for an additional 17 million individuals.

These are difficult issues. The Court has scheduled hearings for six hours over three days, the longest on a single issue in more than 44 years. The stakes could not be higher financially, legally and politically. Annual healthcare spending in the U.S. is about $2.6 trillion or 18% of GDP. The healthcare bill seeks to provide coverage to 30 million people, previously uninsured. **The outcome will affect nearly everyone from individual taxpayers, to company profits and, of course the health care sector, including insurers, drug companies, medical device companies and hospitals.** Even the fiscal health of individual states will be affected by the outcome.

The court will meet in private to discuss the arguments, but probably will not announce their decision until June. Needless to say, we will be watching this with great interest.

Fixed Income Market

As expected, the Fed's one day March meeting led to no new changes in policy. The Fed will continue to keep rates targeted at 0%-0.25% and will maintain Operation Twist in its current form. Chairman Bernanke also reiterated his commitment to keeping rates low through 2014 despite some improvements in the economic picture. **We will be keeping an eye on the discussions for the next couple of meetings as Operation Twist is set to end between the April and June FOMC meetings.** Opinions are split on the possible actions the Fed will take, to extend Twist, a new QE3, or no action at all. Whatever the outcome, expect volatility in interest rates in the short term until clarity is established.

The Fed's relatively upbeat assessments of the economic conditions were reflected in the Treasury market as the 10 year yields surpassed 2.10% for the first time in the last 6 months. Along similar lines, the municipal market also saw an increase in the yields as investors moved from the safety of municipal bonds and into slightly riskier asset classes. **We continue to evaluate the potential benefits of the after tax yield of muni bonds for our higher taxed clients.** In the coming months more and more discussions will revolve around the scheduled ending of the Bush-Era tax cuts. It is still undetermined what changes will be made to income tax rates, as they apply to earned interest. President Obama even recently proposed a cap on tax exempt interest from municipal bonds for higher income taxpayers. Rest assured, we are staying current on all developments related to proposed tax law changes for the coming year and will be adjusting your portfolios accordingly as needed.

In March we also saw the Fed release its results on the bank stress tests, also known as the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR). The tests allowed investors to determine the strength of various banking entities' capital structure by simulating "what if" scenarios. The dire conditions included scenarios with housing prices dropping 21%, equity values falling 50%, and unemployment rates rising to 13%. Ultimately, the results were better than expected as 15 out of 19 institutions passed the capital adequacy tests. **In terms of the bond market, this was encouraging news regarding the stability and low default risk for the many corporate bonds issued by financial institutions**. In fact, Bank of America's 5-year credit spreads tightened 56 basis points and is at its narrowest versus Treasuries for the last two years. We continue to look judiciously at all financial corporate sector offerings, and still see opportunity for investment grade, intermediate term bonds in this category.

International Market

We began to monitor the European sovereign debt issue as early as 2009 and have been discussing its development with our clients through our quarterly newsletter ever since. Back then, the issue was largely ignored as the mainstream media was still in an exuberant mode, reveling in the strongest return from equity markets in a century. However, as time passed and the situation worsened, the debate on Greece's potential default became a "real" issue for journalists. It was at that point that mainstream media began to "report" extreme scenarios and flooded the marketplace with scary headlines. In what can be described as "Robo Journalism", the news agency computers associated unrelated events and created articles equating Greece to Lehman Brothers concluding that a Greek default on its sovereign debt would trigger another round of financial crises that would exceed the disaster experienced in '08.

In fact, Greece did default. On March 9th, the International Swaps and Derivatives Association (ISDA) declared that, the exercise of collective action clauses by Greece to amend the terms of its sovereign debts, was a credit event. But the financial disaster predicted by the media and feared by many did not materialize. On the contrary, all three major U.S. indices closed up on that day. **The positive reaction by the markets illustrates investors' increasing confidence in the European community to address the financial concerns of its constituents.** With help from international communities, measurements put in place by the EU, ECB, and IMF all work together to validate our prior assertion that Europe has a workable model to deal with trouble as it arises.

As the topic of Greek sovereign debt loses popularity, the media needs a fresh angle on Europe to sell advertising**. The latest issue is a possible recession in Europe.** Headlines like, "Europe is headed into a recession, and it will drag the U.S. with it" start to surface. The premise for such statements is that once Europe slows, its demand for U.S. goods will decrease and that will cause the U.S. economy to suffer. On the surface, it seems to be a valid argument, but it does not stand up to further examination of the fundamentals. According to the U.S. Census Bureau, trade in goods with EU nations accounts for, on average, 17% of U.S. international trade. One could argue that 17% is a material amount, but the fact is that not all EU nations are in trouble. The four EU nations with the highest percentage trade with the U.S. (Germany, accounts for 4% of U.S. international trade, U.K., 2.9%, France, 1.8%, and Netherlands, 1.8%), are all fundamentally healthy economies. If we exclude them, 17% drops to 6.5%. **Making the conclusion that a region which accounts for no more than 6.5% of U.S. international trade will drag the entire U.S. economy into a recession is at best, exaggerated.**

Asian countries are also not immune to mainstream media exploitation, especially China. Reports of slowing Chinese economic growth have on numerous occasions been attributed as the cause for market fluctuations. **The press is so often caught up with meaningless terms such as "soft landing" or "hard landing", they fail to recognize that China is a controlled economy, fine tuned by the government.** For years, the Chinese have managed to deliver higher than expected GDP growth and this year will probably not be any different. Instead of focusing on growth, investors should pay more attention to inflation as the determining factor in how much room the Chinese government has to adjust its economy. Recent data suggests that inflation is easing and is expected to decline to a 3.3% rate in 2012. With stimulus policies being implemented and valuations at levels not seen for years (Shanghai Composite valuation, measured by forward P/E, at almost at half of its 4-year average), Chinese equities should be an attractive place to look for investment opportunities.

Global GDP growth is expected to continue at a faster pace than that of the U.S.; most notably that growth should come from emerging markets. **With foreign stock valuations, measured from both trailing P/E and forward P/E at discounted levels, it is prudent to have an exposure, as permitted by each investor's risk tolerance, in international equities.**