

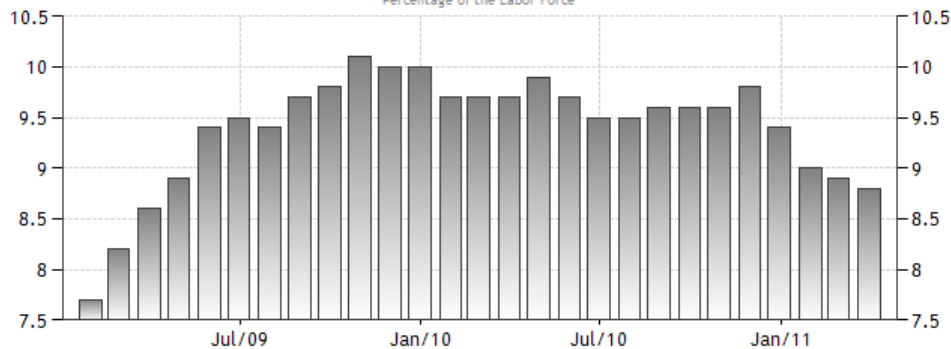
Market Environment – 1st Quarter 2011

The first quarter of 2011 presented multiple headwinds to global investors: political uprisings, price spikes in key commodities, and a huge natural disaster that overwhelmed a major global industrial power. However, despite strong concerns that these events will put the brakes on the already-tenuous global economic recovery, global securities markets managed to weather the turmoil without major shocks and generated strong returns for the quarter. Generally, the economy's fundamentals are improving, but they remain fragile and under stress from a number of threats. Most encouraging are improvements in the job market and the flow of credit; most worrisome are rising commodity prices, potential for inflation and the battle over the federal budget. The economic outlook for this year and next remains positive, but maybe not as good as it appeared just a few months ago.

Evidence of the economy's better fundamentals is clearest in the job market. Jobs are now growing fast enough to consistently bring down the unemployment rate, which has fallen by a percentage point since late last year to 8.8%. State and local governments are cutting jobs and the construction trades still are not hiring, but nearly every other industry is expanding payrolls. Hiring is stronger because businesses are profitable and have solid balance sheets. Rising prices for energy and other commodities are crimping margins for some firms, but unit labor costs continue to decline amid weak wage gains and healthy productivity growth. U.S. manufacturing has been making a robust recovery. The most notable recent data point has been the Philadelphia Fed Manufacturing survey, which rose to 43.4 in March. To put this in perspective, manufacturers in Pennsylvania and New Jersey are reporting the best conditions for growth since 1984. In addition, nationwide, ISM Manufacturing hit 61.4 in February, which ties a May 2004 high and was last surpassed in 1983.

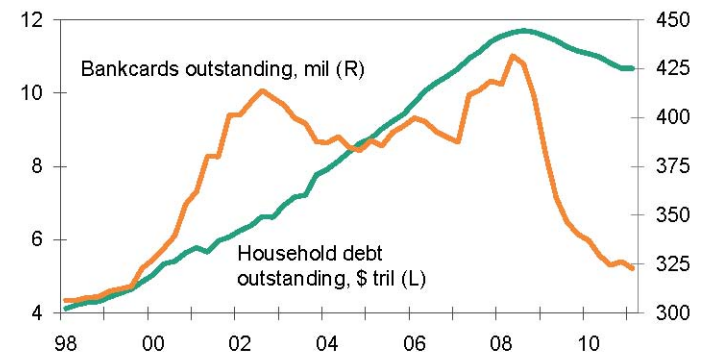
Improving fundamentals are also evident in healthier credit flows. After being depressed during the recession and early recovery, commercial and industrial lending is increasing. Household debt outstanding continues to decline; it is down \$1 trillion since peaking 2½ years ago. The banking system still has many problem loans to work through, but the end of the process is finally in sight. Delinquency rates are falling rapidly for all types of household liabilities. Data from Equifax show that the number of household loans 30 to 90 days delinquent has plunged, from more than 22 million in summer 2008 to 14.5 million in March, the lowest number of problem loans since the late 1990s. The banking system is prepared for any further losses with delinquent first mortgages. Big banks are especially well capitalized after their stress tests and capital raising of the past two years, and are increasingly profitable thanks to improved credit quality and very wide net-interest margins. Stronger loan growth is now the only thing constraining bank profits and so banks should continue to ease underwriting standards, allowing credit to flow more freely.

UNITED STATES UNEMPLOYMENT RATE
Percentage of the Labor Force



source: TradingEconomics.com; Bureau of Labor Statistics

Household debt deleveraging



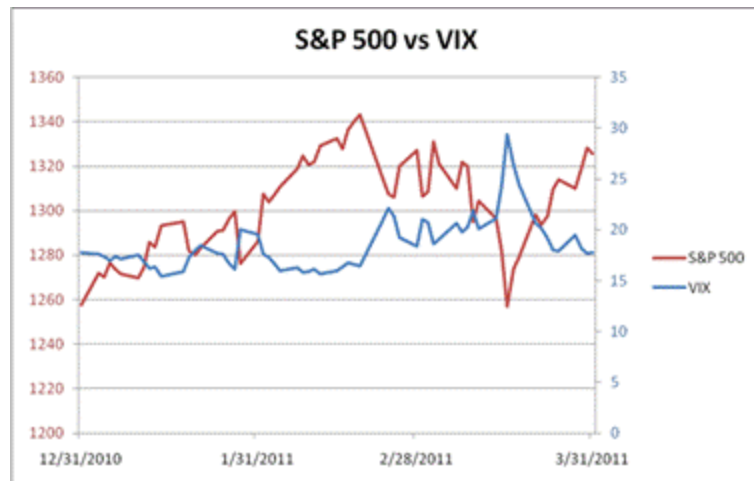
Sources: Equifax, Moody's Analytics



Market Environment – 1st Quarter 2011

Despite this encouraging domestic news, recent global events are clouding the economy's prospects. The catastrophe in Japan will likely send the globe's third largest economy into recession, disrupting global supply chains for autos and consumer electronics. The bailout in Portugal and Ireland's overwhelming bank losses are a reminder that the European debt crisis continues. However, much more worrisome is the unfolding turmoil in North Africa and the Middle East, and the resulting surge in oil prices. What began as civil unrest in Tunisia eventually spread across North Africa and the Middle East. The result, to date, has been regime change in Tunisia and Egypt and international intervention in Libya. Turbulence across the region hasn't subsided; instead, protests have spread and become more violent. The biggest impact of the unrest has been on oil prices, which have pushed above \$100 per barrel - a level not seen since October 2008. This unrest, coupled with the natural disaster in Japan, caused stocks to be sold off briefly in March. However, the sell off was short lived with volatility returning to normal and stock prices - led by energy - quickly rebounding to earlier highs.

Market Volatility



Source: Markov, MPI

The economic damage caused by the Middle East turmoil is mounting though, as the price of crude surged and nationwide gasoline prices closed in on \$3.75 per gallon. If oil prices remain at current levels through the end of the year, U.S. consumers will spend nearly \$100 billion more to fill their gas tanks this year than last.

Consumer Spending on Gasoline (\$B)



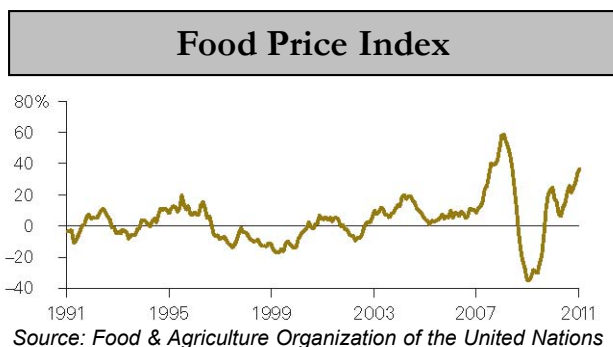
Source: BEA

Fortunately for the United States, the recent disruption occurred against a backdrop of ample spare global production capacity, relatively high U.S. oil inventory levels, and significant slack in demand in both U.S. transportation and refining. The International Energy Agency estimates that OPEC has over 4 million barrels a day of "effective spare capacity" and Saudi Arabia has already begun to fill the void left by the shut-down of Libyan exports. Although global crude oil production capacity appears sufficient to relieve some immediate pressures from the loss of Libyan exports, once the gap has been filled, OPEC will have its lowest spare capacity since late 2008. Looking forward, it is expected that the price of oil is likely to experience increased volatility due to the current tightness of supply and the elevated risk of further political unrest across other parts of North Africa and the Middle East. Bearing this in mind, economic simulations have shown that if crude averages near \$125 per barrel this year - equivalent to around \$4 per gallon for retail gasoline - growth would slow to a crawl and the unemployment rate would rise again. If crude reached its previous record high of \$150 per barrel, and gasoline near \$5 per gallon, the U.S. would likely return to recession.



Market Environment – 1st Quarter 2011

The spike in oil, and a related rise in food prices, pushed consumer inflation to sharply higher levels by quarter-end (U.S. Consumer Price Index, All Urban Consumers, 2.0%). Soaring food prices are battering living standards and threatening to undo the fruits of years of growth in the developing economies. People who have recently made the transition from subsistence find themselves once again scrambling to meet their food bill as food prices outstrip their incomes. The Food and Agriculture Organization's food price index has surged to a new high recently climbing 37% over the past year along with increases in oil, up 27%, and cotton, up 149%.



These skyrocketing prices are adding to the underlying pressures in the Middle East and North Africa. Unlike in the developed world, food and fuel are the “core” consumption basket in the developing world and thus their economies are hit hardest by spikes in food and energy prices. As in 2008, commodity price jumps can be a deflationary force in the developed world. When labor compensation cannot accelerate, consumers paying more for food and fuel soon begin to spend less on other products, causing margins to narrow for these other products and prices to fall.

Due to subdued core inflation and wage pressures in the U.S. the Federal Reserve has been able to maintain their historically low target Fed Funds rate range of 0.0-0.25%. However, a rise in CPI of 2.0% for the quarter is a significant uptick for the first time in several years.

Better U.S. economic fundamentals are also threatened by the bitter debate over the federal budget. Lawmakers narrowly averted a government shutdown over the fiscal 2011 budget, agreeing to reduce spending almost \$40 billion below 2010 levels. Without congressional action, the Treasury will bump up against the debt ceiling in mid-May, and will be forced to make painful cuts in government spending by early July. Given that both political parties are now committed to cuts in discretionary spending, it is possible they could agree on hard, multi-year caps covering this part of the budget. Broader structural reforms to entitlement programs and the tax code are necessary, but will almost surely have to wait until after the next election. Thus the budget battles will remain a threat to the confidence of investors, businesses and households.

A self-sustaining expansion has finally taken hold, but the hold remains tenuous. The outlook for 2011 should remain upbeat, though, as long crude averages close to \$100 per barrel, the Federal Reserve completes its quantitative easing and does not raise interest rates until 2012 and the government comes to terms on the debt ceiling and the 2012 budget. Real GDP is expected to advance 3.3% this year, compared with 2.8% in 2010. Job growth through 2011 should near 2.5 million, double the pace of 2010, and the unemployment rate should end the year well below 9%.

	<u>Qtr</u>	<u>1Yr</u>	<u>3Yr</u>	<u>5Yr</u>	<u>10Yr</u>
Large Cap Equities	5.9	15.7	2.4	2.6	3.3
Small Cap Equities	7.9	25.8	8.6	3.4	7.9
International Equities	3.4	10.4	(3.0)	1.3	5.4
Emerging Markets	2.1	18.5	4.3	10.7	16.8
Real Estate	6.5	24.3	2.2	1.4	11.3
Fixed Income	0.4	5.1	5.3	6.0	5.6
Cash	0.1	0.2	0.5	2.2	2.2
Inflation - CPI	2.0	2.7	1.5	2.3	2.4

Source: Markov, MPI



U.S. Equity Markets – 1st Quarter 2011

Despite the unsettling macro developments throughout the first quarter, U.S. equity markets proved resilient. The effects of the violence in the Middle East and North Africa were evident in equity market volatility in February as markets declined shortly after posting their highest close since June 2008. Additionally, the natural and nuclear disasters in Japan pushed equity markets into negative territory in mid-March. However, stocks resumed their upward swing to end the quarter with an impressive 5.9% gain for the S&P 500.

The U.S. market has rallied 111.38% since its March 9, 2009 closing low and is now off only (-5.7%) since its October 9, 2007 high.

Small-caps outperformed large-caps, value stocks fared best among larger companies, and growth stocks led the way among smaller-caps: Russell 1000 Large Value, 6.5%; Russell 1000 Large Growth, 6.0%; Russell 2000 Small Value, 6.6%; Russell 2000 Small Growth, 9.2%.

	<u>Qtr</u>	<u>YTD</u>	<u>1Yr</u>	<u>3Yr</u>	<u>5Yr</u>	<u>10Yr</u>
S&P 500	5.9	5.9	15.7	2.4	2.6	3.3
Russell 200 Growth	5.3	5.3	15.1	4.2	4.2	1.9
Russell 200 Value	6.0	6.0	12.1	(1.7)	0.3	2.6
Russell 1000 Growth	6.0	6.0	18.3	5.2	4.3	3.0
Russell 1000 Value	6.5	6.5	15.2	0.6	1.4	4.5
Russell Mid Growth	7.9	7.9	26.6	7.6	4.9	6.9
Russell Mid Value	7.4	7.4	22.3	6.6	4.0	9.2
Russell 2000 Growth	9.2	9.2	31.0	10.2	4.3	6.4
Russell 2000 Value	6.6	6.6	20.6	6.8	2.2	9.0

Source: Markov, MPI

	<u>Qtr</u>	<u>YTD</u>	<u>1Yr</u>	<u>3Yr</u>	<u>5Yr</u>	<u>10Yr</u>
Consumer Disc.	4.6	4.6	22.2	10.6	4.4	4.9
Consumer Staples	3.1	3.1	11.2	5.4	8.0	6.9
Energy	17.0	17.0	40.3	4.4	9.7	12.8
Financials	3.3	3.3	6.2	(7.7)	(8.2)	0.1
Health Care	6.7	6.7	8.0	6.1	3.7	3.4
Industrials	8.8	8.8	24.3	2.6	4.0	6.0
Technology	4.4	4.4	15.0	8.8	5.5	3.0
Materials	6.0	6.0	26.4	3.4	8.1	10.3
Telecommunications	4.6	4.6	27.5	2.8	4.1	(0.3)
Utilities	4.1	4.1	14.5	(0.2)	5.1	2.9
MSCI REIT	6.5	6.5	24.3	2.2	1.4	11.3

Source: Markov, MPI

While all MSCI sectors advanced during the quarter, energy stocks, up 17.0%, were the clear winners, as they benefited most from higher oil prices. Crude oil prices jumped partly because of continued strong demand from regions experiencing economic growth as well as fears of supply disruptions resulting from unrest in North Africa and the Middle East.

Besides energy, industrials, up 8.8% and health care, up 6.7% were the only other sectors to outperform the broad U.S. market. For the second quarter in a row the more defensive minded Consumer staples, up 3.1%, financials, up 3.3%, and utilities, up 4.1%, all lagged the broad market.

Shrugging off global turmoil and continued weakness in U.S. residential real estate sales, real estate securities markets extended their 2010 rally into the first quarter of 2011; MSCI REIT, up 6.5%.



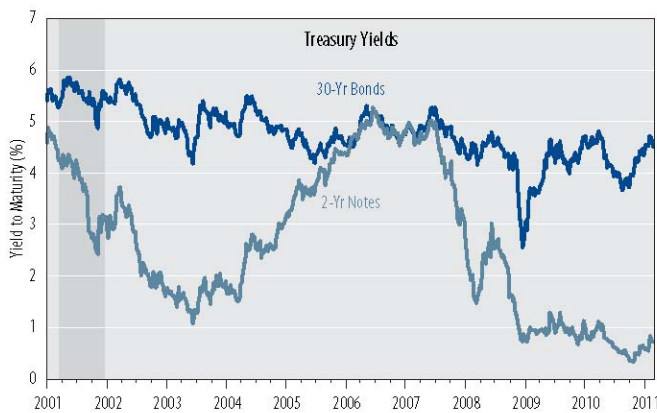
U.S. Fixed Income Markets – 1st Quarter 2011

U.S. fixed income markets posted modest first quarter returns, as the Barclays Capital U.S. Aggregate Bond Index climbed 0.4%. Treasuries (-0.2%) saw a spike in demand at the onset of the Middle East unrest and during the first days of the Japanese crisis, but the advance proved short-lived as riskier assets regained upward momentum. Treasury yields ultimately ended higher for the second consecutive quarter. The yield on 2-year U.S. Treasuries rose 18 basis points to 0.78%, while the yield on 30-year Treasuries moved upward 16 bps. Unsurprisingly, long-maturity Treasuries underperformed short-term Treasuries for the quarter; Barclays Long Treasury, (-1.0%); Barclays 1-3 Year Treasury, 0.02%.

With low absolute yields available from Treasuries and investment-grade securities investors continued to bid up the price of high-yield bonds, up 3.9%, which have been the top-returning segment of the bond market for the past three quarters. Inflation-indexed bonds, up 2.1%, also performed well on a relative and absolute basis, as investors' inflation expectations rose. Finally, a welcome development during the quarter was the positive performance of municipals, up 0.5%, which suffered large losses last quarter amid damaging headlines and state budget deficit worries.

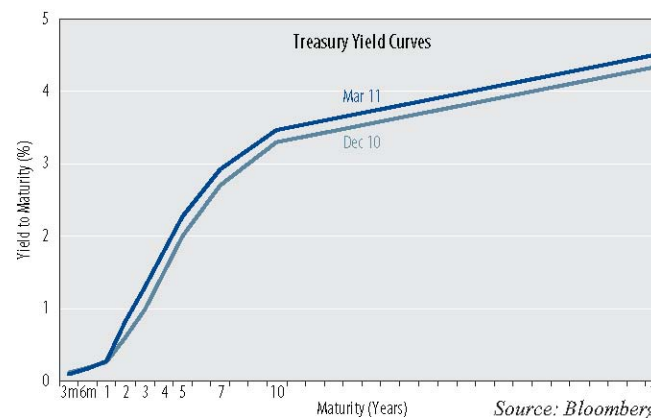
	<u>Qtr</u>	<u>YTD</u>	<u>1Yr</u>	<u>3Yr</u>	<u>5Yr</u>	<u>10Yr</u>
CASH	0.1	0.1	0.2	0.5	2.2	2.2
(1-3)Yr Gov/Credit	0.2	0.2	2.1	3.0	4.5	4.1
Gov/Credit-Intermediate	0.3	0.3	4.6	4.5	5.7	5.2
Gov/Credit-Long Term	(0.0)	(0.0)	8.5	6.5	6.7	6.8
Government Bond	(0.1)	(0.1)	4.3	3.7	5.6	5.2
Credit Bond	0.9	0.9	7.0	7.0	6.4	6.2
Aggregate Bond	0.4	0.4	5.1	5.3	6.0	5.6
Mortgage	0.6	0.6	4.4	5.9	6.5	5.7
High Yield U.S. Corporate	3.9	3.9	14.3	12.9	9.1	8.6
US Treasury Inflation Notes	2.1	2.1	7.9	3.9	6.3	6.7
Consumer Price Index	2.0	2.0	2.7	1.5	2.3	2.4

Source: Markov, MPI



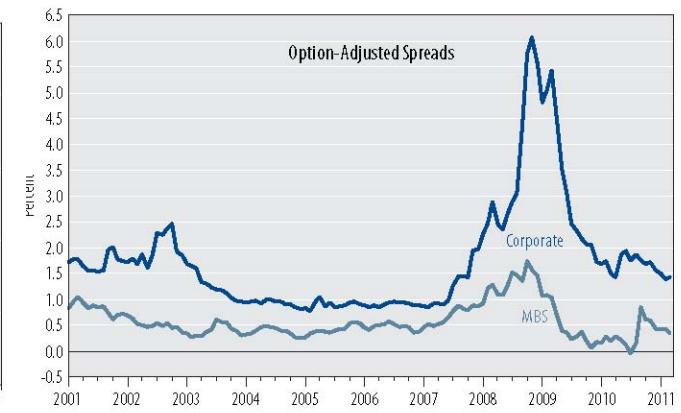
Source: Bloomberg

Interest Rate Trends: Relatively strong economic data, combined with continued accommodative monetary and fiscal policy, continued to alleviate fears of a double-dip recession and caused US Treasury yields to rise across the yield curve.



Source: Bloomberg

Yield Curve Slope: The yield curve slightly flattened. The slope between two-year yields and 10-year yields flattened by 2 bps, whereas the slope between five year yields and 30-year yields flattened by 6 bps.



Source: Barclays Capital

Sector Spreads: Investors were for the most part more willing to take risks, leading to generally strong results versus US Treasuries. Spreads on investment grade, high-yield and mortgages all decreased.



International Markets – 1st Quarter 2011

Returns were less impressive in international equity markets, where unsettling events around the world as well as Europe's continued struggle with sovereign debt tested investors' fortitude. The MSCI All Country World Index ex USA climbed 4.4% in U.S. dollars, but advanced only 1.3% in local currency. Developed markets outperformed emerging markets during the quarter, as the MSCI EAFE Index gained 3.4% compared with the 2.1% increase for the MSCI Emerging Markets Index.

From a regional perspective, Europe posted strong relative returns during the first quarter, 6.5%, notwithstanding continued negative news related to sovereign debt. Headlines from the region included the resignation of Portugal's prime minister after parliament rejected his party's austerity measures; speculation that stress tests would reveal Irish banks need more capital; and the credit downgrades of Spain, Portugal, and Greece.

Not surprisingly, Japan (-4.9%) weighed on the performance of the Pacific region (-2.0%) as investors indiscriminately sold shares of Japanese companies following its disasters. Despite weakness in Japan and the Pacific region, the first quarter marked the first time in more than two years that the MSCI EAFE Index outpaced the MSCI Emerging Markets Index. Egypt (-23.2%) was the worst-performing country among the emerging markets as civil unrest led to the ouster of its president and shutdown of the country's stock market for most of February. In contrast, Russia, up 16.3%, whose index is largely composed of energy companies, benefited from the rise in oil prices and was the top contributor among emerging economies.

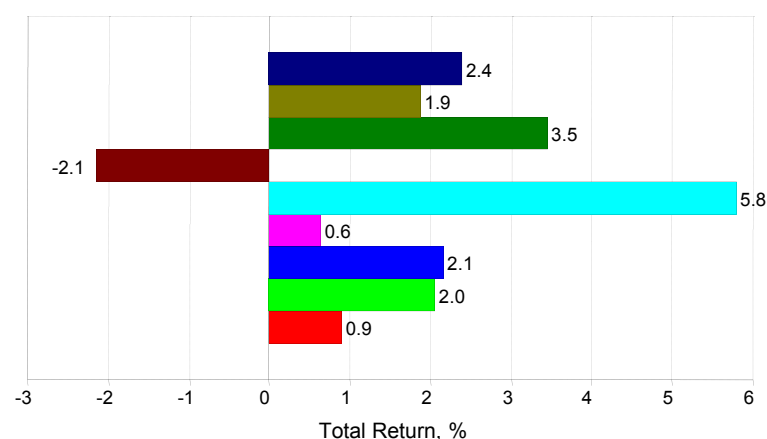
U.S. dollar-based investors benefited from various currency movements; a strengthening euro and pound offset a weaker yen, meaning the MSCI EAFE Index and the MSCI Emerging Markets Index advanced less in local currency terms, returning 1.1% and 0.7%, respectively.

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	<u>Qtr</u>	<u>YTD</u>	<u>1Yr</u>	<u>3Yr</u>	<u>5Yr</u>	<u>10Yr</u>
MSCI EAFE	3.4	3.4	10.4	(3.0)	1.3	5.4
MSCI EAFE Growth	2.2	2.2	12.6	(2.5)	2.1	4.8
MSCI EAFE Value	4.6	4.6	8.2	(3.6)	0.4	5.9
MSCI EAFE Small Cap	3.0	3.0	19.9	1.4	1.4	10.5
MSCI AC World	4.4	4.4	14.1	0.3	2.9	5.0
MSCI AC World Growth	3.4	3.4	15.5	1.0	3.6	4.8
MSCI AC World Value	5.5	5.5	12.6	(0.4)	2.2	5.2
MSCI EUROPE	6.5	6.5	12.6	(4.2)	2.0	5.7
MSCI PACIFIC	(2.0)	(2.0)	6.9	(0.3)	(0.1)	4.8
MSCI Emerging Markets	2.1	2.1	18.5	4.3	10.7	16.8

Source: Markov, MPI

Major Currency Movements vs. the USD (YTD)



■ Australian Dollar
 ■ Brazilian Real
 ■ Canadian Dollar
 ■ Chinese Yuan Renminbi
 ■ Euro
 ■ Japanese Yen
 ■ South Korean Won
 ■ Swiss Franc
 ■ UK Pound Sterling

