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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

For the past two years, the economy has been recovering from a deep recession at a rapid, albeit slower than average pace. It is normal for this early stage of a cyclical economic expansion to occur at an unsustainable rate, as the economy quickly returns to equilibrium. Beyond this initial surge in economic activity the rate of growth decelerates to a pace which is sustainable.

From our perspective, we have reached this inflection point in the economic cycle. The first two quarters of 2011 have been characterized by slower growth, consistent with our expectations for this cycle**. As we have mentioned in the past, our forecast for this cycle is for slower real growth with higher inflation compared to recent past cycles**. So far inflation has been subdued, but we still believe it will become a factor before this cycle is over.

This forecast is based on our belief that economic activity is driven by the money supply. Since the financial crisis of 2008, vast sums of liquidity have been provided by Central Banks on a global basis. Much of this liquidity is not circulating. **While excess reserves held by banks, corporate cash, and household reserves stand near record high levels, the velocity of money hovers near historically low levels.**

As this money begins to circulate, it will stimulate economic activity and higher levels of inflation. Because of the severity of the recent financial crisis, the economic expansion in the U.S. will be characterized by slower real growth and moderately higher inflation. **Corporate profits should grow at a reasonable pace and U.S. equities should deliver returns close to their historical averages.**

The downside to slower economic growth is its vulnerability to shock. The second quarter produced numerous shocks. Perhaps the most significant was the Japanese earthquake/tsunami. It wasn't the meltdown of the nuclear reactor or the tragic loss of life and destruction which held the greatest economic significance. Rather, it was the short term, but global, disruptions to the supply chain**. In part, economists' forecasts for a stronger second half are based on the restoration of Japanese factories producing essential components to supply global manufacturing.**

Almost as significant, to a dampening of economic activity, was the higher price for energy. **While the curtailment of production of oil in Libya was not sufficient to cause global supply shortages, there were some delivery issues in Europe**. This caused some pricing inefficiencies which resulted in higher downstream prices in spite of abundant inventory.

The Greek debt drama returned again this year, casting a long shadow over the international banking community. **We didn't think the European sovereign debt issue was resolved last year, but we were surprised at the importance the financial markets placed on this recurring issue.** Stay tuned, this problem has not been resolved and will continue to grab headlines for years to come.

Finally, once again, weather was a factor in the second quarter. **The longer, colder spring which plagued much of the nation had a dampening effect on retail sales**.

The point we are trying to make is that most of the events that conspired to weigh on the market, during the second quarter, were transitory. They added to market volatility, they delayed some sales, but they had little lasting effect on earnings growth and valuation levels. Economic growth and higher stock prices are still ahead of us.

Fixed Income Market

The end of the second quarter also marks the end of QE2 (Quantitative Easing 2). The merits of the Fed's $600 billion buying spree will continue to be debated, but the end of the program will likely remove the pressure keeping short term interest rates low. In the past year due to QE2, the 2 year Treasury rate declined from 0.65% to 0.45%. **Currently, the Fed replaces its maturing holdings with new purchases, but once it starts to liquidate its holdings (estimated at $1.4 trillion and 17% of all US marketable debt), interest rates will start to rise**.

Recent weeks have seen increased volatility in the equity markets accompanied by economic indicators showing slower growth. This has resulted in increased volatility in the fixed income markets. Investors struggle between the need for higher returns and their aversion to risk. Spreads between corporate bonds and Treasuries have inched up slightly as risk aversion has a small edge over higher returns. **Corporations though continue to improve their fundamental financial situations and are anticipating additional capital expenditures in the coming quarters to further fuel the growth of their businesses.** Thus, we continue to seek opportunity in the corporate bond market for those offerings with the best balance of interest rates versus risk.

Despite the negative news and predictions by analysts, the municipal bond market has held up well in the first half of 2011. With sector total returns higher than aggregate taxable fixed income returns and a lower pace of defaults versus 2010, the municipal market continues to be a viable asset class within fixed income. **In California the state budget debate continues to rage on.** The Democrats passed a budget bill with a simple majority, bypassing their Republican counterparts, but even this bill with very optimistic revenue projections and expenditure deferrals was ultimately vetoed by Governor Brown. State Controller John Chiang was then thrown into the budget fray when he declared the budget was not balanced and thus required legislators to forfeit salary until the issue is resolved. There is therefore increased incentive for the politicians to come to some resolution, but **in the meantime California tax collections have increased 5.9% as of May reflecting higher retail sales and use taxes. Ultimately, these factors have helped to narrow the yields on 10 year CA G.O. bonds versus the national AAA high grade paper at 89bps versus 125bps at the beginning of the year**. Though diminished, CA municipals still provide some opportunity for our higher tax bracket clients.

International Market

European sovereign debt restructuring, supply chain disruptions from the disaster in Japan, and the slowdown of the Chinese economy have dominated headlines this quarter.

There is little question that Greece was close to becoming the first nation in the euro-region to default on its sovereign debt. However, an uncontrolled bankruptcy of a member country would not only endanger the recovery of the region but most likely would also impact the global economy as well. **Since the price is too high, the chance of EU nations and international bodies such as the IMF to let Greece default is remote at best**. At the same time, the Greek bailout is politically unpopular among the stronger EU nation's citizens such as the Germans; thus, the sometimes heavy handed political posturing.

Investors should be aware that despite all the negatives surrounding these troubled PIIGS nations, the stronger EU nations' economies are still growing. For example, Germany, the largest economy in the EU, has benefited from a weakened euro which has made its exports more attractive. German companies have stepped up hiring, sending unemployment to a two-decade low and boosted consumer confidence and household spending, prompting Germany's Bundesbank to raise its growth forecast for 2011 to 3.1% from 2.5%.

In our previous newsletter, we noted, the earthquake and tsunami in Japan caused power shortages which led to a temporary bottleneck in the global supply chain. During this past quarter, the media has often attributed the poor market performance to this supply chain issue. **Yet recent data suggests that the Japanese supply constraints are easing faster than expected and production is returning to normal.** Toyota, Japan's largest automaker, expects its North American plants to return to normal production by September, a full two months ahead of its earlier estimates. **The quarterly Tankan index of sentiment at larger manufacturers further validates this view, showing companies plan to increase hiring and investment as demand rebounds**. Industrial production has increased the most since 1953 and recent readings indicate Japan may be headed for a V-shape recovery.

Lack of growth has not been an issue for the Chinese economy; on the contrary, the more pressing concern is that its economy might overheat. Hence, the Chinese government has implemented various strategies to slow its runaway economy and keep inflation in check. **This engineered cooling down of the Chinese economy is a long-term positive in our opinion. There are signs the strategies utilized by the Chinese government are gaining traction.** Manufacturing in China expanded in June at the slowest pace since 2009, home prices eased in eight of the country's ten biggest cities for the same month, and commodity futures trading in China tumbled 30% in the first half, suggesting there is less need now to introduce any additional measures to tighten monetary policy.

A prudent investor should position his or her portfolio against the most probable scenario, which we believe is for the global economy to continue growing at a more normalized pace. **Hence, we continue to favor Asian and Latin American markets, look for opportunities in stronger EU nations, and search for opportunities to tap into Africa's vast potential.**