MARKET UPDATE

May 2012

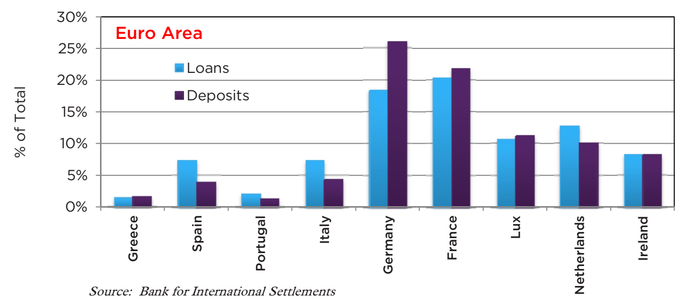
EUROPE'S TURMOIL

Just two months after Greece last restructured its debt obligations in March, Europe is facing a crisis of confidence over the repayment of those debts. The trouble boiled over after Greece's election failed to provide a clear majority, with a strong showing by the anti-austerity party. Reconciliation talks between the three leading Greek parties broke down, and markets reacted promptly. German Chancellor Merkel issued a swift rebuke to the parties, telling Greek voters to elect a coalition that will accept austerity measures as a necessary condition of ongoing financial support. Greece has scheduled a new election for June 17. At concern is the ability of debtor nations to honor their obligations, including Greece, Portugal, Spain, and Italy.

Although many European economies are more dependent upon government spending as a component of their GDPs than the US, the abilities of those economies to support the current levels of government spending are not sustainable. Conditioned through decades of political maneuvering, many European citizens have grown accustomed to a generous social welfare system. While it leads to societal benefits in some ways, in other ways, it is economically detrimental. Much of western Europe suffers from unemployment levels that would be crippling if seen in the US, and labor laws make it challenging for employers to markedly change their employment structures and staffing levels. France recently ousted President Nicolas Sarkozy, after rejecting his reforms, which raised the retirement age and aimed to trim social spending. The election was won by the Socialist Francois Hollande, who ran on a platform of returning the retirement age to 60 and largely expanding the government payroll.

Investors are concerned about the path that much of Europe seems intent on taking, and have backed away from those markets. Economic conditions in western Europe put much of the area in recession, and the near-term outlook is for continued weakness. What is most worrisome to investors is a potential domino effect if Greece fails to pay its debts. While the overall percentage of European debt attributable to Greece is small, the psychological effect looms large. A large percentage of Greece's debt is held within Europe, and constitutes a higher percentage of foreign debts held within countries that face an elevated potential of default, namely Spain and Portugal.

External Bank Loans and Deposits



Source: Bank for International Settlements

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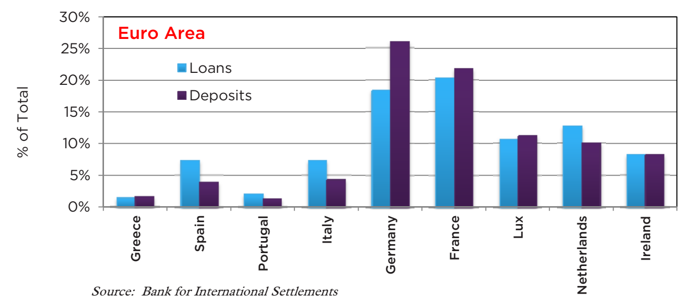
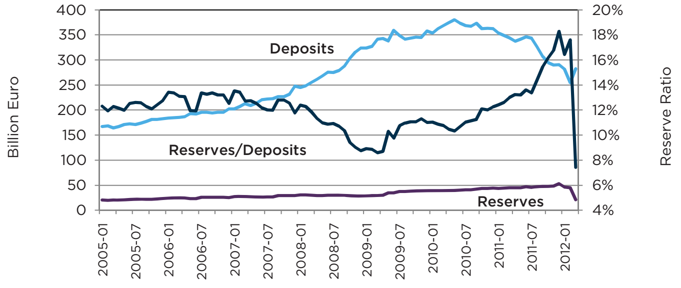


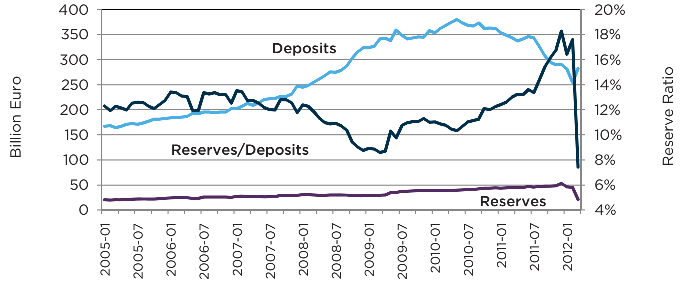
Source: Bank for International Settlements

Greek Bank Deposits



Source: Bank of Greece

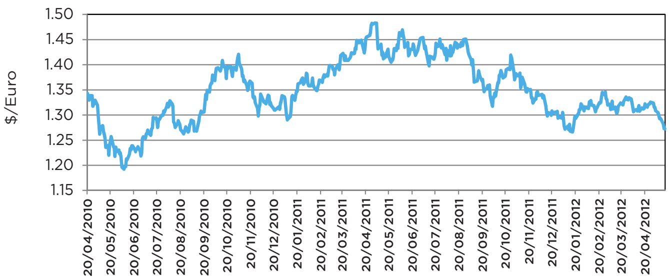
Greek Bank Deposits



Source: Bank of Greece

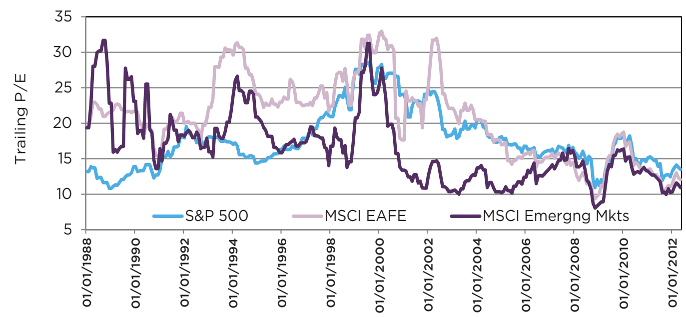
The Euro, although initially avoiding repercussions following the Greek election, has begun to slide. Initial support for the Euro came as European banks began selling foreign assets and bringing the funds back home, increasing Euro demand. Banks are trying to raise capital levels in anticipation of loan losses. Greece ran into trouble this week as citizens started a run on banks, emptying accounts as fear levels rose. Planning by Euro members for a potential Greek exit from the Euro incited the run. The European Central Bank has yet to weigh in, but may be called on to stabilize the Greek banking system. After the removal of nearly $1 billion in a single day, and with reserves of around $20 billion, Greek bank failures are a real hazard to the European financial system.

Euro Weakness



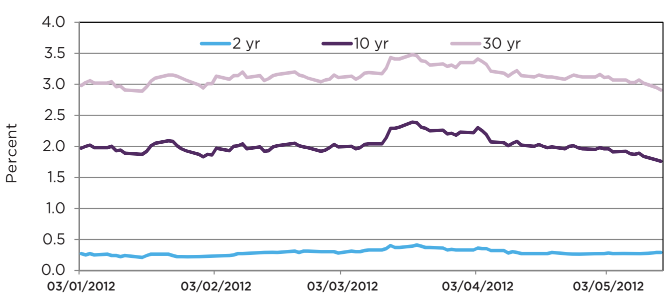
Source: Bloomberg

Market Valuations



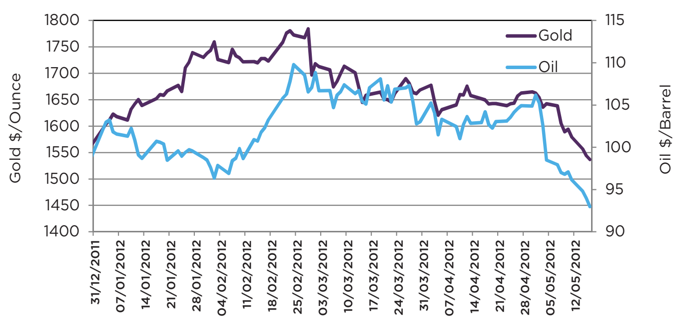
The flight to safety has re-emerged, with US 10-year Treasury bond yields rapidly falling to 1.76%. Gold, which had ridden high on a weak dollar and resilient Euro, fell to $1,537/ounce as Euro support crumbled. Oil also reacted to the strengthening dollar, falling to $92/barrel, although the drop brings the price more in line with demand. The risk trade appears to be sidelined for the moment as investors wait and see what the resolution will be with Greece and the rest of Europe. As it stands now, Europe looks to be in a recession, with negative news far outweighing positive news. The rest of the world will feel repercussions, especially if Greece is removed from the Euro in a disorderly fashion. Countries are already feeling the effects of waning European demand as the European banking system tightens. China's export level to Europe is weakening, and US exports to Europe are expected to fall. There are few positives to take from the situation with regards to European investments in the short-term, given the high uncertainty and potential Euro troubles.

Treasury Yields Move Lower



Source: US Treasury

Gold and Oil Sell Off



Source: Bloomberg

BOTTOM LINE

At the beginning of the quarter, we noted that there was a great deal of political uncertainty surrounding fiscal austerity measures and world growth given pending elections in a number of countries. The outcome of a few recent elections highlights the challenges many countries face today in seeking to promote growth while cutting spending. Amidst this challenging political climate and increased uncertainties, economic growth could disappoint relative to expectations. At the same time, equity valuations look reasonable, particularly for a safe haven market such as the US and most emerging markets, where the long term secular growth case remains intact. We recommend maintaining an underweight to developed international equities, relative to the world allocation as this market segment likely will continue to exhibit above average volatility. In this more volatile environment, interest rates in the US have moved lower. We believe it is important to maintain bond portfolios favoring high quality spread sectors to partially offset interest rate risk and to consider opportunistic allocations where appropriate.