INVESTMENT MANAGEMENT

# Monthly Economic Update & Market Review

July 2010

*Investment Strategy Committee*

*as of*

*July 1, 2010*

MARSHALL FUNDS | SEPARATE ACCOUNT STRATEGIES | ASSET ALLOCATION STRATEGIES | ALTERNATIVE INVESTMENTS

# *Summary of Current Views*

If the first half of 2010 was a World Cup soccer match, investors might be inclined to view the score as a 0 – 0 tie, with penalties. A balanced account of large cap U.S. equities and high quality bonds showed mixed performance through the first six months of the year. The ***S&P 500 return was negative while bonds, particularly US Treasuries, were positive*** (obviously portfolio returns were highly dependent upon the allocation within each asset class). Still, for discussion purposes call it a draw as we head into the locker room for this half-time review, despite many "shots on goal" that brought us to our feet. Whether you blame the goose egg on poor field position, bad calls by the refs, or simply a very worthy opponent, scoring has not been easy in the first half of 2010. June serves as a good example for this year-to-date analysis, with both equities and corporate bonds enduring ups and downs with no obvious trend.

The lack of scoring is not due to poor fundamentals. We continue to hear rather upbeat comments from companies about their own business, most enjoying the efficiency with which they're operating. Even modest top line revenue growth continues to fall nicely to the bottom line, leading to higher earnings. Yet, this has not translated to higher P/E multiples or generally higher stock prices. From a credit perspective, corporate balance sheets are as strong and liquid as they've ever been; a primary reason that corporate default rates, even among high yield credits, have fallen precipitously over the past year. Yet, credit spreads on corporate bonds widened in the last two months leading to the underperformance of corporates relative to Treasuries.

It is the ***macro concerns that have trumped company fundamentals and caused heightened market volatility and investor anxiety***. When European debt problems seem to fade from the headlines, some other geopolitical event, either in Washington or elsewhere in the world, moves into the spotlight. Unfortunately, we don't expect these macro concerns to fade from the forefront until the economic picture improves. Historically, a strong economy has helped erase a multitude of other concerns. While we have now had three quarters of GDP growth in the U.S., averaging 3.6% per quarter, the pace of growth globally is likely to slow over the next six months. Europe is now engaged in fiscal austerity, to one degree or another, while much of Asia is focused on either monetary (China) or fiscal (Japan) austerity as well. Here at home, the federal government has yet to adopt fiscal prudence, but state and local governments are definitely in the mode of restraining spending. Conventional monetary policy is already as stimulative as it can be, and if the U.S. ultimately moves toward fiscal austerity, as it must at some point, the primary engine of recent growth, government stimulus, not only becomes less potent, but becomes a drag on growth.

The Federal Reserve has signaled some moderation in their growth forecast as well. Prospects for a Fed tightening have now been pushed out until mid-2011 by most economists. Investors searching for a higher income stream are likely to remain frustrated. Instead, the steep yield curve will likely continue to encourage investors to extend maturities in search of yield. The wider credit spreads available in corporate issues, particularly high yield, only strengthens our conviction on the corporate sector. We also see slow, but steady, credit improvement in the municipal sector for those seeking tax-exempt income. We believe the favorable fundamentals for equities remain supportive for higher prices. When? And by how much? Well, that would take some of the fun out of the game now, wouldn't it!

## *The current environment - at a glance…*

| | |
|---|---|
| **Spotlight – pgs 3-4**<br><br>This month, we offer some commentary on the current state of consumer spending by looking at historical trends. Also, some initial thoughts on the implications of the Gulf oil spill, and the resultant new factors in investment analysis. | **Large Cap Equities – pg 11**<br><br>Declines in the S&P 500 and other indices in June were driven by negative developments and economic expectations. Outperformance by "high quality" stocks provided glimmers of hope. |
| **U.S. Economic Growth– pg 7**<br><br>Mixed data on the economy suggests slower growth rather than a double-dip recession. Manufacturing is a bright spot, amid worries of retail sales and tax policy. | **Mid- and Small-Cap Equities – pg 12**<br><br>Lower market capitalization stocks followed larger stocks with declines in June. Earnings reports for the second quarter will be monitored closely for clues to future trends. |
| **Employment and Inflation/Deflation – pg 8**<br><br>The employment picture remains an area of frustration for policymakers and economists. Wages remain under pressure, and are likely to keep inflation in check. | **Fixed Income, Taxable – pg 13**<br><br>Treasury yields continued to fall, hitting new lows in several key areas. Economic concerns whipsawed corporate bonds. Mortgage rates fell, but demand remains muted. |
| **Housing – pg 9**<br><br>Momentum in the housing markets appears to have stalled, despite a slowdown in delinquencies. The inventory of foreclosed properties is likely to hold down average home prices. | **Fixed Income, Tax-exempt – pg 14**<br><br>Despite concerns over state and municipal finances, tax revenues are generally improving and necessary spending cuts are being implemented successfully. Demand for tax-exempt bonds is expected to continue. |
| **International – pg 10**<br><br>Several developments around the globe are worthy of mention: stress tests on European banks, currency moves by China, fiscal austerity and the recent G-20 meeting, and interest rate tightening by Canada. | **Alternatives – pg 15**<br><br>Prices of commodities are mixed, reflecting economic uncertainty. Allocations by large pension funds to alternative investments are being influenced by liquidity and leverage considerations. |

# *Financial Spotlight: The Health and Wealth of the U.S. Consumer*

The health of the consumer experienced a dramatic blow beginning in 2008. Multiple hits came from an historic drop in home prices, (most individuals' biggest investment), high unemployment and a stock market decline. The collapse of Lehman Brothers and near collapse of the banking system made it more difficult for the gainfully employed consumer to obtain financing for big items such as autos and homes. These elements conspired to severely damage both the ability and willingness of consumers to spend on discretionary items both large and small. In the last few recessions, the growth of consumer spending has slowed to zero, but not gone negative. This recession was different due to the factors mentioned above, with the result that consumer spending materially contracted on an absolute basis for the first time in decades.

In the near term, some of the volatility in consumer spending can be explained by market volatility and the lack of confidence it breeds. Remarkably, during the last two years there has been a 96% correlation between monthly retail sales and stock market returns. In the long term, the principal factors influencing consumer spending growth are employment, net worth and wage growth. In order for wage growth to improve, companies have to believe there is tightness in the labor markets, something we have not seen across the board yet. Additionally, due to the low market returns over the last decade, investors need to save more to meet retirement goals; this may continue to drive up the savings rate, thereby dampening growth in consumer spending. With the exception of World War II, the savings rate has averaged 5% over the last 80 years. It can be shown from historic data that savings rates fall when net worth is rising and vice versa. For example, during the equity bull market of the 80's and 90's, the savings rate fell by nearly half. This trend has now reversed and the savings rate is near its long term average of 5%. While current income can propel consumer spending, another significant source of funds is consumer net worth. During the last recession, the consumer's net worth suffered a large blow from the bear markets in real estate and equities, which resulted in a substantial loss of confidence.

The last few years has proven to be exceptionally challenging for consumer health. However, history suggests that consumer propensity to spend is rarely diminished, and is likely to grow in tandem with personal income and net worth. Mortgage rates falling to an historic low again this month is another positive for restoring consumer health. Additionally, disposable personal income has been rising while the costs of staples like rent and gasoline have been relatively stable. Accordingly, using history as a guide, the worst may be over and the outlook for future growth in consumer spending is more positive.

## *Spotlight: Gulf of Mexico Oil Spill and its Implications for Investors*

The tragic events in the Gulf of Mexico related to the Deepwater Horizon disaster continue to unfold, and is likely to continue evolving for some time. News coverage has been thorough, with political and economic implications. Our initial analysis would suggest modest impacts on the general U.S. economy, with deeper reverberations for the Gulf Coast states and selected industries. However, it is certain to have profound impacts on the oil industry. Attempting to remove the emotions from detailed analysis, we offer the following initial observations that are likely to unfold over the near future, and which enter into our investment thinking.

Increased regulatory burdens will impact drilling on the outer continental shelf, limiting current activity and new permits for oil exploration. The International Energy Agency, based in Paris, projects little near-term impact; however, "if new offshore oil development is delayed by one or two years, the impact would be 100,000 barrels a day to 300,000 barrels a day by 2015." Should other countries follow suit on restrictions, the impact could become far more significant.

Clearly, insurance premiums, capital and regulatory costs, and potential liability concerns will be larger factors into capital investment decisions by large and small firms. Curtailments may extend beyond the Gulf of Mexico to other projects in Alaska and Virginia. Service and drilling companies will likely restructure contracts to refine definitions on risk and liability. More partners are likely to be included in projects to diversify capital project risks.

Despite the creation of a $20 billion escrow fund by BP, Congress is likely to allow an increase, or completely remove, any cap on liabilities associated with oil exploration and drilling.

Tax-related incentives for exploration are likely to be curtailed, and proposals for new taxes on income and royalties are likely to be proposed. The Oil Spill Liability Trust Fund, originally created in 1986, will likely grow via an increased "barrel tax." Currently, a tax of 8 cents per barrel of oil produced in or imported into the U.S. is levied. Congress is reviewing proposals to increase this tax; discussions in the House center around 41 cents, and the Senate has discussed 48 cents per barrel.

The National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling will begin meeting in mid-July; its report is not expected until 2011.

Communities impacted by the spill, direct and indirect, will face a new factor in budget considerations and financing constraints.

## *Monthly Performance Review*

| **Equity Indices** | 10-Jun | 3-Mos. | 6-Mos. | YTD | 12-Mos. | 3-Yrs | 5-Yrs |
|---|---|---|---|---|---|---|---|
| S&P 500 Index | (5.23) | (11.43) | (6.65) | (6.65) | 14.43 | (9.81) | (0.79) |
| Dow Jones Industrials Index | (3.43) | (9.36) | (5.00) | (5.00) | 18.94 | (7.39) | 1.66 |
| NASDAQ Composite | (6.55) | (12.04) | (7.05) | (7.05) | 14.94 | (6.77) | 0.50 |
| Russell 1000 Index | (5.57) | (11.44) | (6.40) | (6.40) | 15.24 | (9.54) | (0.56) |
| Russell 1000 Growth Index | (5.51) | (11.75) | (7.65) | (7.65) | 13.62 | (6.91) | 0.38 |
| Russell 1000 Value Index | (5.63) | (11.15) | (5.12) | (5.12) | 16.92 | (12.32) | (1.64) |
| Russell MidCap | (6.25) | (9.88) | (2.06) | (2.06) | 25.13 | (8.19) | 1.22 |
| Russell MidCap Growth Index | (6.36) | (10.20) | (3.31) | (3.31) | 21.30 | (7.53) | 1.37 |
| Russell MidCap Value Index | (6.14) | (9.57) | (0.88) | (0.88) | 28.91 | (9.44) | 0.71 |
| Russell 2000 Index | (7.75) | (9.92) | (1.95) | (1.95) | 21.48 | (8.60) | 0.37 |
| Russell 2000 Growth Index | (6.71) | (9.22) | (2.31) | (2.31) | 17.96 | (7.54) | 1.14 |
| Russell 2000 Value Index | (8.73) | (10.60) | (1.64) | (1.64) | 25.07 | (9.85) | (0.51) |
| MSCI EAFE Index | (1.21) | (13.97) | (13.23) | (13.23) | 5.92 | (13.38) | 0.88 |
| MSCI Emerging Mkts Index | (0.73) | (8.37) | (6.16) | (6.16) | 23.15 | (2.50) | 12.73 |
| | | | | | | | |
| **Alternative Indices** | 10-Jun | 3-Mos. | 6-Mos. | YTD | 12-Mos. | 3-Yrs | 5-Yrs |
| DJ UBS Commodity Index | 0.32 | (4.81) | (9.60) | (9.60) | 2.75 | (8.36) | (1.32) |
| DJ Wilshire REIT Index | (5.39) | (4.23) | 5.17 | 5.17 | 55.46 | (10.33) | (0.35) |

Source: Dow Jones; Barclays Capital; Russell Investments; Bloomberg

## *Monthly Performance Review*

| **Fixed Income Indices** | 10-Jun | 3-Mos. | 6-Mos. | YTD | 12-Mos. | 3-Yrs | 5-Yrs |
|---|---|---|---|---|---|---|---|
| Barclays Aggregate Index | 1.57 | 3.49 | 5.33 | 5.33 | 9.50 | 7.55 | 5.54 |
| Barclays G/C Interm. Index | 1.36 | 2.97 | 4.56 | 4.56 | 8.29 | 6.97 | 5.26 |
| Barclays US Treasury Index | 1.86 | 4.68 | 5.86 | 5.86 | 6.67 | 7.81 | 5.38 |
| Barclays High Yield Index | 1.24 | (0.11) | 4.51 | 4.51 | 26.77 | 6.54 | 7.17 |
| Barclays 1-10-yr Muni Index | 0.28 | 1.81 | 2.68 | 2.68 | 6.63 | 6.10 | 4.57 |

**Month-end Market Levels**

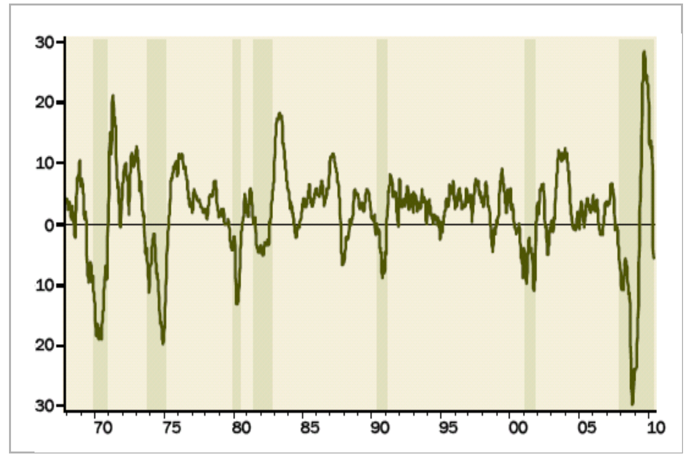
| **Bond Yields** | 10-Jun | 10-May | 10-Mar | 09-Dec | 09-Jun |
|---|---|---|---|---|---|
| Fed Funds Rate | 0.13 | 0.13 | 0.13 | 0.13 | 0.13 |
| 3-month T-bill yields | 0.18 | 0.16 | 0.15 | 0.05 | 0.18 |
| 2-yr Treasury yields | 0.61 | 0.77 | 1.02 | 1.14 | 1.11 |
| 5-yr Treasury yields | 1.78 | 2.09 | 2.54 | 2.68 | 2.55 |
| 10-yr Treasury yields | 2.93 | 3.29 | 3.83 | 3.84 | 3.53 |
| | | | | | |
| 5-yr Agency | 2.12 | 2.33 | 2.78 | 2.95 | 3.00 |
| 5-yr A-rated ML Corp Master | 3.71 | 3.93 | 3.99 | 4.50 | 5.63 |
| 5-yr AAA Muni yields | 1.66 | 1.59 | 1.77 | 1.57 | 2.07 |
| | | | | | |
| **Other Markets** | 10-Jun | 10-May | 10-Mar | 09-Dec | 09-Jun |
| WTI Crude Oil ($/bbl) | 75.63 | 73.97 | 83.76 | 79.36 | 69.89 |
| Gold (US$/troy oz) | 1,239.30 | 1,215.00 | 1,114.50 | 1,096.95 | 941.30 |
| US$/Euro | 1.22 | 1.23 | 1.35 | 1.43 | 1.40 |

Source: Dow Jones; Barclays Capital; Russell Investments; Bloomberg

**U.S. Economic Growth:**

- The pace of economic growth appears to be slowing as we enter the second half of 2010. One timely gauge of economic expectations is the ECRI Weekly Leading Index, which has fallen sharply from its April peak (Chart 1). While the percentage change in the index has turned negative, it is signaling a slower pace of growth at this point rather than a double-dip recession.
- Many sectors of the economy remain quite robust, however, as firms continue to rebuild inventory and demand from emerging economies is strong. The Fed's Beige Book report showed that all twelve Fed districts had improved activity for the first time since October 2007. Manufacturing is among the strongest segments of the economy, evident in the sharp recovery in industrial production YoY (Chart 2). U.S. rail traffic tells a similar story with volume up more than 20% on a YoY basis, although the rate of improvement is slowing.
- Recent data on retail sales data have been mixed. The International Council of Shopping Centers reported chain-store sales rose 2.6% YoY in May, yet advanced retail sales reported from the Census Bureau fell 1.2% MoM. The choppiness in retail sales will likely persist until the employment picture improves.
- Company executives express growing concern about the impact that rising income tax rates may have on economic activity in 2011.

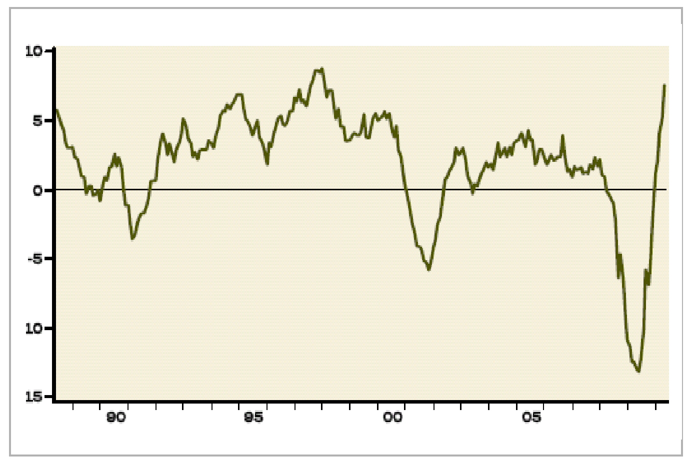
**Chart 1: ECRI Weekly Leading Index: Growth Rate (%)**




Shaded areas represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

**Chart 2: Industrial Production (YoY % Change)**




Source: Gluskin Sheff

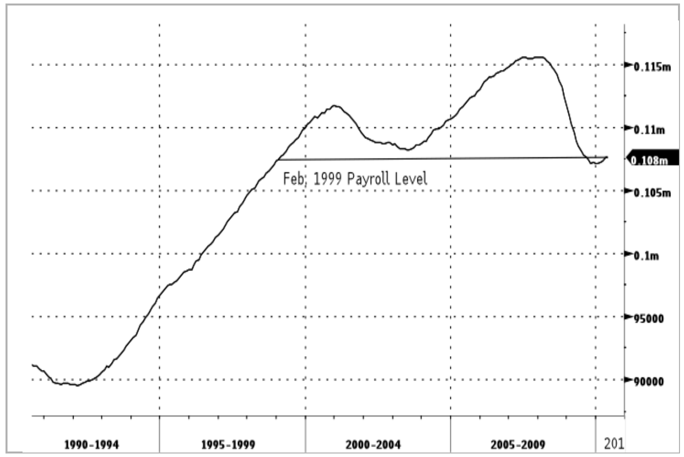
# Economy & Markets

Monthly
Economic Update
& Market Review

**Employment and Inflation/Deflation:**

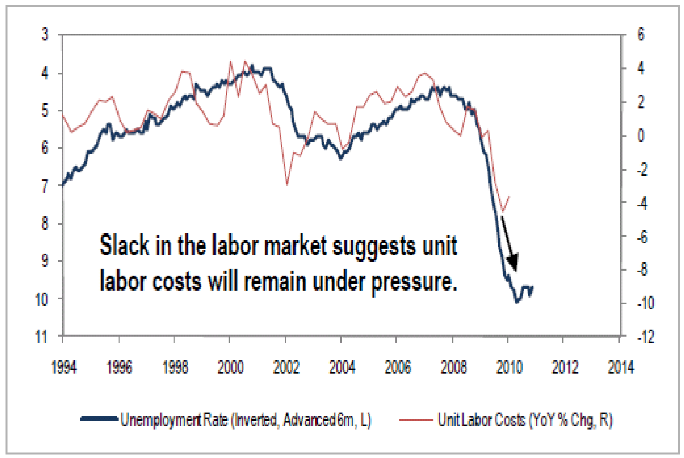
- While the unemployment rate for May fell to 9.7% from 9.9%, the report was nonetheless disappointing. The reason for the drop in the unemployment rate was 332,000 workers left the job market. A total of 431,000 new jobs were added, but most were part-time census workers. Private sector payrolls grew by just 41,000.
- Private sector hiring has been positive, but modest. A total of 8.47 million private sector jobs were lost during the recession, and just 495,000 have returned so far (Chart 3). In fact, total private sector payrolls are just at 1999 levels, further evidence of the weak backdrop.
- Congress has been unable to reach an agreement on the extension of jobless benefits, hung up on the ability to offset the cost with cuts elsewhere. The Labor Department estimates that 1.3 million will have lost their benefits over the four weeks ending June 26 due to this delay. Most believe the extension will be granted with retroactive benefits for those who remain unemployed.
- Deflation concerns trumped inflation fears as fiscal austerity measures in Europe and among the U.S. states will put downward pressure on prices. Wage pressures remain nonexistent across most industries. The strong historical correlation between the unemployment rate and unit labor costs (Chart 4) suggests wages may experience downward pressure.

**Chart 3: Private Sector Payrolls**




Source: Bloomberg

**Chart 4: Unemployment and Unit Labor Costs**

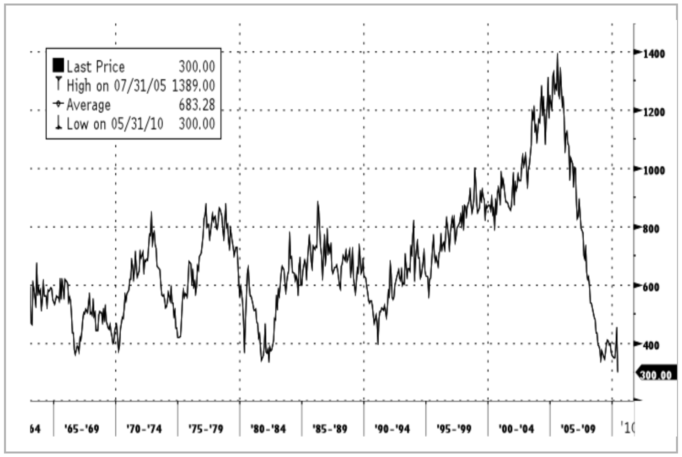



Source: Strategas Research

**Housing:**

- Housing activity appears to have fallen off even further than expected following the expiration of the first time buyers tax credit in April. New home sales fell to a record low 300,000 annualized pace, off 32.7% MoM (Chart 5). Existing home sales fell less, declining 2.2% MoM, but still near the 5.85 million average pace over the last decade.
- Fears of a double-dip in housing have risen with the latest data as prices have also come under some pressure with the slowing sales pace. The Commerce Department reported that median home prices are 9.6% lower YoY, to $200,900 and the lowest level since December 2003.
- The slow pace of sales and still rising inventories has kept the months supply of home inventories elevated. There is an 8.3 month supply of existing homes at the current pace of sales (Chart 6), and new homes of 8.5 months. The shadow inventory of bank foreclosed properties not yet listed also looms on the horizon.
- On a slightly more positive note, the Federal Housing Authority reported a slowing in delinquencies. The percentage of homeowners that were at least 90 days late with their mortgage payment fell to 8.5% in April, the third month of improvement and down from 9.4% in January.

**Chart 5: New Home Sales – Annualized (000's)**




Source: Bloomberg

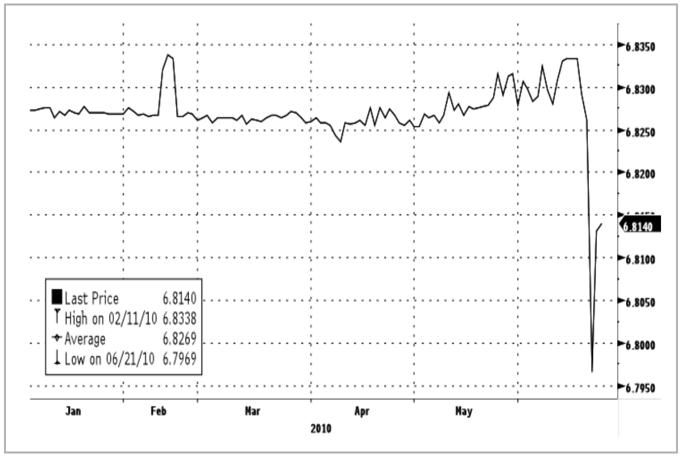
**Chart 6: Existing Home Sales – Months Supply**


Source: Bloomberg

**International Developments:**

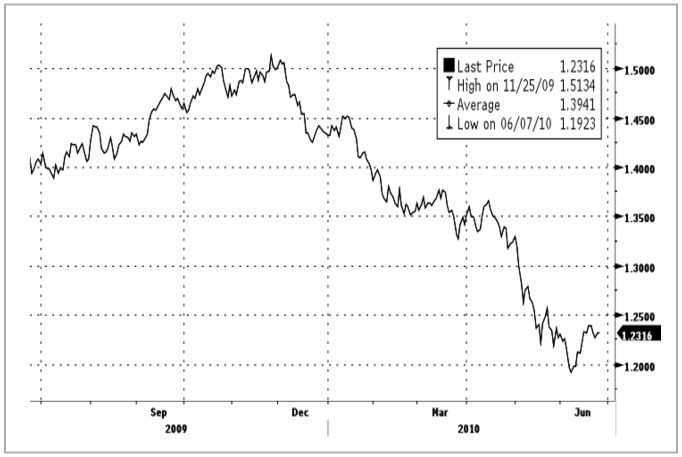
- European governments agreed to run stress tests on their banks, just as the U.S. did in early 2009, to identify those that may need additional capital. It's expected they would release the results of the 25 biggest, cross-border banks first to help ease investor fears regarding the viability of banks in the region. Results are expected to be released starting in July.
- The timing of China's decision to break the yuan's peg to the dollar was a surprise to the markets, coming just prior to the G-20 meeting in June. While few details were given by Chinese authorities the initial reaction was moderate as the dollar fell just 0.5% against the yuan (Chart 7) on the first trading day after the announcement. It does appear that China wants more currency flexibility which should ultimately help boost domestic consumption at the expense of Chinese exports.
- Fiscal austerity efforts are spreading across Europe, as noted in the G-20 meeting. In addition to Greece and other southern euro-zone countries, Germany and the U.K. both announced plans to cut spending to narrow or eliminate budget deficits over the next several years. After falling to a low of 1.19 vs. the U.S. dollar, the euro stabilized and rallied into month end (Chart 8).
- Canada became the first G-8 country to hike interest rates this cycle. Their central bank raised rates 25 bps to 0.50% based on strong growth, up 6.1% in 1Q, more than twice that of the U.S. in the same period.

**Chart 7: U.S. $ in Yuan**




Source: Bloomberg

**Chart 8: Euro Spot Price in U.S. $**




Source: Bloomberg

**Equity Market:**

- The S&P declined 5.2% in June as equity markets traded lower due to unimpressive leading indicators (see pages 7-9), poor housing data and headline fears of a double-dip recession. On the political front, Congress moved forward with softer-than-anticipated banking reform and the gulf oil spill continues to grow; both remain on the forefront of investors' minds.
- Stocks took their cue from technicals during June due to the lack of companies reporting earnings. The S&P traded below the May 25th intra-day low (1040) and established a new YTD closing low on June 30th (1030). Some of the more cyclical economic bellweathers (Transports and Semiconductors) broke below their important 200-day moving averages late in the month.
- Higher-quality stocks have modestly outperformed lower-quality stocks YTD. However, higher-quality stocks have significantly outperformed since the market peak of April 23rd as investors seek out companies with a greater certainty of earnings and stronger balance sheets (Chart 10). We define high quality as companies exhibiting high and stable ROEs, with good sales and margin trends, that have consistently improved ROE, and repeatedly have high net cash to market capitalization. High quality stocks held up the best in Consumer Staples while low quality sold off the most in Consumer Discretionary.

**Chart 9: S&P 500 Sector Performance**

| Sector | Weight | 1 Mo | YTD | 1 Year |
|---|---|---|---|---|
| Consumer Discretionary | 10.1% | -9.7% | -1.6% | 28.1% |
| Consumer Staples | 11.5% | -2.3% | -2.8% | 13.7% |
| Energy | 10.7% | -5.7% | -12.2% | 2.1% |
| Financials | 16.3% | -5.9% | -3.7% | 16.9% |
| Health Care | 12.0% | -1.7% | -8.8% | 9.0% |
| Industrials | 10.4% | -6.9% | -0.9% | 27.4% |
| Info Technology | 18.7% | -6.2% | -10.6% | 15.8% |
| Materials | 3.4% | -6.9% | -12.9% | 13.7% |
| Telecom Services | 3.0% | -0.2% | -8.4% | 3.9% |
| Utilities | 3.6% | -0.6% | -7.1% | 5.7% |
| Total | | -5.2% | -6.6% | 14.4% |

Source: Bloomberg, Wilshire Atlas

**Chart 10: Quintile of Quality for S&P 500 Index**

| | Return % | |
|---|---|---|
| | 12/31/09 - 06/30/10 | 04/23/10 - 06/30/10 |
| Q1 High Quality | -1.9 | -11.5 |
| Quintile 2 | -2.3 | -12.1 |
| Quintile 3 | -3.5 | -12.6 |
| Quintile 4 | -2.4 | -16.0 |
| Q5 Low Quality | -5.1 | -21.9 |

Source: Wilshire Atlas, M&I Quantitative Strategies Group

## Mid & Small Cap Equities:

- The secondary stocks bore the brunt of investors' risk reduction posture during the month, as the Russell 2000 index declined 7.8% and the Russell Mid-cap index fell 6.2%. Year-to-date, both small and mid-caps are down about 2% maintaining a significant return advantage over large-caps.
- In Mid-caps (Chart 11), the fears of a waning consumer and global slowdown were most evident in the large declines in Consumer Discretionary (-10.4%) and Materials (-8.6%). The perceived safe-haven sectors of Consumer Staples (-2.0%) and Utilities (-1.5%) held up the best. Both Growth and Value styles performed similarly during the month.
- In Small-caps (Chart 12), a similar pattern unfolded for the month but with larger declines of -14.0% and -11.0% respectively, for Consumer Discretionary and Materials. Small Growth outperformed Value by about 2% during the month as the Technology and Health Care sectors held up better and comprise about half of the Growth index.
- The second quarter earnings reports are just around the corner with the Street looking for significantly better earnings and sales growth in small and mid vs. large. Investors will also be looking to hear companies address the European situation and the effect on their business going forward.

**Chart 11: Russell Mid Cap Sector Performance**

| Sector | Weight | 1 Mo | YTD | 1 Year |
|---|---|---|---|---|
| Consumer Discretionary | 14.5% | -10.4% | 0.4% | 33.0% |
| Consumer Staples | 6.6% | -2.0% | 2.5% | 20.8% |
| Energy | 7.8% | -5.1% | -7.9% | 19.8% |
| Financials | 19.1% | -5.7% | 2.0% | 30.1% |
| Health Care | 9.5% | -3.2% | 1.6% | 24.9% |
| Industrials | 12.8% | -7.1% | -2.4% | 22.9% |
| Information Technology | 14.5% | -7.3% | -6.9% | 26.1% |
| Materials | 6.2% | -8.6% | -5.9% | 25.4% |
| Telecomm Services | 1.9% | -3.2% | -1.0% | 23.4% |
| Utilities | 7.3% | -1.5% | -6.2% | 10.8% |
| Total | 100.0% | -6.2% | -2.1% | 25.2% |

Source: Bloomberg, Wilshire Atlas

**Chart 12: Russell 2000 Sector Performance**

| Sector | Weight | 1 Mo | YTD | 1 Year |
|---|---|---|---|---|
| Consumer Discretionary | 13.7% | -14.0% | 1.8% | 33.9% |
| Consumer Staples | 3.2% | -4.3% | 0.8% | 21.3% |
| Energy | 5.4% | -7.3% | -10.9% | 22.0% |
| Financials | 21.4% | -7.2% | 0.8% | 21.2% |
| Health Care | 13.8% | -5.6% | -3.1% | 13.2% |
| Industrials | 15.6% | -8.1% | -2.2% | 19.5% |
| Information Technology | 17.8% | -5.6% | -2.8% | 20.9% |
| Materials | 4.8% | -11.0% | -8.0% | 38.1% |
| Telecomm Services | 1.0% | -4.7% | -11.7% | 1.5% |
| Utilities | 3.2% | -0.7% | -0.7% | 13.7% |
| Total | 100.0% | -7.8% | -2.0% | 21.4% |

Source: Bloomberg, Wilshire Atlas

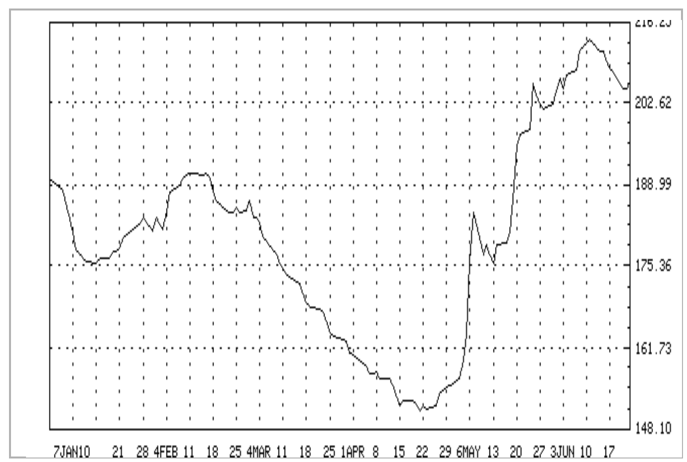
**Fixed Income Market – Taxable:**

- Treasuries continue to benefit from the flight to safety. On June 22nd the 2-year Treasury issue came with a yield of 0.738% (a new issuance record low), and the 2yr yield reached a record low (Chart 13). The Treasury curve has flattened over 40 bps since February (2yr vs 10yr Treasury curve).
- Three month Libor was essentially flat through June at 0.54% after a rapid rise of approximately 30bp since March. Rates remain well below the 5%+ yields during the financial crisis but are evidence of heightened financial system risk.
- The corporate new issue market slowed from May with a 49% decline over the first week of June. Investment grade corporate credit spreads widened by 11 bps over the first part of June, but moved back to unchanged (Chart 14). High yield generally widened. Financial regulatory reform, cresting economic indicators, the repercussions from the Gulf oil spill and the fiscal situation in the EU overhang the market.
- Agency MBS tightened to Treasuries during the month of June after reaching their cheapest level to Treasuries in late May. Despite low absolute rates, refinance activity remains muted and the supply of new mortgage products continues to dwarf demand. As June ends, mortgages remain slightly cheap to LIBOR and neutral to Treasuries.

**Chart 13: 2-Yr Treasury Note Yield, Last 12 Months**


Source: Bank of America Merrill Lynch, Bloomberg

**Chart 14: BofA/Merrill High Yield Master II Index (OAS)**

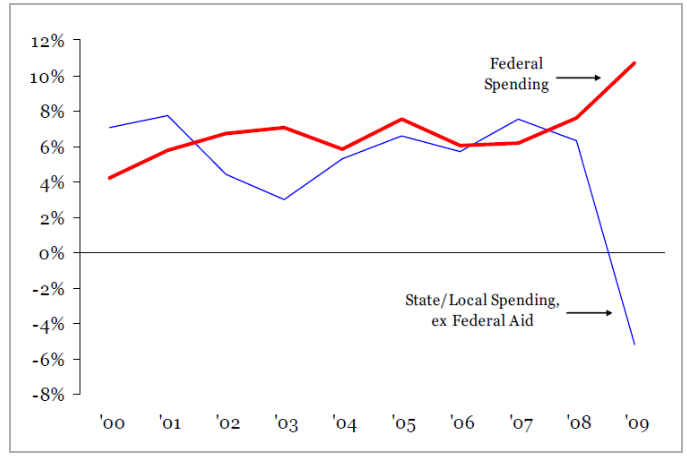



Source: Bank of America Merrill Lynch, Bloomberg

**Fixed Income Market – Tax-exempt:**

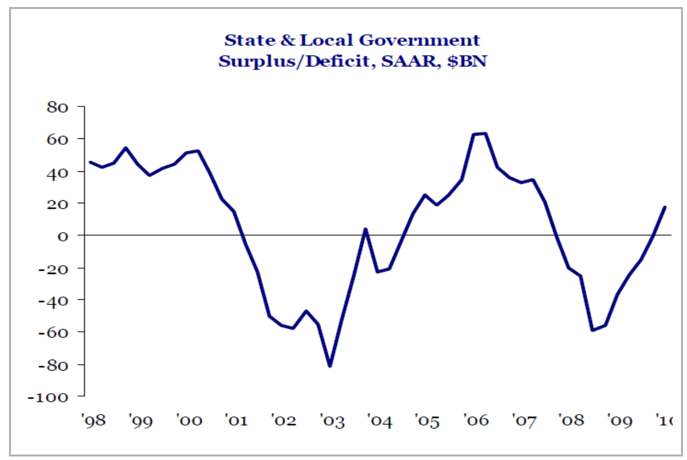
- Warren Buffett added to credit concerns in the municipal market last month when he warned that the federal government may someday have "to step in and help" states and major municipalities. He said it's uncertain "how the federal government will act over time," therefore adding to the uncertainty of what ratings are appropriate for municipal credits.
- Despite his comments, municipal yields were stable to lower on the month. There is ongoing evidence that municipalities are making the difficult spending decisions that are necessary, in contrast to the federal government (Chart 15). More cuts will be needed until tax revenues increase further, but the process is well underway.
- Tax revenues are improving despite perceptions to the contrary. State and local governments had a $17B surplus in 1Q, the first surplus since 3Q of 2007 and the trend is improving (Chart 16). In addition, there is still $47B of federal aid left in the pipeline yet to be distributed.
- The municipal yield curve remains very steep, encouraging investors to extend maturities. Municipal fund flows have slowed, but remain positive. Despite record flows over the past 18 months, Treasury and municipal holdings as a percentage of total household assets (at 3%) are just one-half the allocation they were in the low rate environment of the 1950's.

**Chart 15: Federal, State& Local Spending (YoY % Change)**




Source: Strategas Research

**Chart 16: Municipal Government Surplus**




Source: Strategas Research

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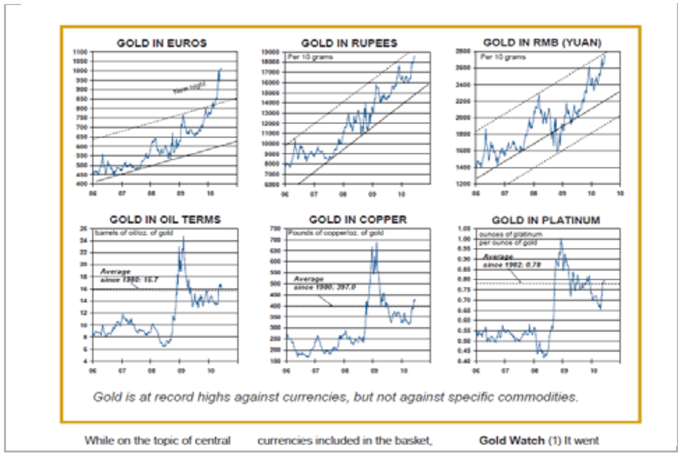
## Alternative Markets

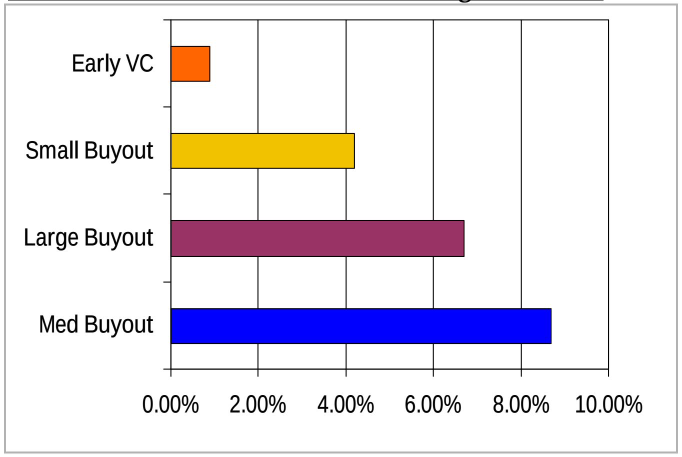
- For many macro hedge funds, trend trading is systematized, but in the past two months, bond markets and equity markets reversed sharply, leaving these trend followers with modest losses for the year. The US Treasury bond rally hurt, as did the two month correction in the equity markets. Though gold has performed well, its gains were offset by losses in other commodities and diminishing momentum. As Chart 17 indicates, gold remains strong against all currencies but has lost some of its relative strength vs. oil, copper, and platinum.
- The "denominator" effect has been much discussed by investors and fund managers of alternatives. It describes the phenomena in the wake of the credit market crisis and subsequent equity market meltdown of 2008, whereby investor portfolio values (the denominators) were reduced by as much as 40%, leaving certain asset allocations (the numerators) over weighted. For some institutions such as the Pennsylvania State Employees Retirement System, steps to rebalance its portfolio to target weights for international and domestic equities are overridden, determining instead to maintain its less liquid and less volatile alternative commitments to private equity and hedge fund of funds.
- In this low capacity environment, new private equity capital raises have been difficult. Investors are spurning the most speculative venture capital funds, while rewarding the lower levered mid market buyout funds.

**Chart 17: Gold Measured in Various "Currencies"**




Source: Dundee Wealth Economics

**Chart 18: 5-Year Pooled Returns though Dec 2009**




Source: Hammond Associates, Venture Economics

For further information, please visit our websites at…

Marshall Funds   www.marshallfunds.com

M&I Investment Management Corp.   www.mi-imc.com