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MARKET COMMENTARY May 25, 2011

Dow Jones Industrial Avg.	**12,319.73**	**Standard and Poor's 500**	**1325.83**
2011 (YTD) +6.4%	1st Qtr. +6.4%	2011(YTD) +5.4%	1st Qtr. +5.4%

"There are no exceptions to the rule that everybody likes to be an exception to the rule."
Malcolm Forbes

Overview – Why begin with such an unusual quotation? The country is in a tight spot. The simple truth is the nation's fiscal affairs are so out of whack, we are all going to be required to make sacrifices. Further complicating the matter, "The Great Recession" is reluctant to depart. Washington has attempted to float the ark of the economy with a flood of stimulus dollars to no avail. A compliant Federal Reserve has doggedly tried to stabilize and revive the crippled housing market. Their instrument of choice, historically low interest rates, has thus far failed to achieve the desired goal. However, the low interest rates have caused several unintended and undesirable consequences. At the top of the list has to be the denial of a fair return to savers, particularly retirees. Instead of earning a reasonable return on their life's savings, they are forced to take more risk than they would prefer to earn what is necessary. Failing that, they must invade their principal and risk exhausting their nest eggs. A second expectation of the low interest rate environment was to stimulate business activity. Every politician in Washington has declared how committed he or she is to job creation, yet unemployment remains stubbornly anchored near nine percent, not far from the peak of 10.2% in 2009, yet years removed from the 5% level at the beginning of the recession.

A case can be made the greatest beneficiaries of low interest rates are the commercial and investment banks, who ironically are considered to be the main architects of the recession based on the mortgage products they created, bought and sold. As the economy and the markets continue to recover from their brush with financial calamity in the fall of 2008, the chain of responsibility is still being revealed. These financial heavyweights battled fiercely for the upper hand in the markets for mortgage products and derivatives. Some succumbed in the battle, including Bear Stearns, Lehman Brothers, Countrywide Credit, Washington Mutual, and Wachovia Bank. Some were "too big to fail", including American International Group (A.I.G.), Fannie Mae, and Freddie Mac. Other casualties, which might be listed as "the walking wounded", include Bank of America and Citibank. One book, which makes a reasonable effort to logically outline the financial mosaic is "All the Devils Are Here, The Hidden History of the Financial Crisis." by Bethany McClean and Joe Nocera. Three years later the mortgage market continues to flounder, but the stock market has fully recouped all that had been lost. Many feel the nation remains well below the level of economic activity attained before the recession.

In spite of our economy's lethargy, the political and economic activities outside our borders are more unsettled. One problem, which appears intractable, is the multi-country debt burden gripping the European Union. A close second is the political unrest among the North African and Middle Eastern countries. The complexity of some of the issues involved has been highlighted over the past few days in the talk between President Obama and the Israeli Prime

Minister Netanyahu. Finally, there are concerns about the sustainability of China's rapid expansion and whether or not it will have to impose restrictions to limit growth in order to defuse its inflationary pressures. This is the primary reason there has recently been such a pronounced and dramatic pullback in commodity prices affecting stock markets around the world.

Outlook for Markets -The stock market is noted for being able to overcome such negativity and successfully register advances by "climbing a wall of worry". It has been able to shrug off a steady diet of disconcerting headlines by focusing on a steady stream of positive corporate earnings reports. Considerable assistance is derived from the abnormally low interest rates, which has forced investors to consider riskier alternatives. Last quarter's comments suggested a cautionary stance. Now the recommendation is more explicit. It has become almost impossible to identify stocks, which can be regarded as significantly undervalued. Even fairly valued holdings have become more scarce. Take some profits, particularly among any "high fliers" you may have with meaningful gains. Adopt a more defensive posture.

What next for interest rates? The FED's intervention in the fixed income market is scheduled to end in a few weeks. Some thought when their demand for government securities subsided, interest rates would have to rise. (I was definitely in that camp.) Circumstances have changed, however, with the prolongation of the European debt crisis and the mounting unrest in the Middle East. Now Syria has been added to the list of countries in turmoil there. Therefore, expect the low interest rates to persist unless there is a dramatic increase in economic growth or a battle royal erupts over the deficit in Washington. No fixed income sector stands out as being especially attractive. A modest case can be made for municipal bonds, yet selectivity is critical because of the wide-spread budget challenges at the state and local levels. A note of caution, resist the allure of higher yields because something, such as quality or liquidity, must be sacrificed to attain them.

Politics and the Budget - Although the third year of the presidential election cycle is regarded as the "sweet spot" for stock investors, there is good reason to believe history will be tested over the balance of this year. Not only has the market advanced significantly over the past two years, the outlook is more guarded. As hard as it is to imagine, the political noise will actually be ratcheting up as the campaigning increases. Expect the budget battle to intensify as Congress attempts to come to resolve the debt ceiling stand-off. In spite of the posturing, no one expects any serious negotiations regarding the elephant in the room – the budget deficit - until after the 2012 elections. Each political party fears it may provide an unintended advantage to their opponent.

In conclusion, rather than complaining about the government benefits or entitlements that might be lost or reduced, all citizens must be prepared to make their own modest contribution or sacrifice to the nation's effort to restore fiscal responsibility and accountability. Government at all levels, federal, state, and local must remember budgeting, by definition, means managing with the resources at hand. How much longer do we think we can rely on the Chinese or the Japanese or the Europeans to pay our bills? Today we still have some control over the timing of these decisions if we wait much longer we will have none. - JML