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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

In economics there is a theory called **adaptive expectations which holds that our expectations for the future are strongly influenced by the most recent past**. Like most theories of behavioral finance, the notion of adaptive expectations is reasonable, in a descriptive sense.

The financial meltdown of 2007 to 2009, as we commented in past newsletters, was described as a Black Swan event. **In general, a Black Swan event has three attributes: 1) It is rare, beyond the realm of normal expectations. 2) It conveys an extreme historical impact. 3) In hindsight it can be rationalized to have had greater predictability**. In other words, we should have seen it coming.

Why are we starting our newsletter with these observations from theoretical finance? Quite simply, **understanding these two principles helps us to understand the investor sentiment dominating the current market.** Since March 2009, the stock market has been in a recovery mode, with relatively minor, but volatile, corrections along the way. The first occurred a year ago as concern spread that stresses confronting marginal economies in Europe could bring down the European monetary collaboration, known as the Euro, and once again freeze the global financial system. It didn't happen and the recovery continued.

Last month, the markets had to contend with political upheaval and regime change in the Middle East, the earthquake, tsunami and nuclear crisis in Japan, and continued, chronic, financial issues within the European community. In the midst of all of this, there was a major options and futures expiration which only amplified the volatility in the financial markets.

As the markets began to evaluate the financial impacts that had taken place in the days and weeks prior, a Bloomberg headline proclaimed that the "Financial Markets Gloss Over Multiple Black Swan Events." Indeed! **Our view is that none of these events meet the criteria of a Black Swan event.** We don't deny the human tragedy that took place in Japan, but Japan is prone to earthquakes, was prepared and will rebuild. The cost is estimated to be $300 billion. The nuclear reactors are an environmental disaster, not unlike the BP blowout in the Gulf of Mexico, a year ago. It may lead countries to consider alternative energy sources, where economically viable alternatives exist. But in countries like China, where there are no alternatives, we expect nuclear generation will continue to be a major source of electricity.

Over the past several months, we have been commenting on the record accumulations of cash by banks, corporations, and individuals. We think this cash eventually will begin to circulate. The unusually low M-1 multiplier is one indicator that fears borne of recent past experience is discouraging investors from putting money to work. Banks, for example, have appreciated as much as they can on the improved quality of their loan portfolio. Now, they need to show loan growth. They do not deserve to earn a multiple on the near zero interest rate they receive from the Fed.

A reliable study estimates that $100 trillion will be spent on infrastructure projects over the next decade. With some exceptions, much of that money will come from private investment sources. **The magnitude of such funds will not only change the world as we know it, but will also provide opportunities of enormous economic expansion**.

As cash is deployed, not just here but globally, we see it driving economic expansion. However, as this money begins to circulate, we also see inflation as part of the longer cycle. While re-inflation is not the best environment for bond investors, it is positive for equity investors, as long as it does not get over heated.

Recent history was traumatic and money remains underutilized because investors' expectations are influenced by the last Black Swan event. **Yet as long as investors are worried about the recent past they will remain too cautious, providing investment opportunity for those with a long term disciplined approach**.

Fixed Income Market

With the unrest in the Middle East and the recent calamities facing Japan, the demand for US Treasuries, as a safe haven, has slightly improved. This reinforced existing demand due to QE2 (Quantitative Easing, part 2), where the Fed has been purchasing Treasury securities, in an effort to keep yields at historically low levels. **Yet in June QE2 is scheduled to end and, as global events settle and the focus returns to domestic growth, bond yields are anticipated to rise, putting pressure on bond prices.**

Although higher expected inflation and interest rates loom over the fixed income market, the market behavior of fixed income instruments is quite varied. For investment grade bonds, the first quarter of 2011 has seen a shift from financial institutions issuing debt to non-financial companies increasing their debt issuances. It appears that this is partially the result of companies financing mergers and acquisitions activity. Reduced lending and financial firms' cash hoarding in the face of financial regulation have likely prompted this shift in the corporate bond issuance market. **This presents an opportunity for investors to diversify corporate bonds across various sectors and seek out those bonds that provide an attractive balance between low default risk and higher yields.**

Mortgage backed securities (MBS), which have already been depressed by the dismal housing market, are now further pressured by Treasury Secretary Geithner's recent announcement to sell another $142 billion from the Treasury's portfolio at a rate of $10 billion per month. Although these sales will account for less than 3% of the mortgage securities outstanding, it is the first step for the government to unwind its large holdings. Ironically these sales are in stark contrast to the purchases made by the Fed with QE2 and may be a precursor to the future shift in the government's monetary policy, in that it partially offsets the Fed's remaining purchases under QE2. **In any case, the pressure on the MBS market continues to discourage us from participating in this arena**.

During the final quarter of last year, we saw one of the worst performance quarters for municipal bonds. Several factors including industry analysts' dire predictions, the ending of the Build America Bond program, and outflows from municipal bond funds all contributed to the poor results. For our California taxed clients we continue to monitor the situation in Sacramento, and though Governor Brown's recent pull back from budget negotiations are not ideal, California tax revenue has steadily increased with the economic recovery. In addition, the various tools available to repay General Obligation bonds, and the large tax benefit for our higher income clients, make California General Obligation bonds a compelling investment consideration**. It is important to remember the current Federal tax cuts are only extended for two years and an anticipation of higher tax rates in combination with low valuations could renew interest in the municipal bond category.**

International Market

Global markets dominated the headlines in this recent quarter. In addition to the natural disasters in Japan and the uprisings in the Middle East and North Africa, the troubled European region still has not yet resolved its sovereign debt issues. **Although each headline conveys enough drama to severely impact markets, they have displayed a fair amount of resiliency leading us to believe that the world's economic recovery is strong enough to be self sustaining**. Despite all the negative news, most global markets had positive returns for the quarter. The MSCI EAFE Index finished the quarter almost 3 percent higher while the Emerging Market Index inched up nearly 1 percent.

The tsunami and earthquake in Japan not only had a tragic impact on life and property; it also brought the global supply chain, for certain industries, to a halt. These disruptions have caused companies to shut down assembly plants far removed from the disaster zone. Although longer term, this could result in an increase in business costs as companies opt to hold larger inventories, **the immediate impact should be eased once companies either reroute their global logistics chains or gradually bring their production back online.**

The Japanese are a resourceful and resolute people. Hard as it is to imagine, the devastation from this crisis could ignite an economic revival as the nation begins to rebuild. If history can provide a precedent, major earthquakes in Japan, in 1855, 1923, and 1995, coincided with, and perhaps caused, significant turning points in Japanese economic development. Some pessimistic analysts think otherwise, claiming that Japan is a nation ridden with debt, with Japan's public debt already twice the size of its GDP. Although the observation is valid, as far as it goes, they have failed to realize that while Japan is the world largest debtor, it is also the world's largest creditor. **With 95 percent of the Japanese public debt held domestically, there is little to no risk of capital flight. Additionally, the private sector has a financial surplus that exceeds the government deficit, while the country has $886 billion worth of dollar reserves to help fund the rebuilding effort without adding to the national debt**.

More than two months of unrest across the Middle East and North Africa has toppled the governments of Tunisia and Egypt, led to civil war in Libya, and caused deadly clashes in Yemen, Bahrain, and Syria. As turmoil in the region disrupted exports, the price of crude oil has hit a 29-month high, threatening to damage demand and spur inflation. However, much of the price increase came from stronger demand by emerging markets, not from reduced supply. In addition, on the supply side, the cost to quell political tensions by oil producing nations will force them to produce even more oil which **leads us to believe there will be ample supply of oil in the immediate- to middle-term to fuel further economic growth globally**.

The European sovereign debt situation was cause for concern throughout the quarter, producing volatility in European and developed markets. **We think that the worst is behind us as the EU, along with IMF, have demonstrated a workable model to deal with trouble as it arises.** Although Portugal and Greece were recently downgraded by Standard & Poor's, there were encouraging signs of stability as the ECB moved to suspend minimum credit rating thresholds for Irish debt and is now willing to accept all debt instruments backed by the Irish government as collateral against ECB loans.

Unemployment is falling around the world, company profits are rising and monetary policy is easing. Any reasonable investor would infer that the global economic recovery will continue. In fact, analysts are still predicting the global economy to grow between 4.5 to 5.0 percent for the year, which is about a full percentage higher than the average growth of the past two decades. However, the uncertainty and complexity of the evolving global economy compels us to monitor international developments carefully and closely.