

MONTHLY PERSPECTIVES

ECONOMY & MARKETS

“Come on everybody, let’s raise the roof.”

Alaska ACES fans hear this often from hockey announcer Bob Lester and respond immediately. Maybe we can get him to encourage the politicians in Washington to raise the debt ceiling?

We hit the federal debt ceiling (it’s \$14.3 trillion) on May 16th and according to Treasury Secretary Geithner have until August 2nd before all hell breaks loose and we either default on our debt or stop sending grandpa his social security check.

The federal government will take in about \$2.2 trillion in revenues and spend \$3.7 trillion this year. That’s a \$1.5 trillion deficit that will have to be financed by selling a similar amount of debt. That is if the debt ceiling is raised. Bet that it will be, but not after much gnashing of teeth, finger pointing and last minute histrionics.

Think about this, if you earned \$22,000 and spent \$37,000 each year you’d be in trouble. Eventually VISA would call and tell you “no mas.” You’d have to change your lifestyle and pay off debt. So far, the US government’s VISA – our foreign creditors — haven’t pulled the plug. They still buy US bonds. This is despite a warning by the S&P rating agency that America’s AAA rating is in jeopardy.

There is not a whole lot we can do about the deficit this year. But we need to solve the long term fiscal problem that has the US accumulating more than \$7 trillion in additional debt over the next decade (according to CBO estimates).

To solve this problem the Democrats want to raise taxes — but only on the rich who are defined as families earning more than \$250,000 per year. It’s not enough, not even close to solving the long term budgetary problems that generous benefit payments

and unfavorable demographics have created for the so called entitlement programs: Social Security, Medicare and Medicaid.

The Republicans are looking for budget cuts, but no new taxes. Laffer curve thinking is alive and well in the Republican Party. Their idea is that cutting tax rates will spur the economy and increase tax revenues. That won’t fly either.

The electorate is worried about deficits and debt. They want something done about it. But don’t raise taxes and don’t cut any programs near and dear to their hearts. That ain’t gonna happen either.

Everyone will have to share in the pain of deficit reduction and debt repayment. Look, we lived beyond our means for several years and took on too much debt. The current situation is unsustainable.

Winston Churchill was probably right when he said “The United States will do the right thing...after they’ve exhausted all other options.”

It looks more and more that this is an issue for the 2012 election campaign. There will be an increase in the debt ceiling in 2011, but no major reform. It’s a short term fix with the heavy lifting down the road.

Meanwhile, as my colleagues can attest, the stock markets “corrected” in May. US stocks lost -1.1% while the developed international markets fell almost -3%. Bonds gained, as interest rates fell, with the ten year treasury ending the month yielding 3%. Commodities pulled back sharply; WTI oil fell \$14 to \$102 per barrel, gold dropped \$21 to \$1,557 an ounce, and silver slid almost 20% to end May at \$38 an ounce.

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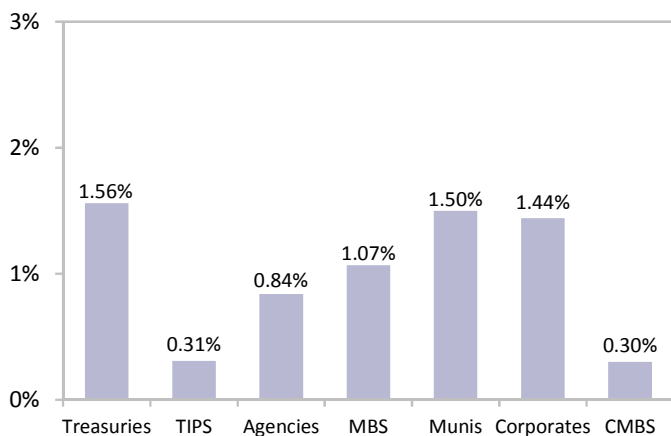
■ Fixed income markets continued their rally as interest rates declined for a second consecutive month.

■ The Federal Reserve minutes for the April 25th FOMC meeting highlighted discussion and debate on the exit strategy for quantitative easing. Participants agreed the

first step to take is to cease reinvestment into agency securities.

■ The Treasury market produced a +1.56% return with two and thirty year yields decreasing 14bps and 30bps respectively. The ten year yield is now sitting at 3.06%. There is still uncertainty with how the market is going to respond to the ongoing sovereign debt concerns in Europe and debt ceiling negotiations in the U.S.

May 2011 Bond Total Return



Barclays

■ TIPS underperformed the treasury market as break-evens declined across the curve but the sector produced a +0.31% return. The decrease in commodities and downward revisions in GDP deflated inflation expectations.

■ The corporate sector held up in the face of weaker economic data and gained +1.44% for the month. Companies still have strong credit metrics despite increased shareholder friendly actions such as stock buybacks and higher dividends.

■ The municipal market gained +1.50% in line with the Treasury market. It has performed well over the past 2 months although mutual funds have yet to see inflows. A still cheap market and light new issue calendar has brought in buyers.

■ In May, the reemergence of fears over the European sovereign debt crisis, and heightened uncertainty regarding the sustainability of global growth prompted investors to reduce their exposure to risky assets. Equities sold off (S&P 500 -1.1%), the dollar rallied (+1.5%) and commodity prices weakened (-5.1%).

■ EAFE (-3.0%) was the worst performing region, brought down by European equities. For the month, Spain declined (-7.0%), Italy lost (-8.6%), and Greece lost (-11.7%) of its value. New Zealand gave the best performance, advancing (+2.4%).

■ Emerging markets declined by -2.6%, marking the worst monthly performance in a year. Asia was the best performing region (-1.8%). Turkey (-13.0%), Hungary (-7.8%), and Russia (-7.7%) were amongst the worst.

■ REITs outperformed the broader markets posting a positive +1.4% return. YTD performance is widely dispersed across REIT sectors. Self storage is up +15% while Retail is down -1.5%.

■ Commodities sank on reversal of the so-called "inflation trade," as weaker economic data and a stronger dollar dampened future inflation expectations.

Total Return (%) as of May 31, 2011

	One Month	Three Month	Six Month	Twelve Month
Domestic Equities				
Large Cap S&P 500	-1.1	1.8	15.0	26.0
Mid Cap S&P 400	-1.4	3.8	18.1	33.0
Small Cap S&P 600	-0.9	4.7	17.9	29.7
International Equities				
Developed MSCI EAFE	-3.0	0.5	14.9	30.7
Emerging MSCI Emerging Markets	-2.6	6.3	9.8	28.8
Other				
Commercial Property S&P U.S. REIT	1.4	5.6	19.3	31.4
Commodities DJ-UBS Commodity	-5.1	0.3	13.6	33.0
Fixed Income				
Total Bond Market Barclays Aggregate	1.3	2.7	1.9	5.8
1-3 Yr U.S. Treasury/Agency Barclays 1-3 Gov	0.4	0.8	0.7	1.9
Int'l Treasury Barclays Global Tsy ex-US	-1.0	4.7	9.0	17.1



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