

# FINANCIAL MARKET REVIEW

First Quarter 2011

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## Economic Outlook and Review

M&I Investment Management Corp.

### GDP: MODERATELY PACED AND SELF-SUSTAINING

Final fourth quarter 2010 GDP numbers showed an upward revision to a 3.1% annualized pace, aided by a 7% annualized gain in final sales and strong consumer spending. Recent economic reports are consistent with a slightly slower pace of GDP growth for first quarter 2011, likely in the range of 2-2.5%. These reports may actually mask the underlying strength of the economy due to the worst snowstorms we've seen in 15 years, coupled with a late Easter that depresses March retail sales activity. Consensus economic growth forecasts for the balance of the year remain centered around 3.5%. Despite this positive forecast, many commentators still refer to our recovery as fragile and weak. We believe recent signs point to a sustainable recovery, unlikely to boom, but just as unlikely to bust.

### EMPLOYMENT PICTURE LOOKS BRIGHTER

The recently released March employment report offered solid evidence of an improving job market. Private payroll growth over the last two months has seen its biggest gain in five years. Manufacturing employment has grown for five straight months, and the employment diffusion index is close to a record high. This index indicates the widespread creation of jobs across different types of industries — a very positive sign that the recovery is branching out to wider swaths of the economic landscape.

Even if employers added 200,000 jobs per month, it would still take until the spring of 2014 to recover all the jobs lost in the last recession. As it stands today, only 17% of jobs lost since 2007 have been regained. Unfortunately, between the housing and the automotive industries, over 1,200,000 jobs have been eliminated, many of which may be permanently gone. Although the recent upturn in vehicle sales and production is positive, the housing market remains lifeless.

Many different employer surveys point to increasing plans to hire new workers. One of the best and timely indicators of an improving job market is a decline in the four-week moving

average of weekly unemployment claims. Coupled with a significant decline in mass layoffs, the claims numbers signal positive news ahead for the labor market and the overall economy.

### INFLATION: THE BIG WORRY

The consumer price index has been rising at a 5.6% annualized rate over the last three months. Soaring commodity prices, especially for oil and gasoline, have led to higher inflation expectations. Rising crop prices lead to higher livestock prices and ultimately to greater food costs. Year-over-year average hourly earnings in March were up only 1.7%, half of the prerecession rate of change, while the price of gasoline was up 27.3% for the same period. Consumer confidence tends to drop as oil prices rise. For many consumers, real inflation-adjusted purchasing power is declining.

Ironically, the inability of workers to demand higher wages serves to hold back any major concern about overall inflation. Labor is the single largest cost of doing business, and there still remains a lack of overall wage pressures. Average hourly earnings have been flat for four of the last five months; the weakest reading in 25 years. While not great news for consumers, it is positive for corporate profits. In a recent Business Roundtable survey, capital expenditure plans for the first quarter are in record territory. Capital expenditures and employment are positively correlated, another reason to look for net job creation to continue.

Another important sign to track will be if producers are able to pass on the price increases they are experiencing. Manufacturing surveys and the Fed's own monthly Beige Book should be monitored for increases in prices received, an indicator of potential concern.

### THE FED IN NO HURRY TO RAISE RATES

The Fed Funds futures market now anticipates a Fed tightening as early as December 2011. In contrast, after the most recent FOMC meeting, the Fed reiterated its stance of keeping the Fed Funds rate "exceptionally low... for an extended period." The Fed would prefer to keep monetary policy easy enough to ensure sustained economic growth.



INVESTMENT MANAGEMENT

## Alternative Investments Review

### Alternative Investments Group

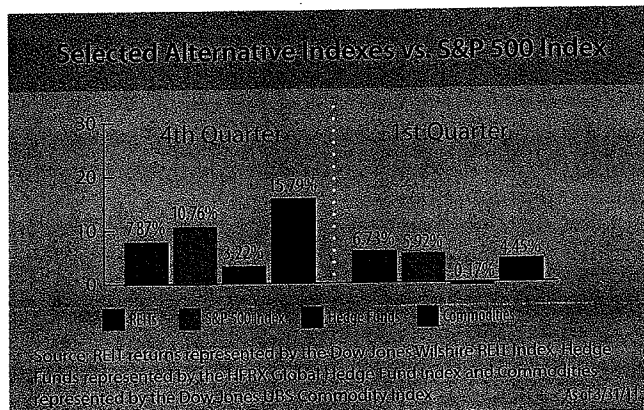
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March blew in like a lion, as the commodity markets traded from their year-to-date highs down to yearly lows, and then back to highs again — all within three weeks! The sharp spike in mid-month volatility was in response to the tragic earthquake in Japan and an indication of the speculative positioning in oil, gold and agricultural commodities given Middle East turmoil and unprecedented quantitative monetary easing. Commodity investors foresee potential future shortages (i.e., oil) and future inflation (i.e., gold and agricultural commodities). The fact that the Dow Jones UBS Commodity index (167.17) still stands 30% lower than the 2008 market panic high (238.50) shows how volatile these markets can be — even for those with long-term outlooks.

In turbulent markets, hedge funds have been the refuge of many cautious institutional investors and their consultants. Capital inflows continue with assets back over \$2 trillion globally. Some of the industry's long standing positions, like the Japanese yen carry trade (e.g., short yen/long Australian dollar) produced losses when managers anticipated a Japanese repatriation of foreign assets. Instead, central bank intervention stabilized the yen within its former trading range, as the Japanese government avowed that onshore financing was capable of funding recovery. With 50% less market exposure than long-only mutual funds, hedge funds have likely produced half the net returns with lower volatility. The maxim remains true that most hedge funds underperform in bull markets and outperform in bear markets.

Private equity funds continue to be raised, though legacy funds of the 2005-2008 vintage have yet to fully deploy their capital. Fund managers and limited partners remain sidelined as liquidity is fiercely guarded in the current volatile geopolitical environment. While economic activity is currently encouraging, the longer-term horizon depends upon governments resolving deficits, while scaling back from potential stimulus programs. With these macroeconomic issues unresolved, institutions have limited private equity investing.

Commercial real estate has remained attractive for yield-seeking investors. Unlike residential real estate, which continues to suffer from unsold inventories, prime commercial real estate has not suffered from excess capacity or overbuilding. In fact, multi-family residential properties are benefiting from the weakness in the housing markets.



### Monthly Updates:

Readers are reminded that our detailed Monthly Economic Update & Market Review publication is available from our websites at [mi-imc.com](http://mi-imc.com) and [marshallfunds.com](http://marshallfunds.com).

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# Financial Market Review *First Quarter 2011*

## Fixed Income Market Review

### Fixed Income Policy Group

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#### TUMULTUOUS WORLD NOT EVIDENT IN U.S. BOND MARKET

Despite a multitude of world events, the U.S. bond market remained surprisingly tranquil. In uncertain times, bond investors often turn to the comfort of owning Treasury securities. During the first quarter, this flight-to-quality trade didn't appear as popular as in past times of turmoil. Perhaps the growing concern over inflation offset any support associated with geopolitical risk.

Total returns for Treasury bonds were negative for the quarter, as yields rose in a bearish flattening pattern. The short end of the yield curve was anchored by a continuation of easy Fed monetary policy, while longer-term yields rose modestly. For example, the 10-year Treasury bond began 2011 with a yield of 3.30% and ended the quarter at 3.47%. Even this modest increase in yield was enough to translate into -0.37% total return for the quarter. For the quarter, the longer the maturity, the worse the total return performance.

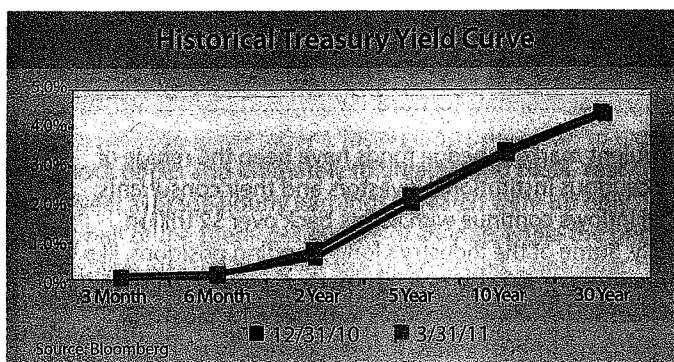
Looking ahead, the anticipated end of QE2 may cause Treasury issuance indigestion. Recall that the Fed committed to buying approximately \$600 billion of Treasury securities before the end of the second quarter. Interestingly enough, the Fed bought approximately \$320 billion of government bonds during the first quarter, nearly matching the net amount of Treasury issuance for the period.

#### YIELD-SEEKING BEHAVIOR REWARDED AGAIN

Although most bond investors would believe that outsized return opportunities in corporate bonds are behind us, the hunger for yield remains. Positive flows estimated at \$37.7 billion continued into corporate bonds during the quarter, driving corporate bonds into the winner's circle versus all other bond market sectors. Intermediate corporate bonds outperformed all others even though the impact of rising longer-term interest rates detracted a bit from overall returns. As measured by the Barclays Capital U.S. Credit Index, corporates were up 0.89% for the quarter, aided by modest spread contraction of 14 basis points versus comparable maturity Treasury bonds. Lower-quality investment grade securities outperformed, with each lower-quality rating tier outperforming the tier above it (e.g., BBB outperformed A).

For those investors willing to buy high yield debt, the quarter was even more rewarding. Junk bond returns for the Barclays High Yield Index were up 3.9%. High yield bonds are typically more correlated to stock market returns than other bond market sectors. As we have witnessed, equity returns were quite positive for the overall quarter — a definite tailwind for high yield bond performance. Just as important, corporate defaults have been rare as of late, with only three defaults so far this year compared to 29 for the same period last year.

The high yield landscape is becoming more difficult to navigate as issuers are eager to meet seemingly insatiable demand. According to Dealogic, high yield issuance set a quarterly record of \$114 billion, while overall corporate borrowing reached \$771 billion. Fortunately, cash stockpiles on corporate balance sheets remain high, and most issuance has been for refinancing purposes, holding down the level of net new issuance. This too seems poised to change as more companies raise cash in the bond market to finance merger and acquisition activity. Additionally, foreign banks have been heavy issuers of dollar denominated bonds. This so-called "Yankee" bond activity shows no signs of abatement.



#### MUNICIPAL BONDS...THE UNLOVED SECTOR OF THE MARKET

In many ways, the retail investor-dominated municipal bond market acted unlike the rest of the bond market in the first quarter. As opposed to the taxable corporate market, municipal bond flows were decidedly negative for the quarter, as evidenced by municipal bond mutual fund outflows greater than \$19 billion. In terms of overall performance for the quarter, lower tiers of credit quality did not keep pace with the higher tiers of quality as default fears remained prevalent. Thankfully, issuance was extremely low, allowing for total returns to remain positive in spite of tepid demand. For example, the Barclays 10 Year Municipal Index was up 0.76% for the quarter, outpacing the 10-year Treasury by 113 basis points.

#### WHO LIKES TREASURIES?

With the economy showing signs of improvement, the necessity of continuing the many unprecedented government interventions will be called into question. The Fed will have to walk a tightrope between promoting full employment while attempting to keep the inflation genie bottled up. It is extremely unlikely that there will be another round of quantitative easing. On the contrary, the Fed may become a better seller than buyer as it seeks to wean the market from explicit support. Look for Fed governor speeches to include increasing references to the end of the extraordinarily easy monetary policy in place over the past two years. When demand for U.S. government debt decreases due to meager or negative inflation-adjusted yields, then there are meaningful implications when constructing a bond portfolio from both a yield curve and sector perspective.

# Financial Market Review *First Quarter 2011*

At 8.8%, the unemployment rate is simply too high to justify higher rates, despite rising inflation expectations. The share of the working-age population in the labor force is still stuck at low levels unseen since 1984. The Fed still sees tight credit conditions, weakness in the housing market, fiscal strains within state and local budgets, and global shocks to the system as significant impediments to long-term economic health.

## REASONS FOR OPTIMISM

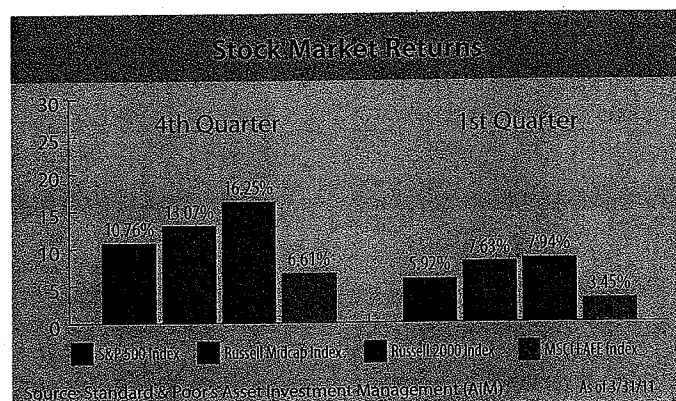
At some point, increases in employment will lift house prices. Retail chain store sales still show growth despite rising petroleum prices. Spending is outpacing income, supplemented by reduced payroll tax withholding, lower levels of indebtedness and a rise in overall net worth due primarily to a buoyant equity market. Increased merger and acquisition activity indicates a revival in the so-called "animal spirits" that can drive our economy forward. If rising stock prices are truly an accurate discounting mechanism of future prosperity, evidence of sustainable economic growth will continue.

## Stock Market Review Equity Policy Group

M&I Investment Management Corp.

March 9 marked the two-year anniversary of the end of one of the worst bear markets in history. The credit markets have healed, the stock market has rallied and the economy is slowly improving. Unemployment remains stubbornly high and housing is struggling to find a real bottom. In the first quarter, a major earthquake in Japan, oil disruptions in the Middle East, and continued European financial problems could not dissuade investors from buying stocks. Large-cap stocks, as represented by the S&P 500® Index, rose 5.9% for the quarter. Small- and mid-cap stocks, as represented by the Russell 2000 Index and the Russell Midcap® Index, increased 7.9% and 7.6%, respectively. Much of these returns came in the last week of the quarter. International stocks also had a good quarter, but lagged U.S. equities with a 3.4% return for the MSCI EAFE Index. Certainly, Japan's large-index weighting (20.4%) and performance (-4.6%) lowered the overall return. Emerging market stocks struggled for most of the quarter, but still managed to post a gain of 2.1%.

The Fed has successfully moved investors to riskier assets such as stocks. Though stocks have had a terrific rally over the past two years, it is important to remember just how poorly stocks performed over the previous decade (i.e., 2000–2010). Part of what we are now experiencing with stocks is a reversion to the mean. In other words, prices are now adjusting upward behind reasonable valuations and improving fundamentals. In the face of a tremendous amount of global uncertainty, investors are confused by the strength of this stock market rally. Perhaps last year's BP oil spill and the European financial crisis have conditioned investors to buy on dips rather than panic.



Recent world events did dampen some short-term bullishness, as stocks gave up their early-year gains by mid-March, but prices rallied all the way back by the end of the quarter.

There have been two constant themes underpinning the market's advance. First, the Fed is determined to keep interest rates historically low over a long period of time. Second, a strong corporate profit recovery has literally transformed the balance sheets of many corporations. This combination has left many companies with the unusual pressure of finding ways to utilize excess cash sitting in short-term accounts earning virtually no return. The three most common uses for these excess funds include acquisitions, dividend increases and stock buybacks. Of the three, acquisitions and dividend increases seem to be the two most popular choices for the cash. Many of the larger banks were just recently given clearance to resume paying, or to significantly increase, their dividends. Rising dividends tend to offer a concrete sign that corporations believe that the economic recovery is here to stay. Investors that buy stocks as a long-term investment have already benefited from higher prices, but now they are going to get the added benefit of rising dividends.

Moving into the second quarter will undoubtedly usher in new challenges not currently on the radar. We do know that the end of the second quarter will bring the end of quantitative easing (QE2). QE2 is the latest Federal Reserve program used to purchase large quantities of Treasury securities with the purpose of keeping interest rates low. Theoretically, less demand for bonds would cause interest rates to rise. In this case, investors have known the end date for this program for some time and the effects of ending this program may already be discounted by the market. It is also possible that the Fed replaces this program with something else to keep rates down. Despite a two-year rally, investors are now just beginning to take notice and shift money back into stocks. As long as interest rates don't significantly move up, investors will likely continue to focus on an improving economy and the benefits to stock prices that result from better corporate profitability.