To us, it feels like we are in a perpetual state of waiting. Waiting for the equity markets to rally like they did in the 1990's. Waiting for the "all clear" sign that the economy is back on track. Waiting for financial regulatory reform to be finished. Waiting for Northwestern University to finally make the NCAA basketball tournament. And, waiting for businesses to start hiring again so employees can trade up to better jobs with higher pay. As we wait for a return to normalcy in the capital markets, it just seems that we are in a prolonged state of uncertainty.

However, investors largely looked past this uncertainty during the first quarter and have once again embraced risk. Equities, measured by the S&P 500, surged 12% so far this year, posting their best quarterly return since 1998. Catalysts for the rally in stocks included signs of an improving economy, an accommodative Federal Reserve, and diminished fears with Europe's debt crisis. Our long-time readers know that, until the structural problems in the economy and capital markets are addressed, we do not believe this rally is sustainable. At the same time, we believe the 30-year bull market in bonds has largely come to an end as the yield on the 10 year US Treasury note climbed to 2.1% from its low of 1.8%, and the Barclays U.S. Aggregate Index returned 0.30% for the quarter.

Our investment views are centered around several key themes. First, the developed countries around the world simply have too much debt; and as a society, we are living beyond our means. The consequence is that the growth in the economies of developed countries will likely be hampered. We are in a prolonged period of deleveraging and Europe is ahead of us in addressing its huge debt burden. Last quarter, Greece was finally allowed to default on its debt, allowing the European Union to cross one thing off their 2012 To-Do list. We expect the austerity measures that are being implemented, combined with slower credit expansion, will keep Europe in a recession for most of this year as they continue to struggle for a more integrated fiscal structure. While European leaders dithered trying to resolve Greece's debt crisis last year, the US Congress showed a divisive lack of initiative to address our country's growing debt burden and outsized spending problems. *This is one of those rare times that politics in Washington DC is affecting security valuations and the prospective outlook for investment returns.* We expect that tax policy will be hotly debated during this election campaign.

As we mark time after the Financial Crisis wreaked havoc on our economy and capital markets over four years ago, we are struck by the *unsustainable* state of so many major issues that impact our investment landscape. These issues include Iran's not-so-clandestine pursuit of its nuclear weapons program, the deterioration in the U.S. fiscal situation, the current U.S. tax policy, the European Union's process for dealing with its debt burden, the Federal Reserve's ongoing intervention in our capital markets, China's ability to build empty buildings to support its economic growth, and Japan's inability to service its massive debt. *At some unknown point in time, each one of these issues (and many others that we haven't raised) will face some form of reconciliation. The result will likely be the sharp repricing of risk in dislocated markets.*

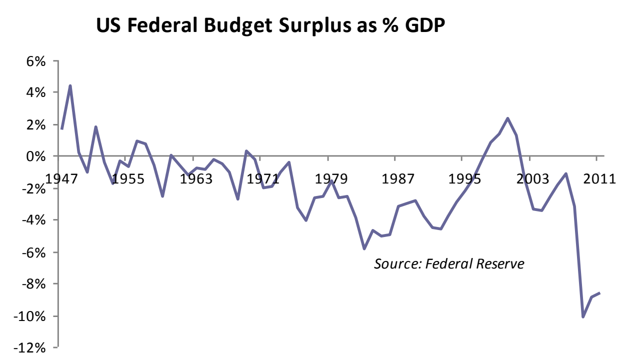
The U.S. government's intervention in our capital markets over the past four years has been so invasive that any outsider would think there is little difference between our form of capitalism and China's. Don't misunderstand; we are patriotic Americans and card carrying free market capitalists. But, we recognize that we have a form of *government-sponsored capitalism* in which we now operate. We are in the midst of a huge experiment in monetary policy, and implementing massive open market purchase initiatives that have never been done before. Our political leaders don't even understand the fiscal issues; much less provide cohesive recommendations to fix them. As we measure the progress over the past four years, we have reached a number of milestones - these are not necessarily our proudest moments as a country. The U.S. has accumulated a record $15.5 trillion in debt since the financial crisis, we have had four straight years of budget deficits that exceeded a trillion dollars, we have seen the AAA credit rating of the United States downgraded, and we have watched the government bailout our banking system and make direct investment in private companies at a rate not seen since the 1930s.

And, so we wait.

Lather – Rinse - Repeat

Yes, there are actually directions on a bottle of shampoo – Lather, Rinse, Repeat. We openly acknowledge that many of our clients are bald and have no use for directions on a bottle of shampoo. Yet, in the ongoing quest for *sustained economic growth*, we are struck that current global monetary policy is similar to the directions on a shampoo bottle: Stimulate – Recover - Repeat.

The amount of global stimulus since 2009 is massive. Through its two asset purchase programs, the Federal Reserve has accumulated a bond portfolio that is in excess of $2.6 trillion in size. Since December, the European Central Bank has pumped over €1 trillion in low interest loans into the European banking system, staving off a credit crunch and buying time for the Eurozone to address its huge debt problem. This entire stimulus has helped to boost asset prices here in the United States and raise the confidence in our money market funds. (Because the European banks lack the retail deposit base to support their lending operations, they rely on wholesale funding which in the United States takes the form of commercial paper). However, there are consequences to these hyper-liberal monetary policies which include distorted valuations in the capital markets, higher rates of inflation, lower expected returns on investments, and lower cap rates in the real estate market. *Easy money is the grease that lubricates the capital market machine and allows it to work more efficiently. With the machine running more smoothly, now is the time for government to take the hard steps and repair the damaged financial position including addressing the huge debt burden.*



The ratio of net debt as a percent of GDP is nearing 100% for the United States. This is a troubling consequence of the easy money policies that were required to avert an economic collapse following the Financial Crisis. *Yet, there is still no plan to reduce the debt burden and institute better fiscal discipline over our spending.* In the absence of a plan, we estimate that the U.S. economy would have to grow by 11.65% over the next two years in order to move the debt to GDP ratio back to 85% where it was in 2009. We expect that a plan to reduce the deficit will be center stage during the presidential campaign this year. *Real debt reduction will require true austerity. And, we have shown a consistent lack of the political will required to implement expense cuts in our massive entitlement and social programs. As a result, we expect the credit rating of the United States government will likely see another negative action from a rating agency this year.*

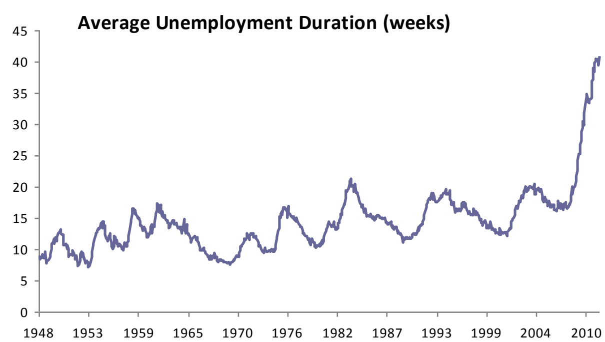
Global monetary policy has been more stimulative in the past six months than at any time since 2009. The result of this massive stimulus effort is that global growth has increased, asset prices have increased, credit spreads have declined, business investment has risen, volatility has declined and interbank lending has increased. The hope now is that the private sector will be able to step in and fill the gap helping to sustain economic growth. With household sector balance sheets still recovering from the impairment brought on during the downturn, we doubt that the private sector can fill the entire gap. If additional monetary stimulus is not announced over the coming months, we expect the sustainability of the current expansion will be tested again.

Stimulate – Recover – Repeat.

The US Economy – the Path to Sustained Economic Growth

The easy monetary policies of the developed countries have provided the time necessary for economic recovery to take hold, and the United States is showing encouraging signs of a pickup in economic activity, which is reducing some of the slack resources in labor and capacity. The economy, measured by real GDP, grew by 3.0% in the fourth quarter of 2011 according to the Bureau of Economic Analysis. This brings the annual growth to a measly 1.7% for 2011. The increase in real GDP in the fourth quarter reflected positive contributions from private inventory investment, personal consumption expenditures, exports, nonresidential fixed investment, and residential fixed investment. Growth was partly offset by negative contributions from federal government spending and state and local government spending as retrenchment from budget cuts continued. Imports, which are a subtraction in the calculation of GDP, increased.

We have seen improvement in job growth as employers posted three straight months of job growth in excess of 200,000 jobs. Job growth is critical to a sustained economic recovery and rising wages. Up until this point, we have been reeling from the massive lay-offs that were implemented as a result of the Financial Crisis. Still, we estimate that we need three years of job growth in excess of 200,000 jobs per month to get back to an unemployment rate closer to 5%, and until there is clarity in regulation, tax policy and the political environment in Washington DC, we expect companies will be slow to hire.



We are troubled that the average unemployed worker has been jobless for over 40 weeks. Back in February of 2010, 4.0% of the labor pool that had been unemployed longer than six months. Today, we are at 3.5%. The lack of improvement speaks to two issues: first, unemployment benefits are not providing an incentive for workers to return to work, and second, the longer the workers stay out of the active workforce, the larger the structural unemployment problem grows. Workers will find that their skills are not current with new software and processes making them less competitive for open jobs.

The consumer sector has shown improvement during the first quarter. Retail sales are now above pre-crisis levels. With interest rates low, stronger employment growth, and an improved housing market, we expect the consumer is positioned to make a more significant contribution to the overall economy this year. Much of the pickup in consumer spending at the end of last year was the result of an increase in consumer credit. This is a reversal of the trend we've seen since the financial crisis which showed improvement in household balance sheets. *The largest area of loan growth has been student loans financed by the Federal government. In fact, Consumer Financial Protection Agency disclosed that there is now in excess of $1 trillion in student loans outstanding, surpassing both credit card debt and auto loans. This represents a form of hidden private credit expansion which is stimulative, but it comes at a significant cost if employment and wage growth can't accommodate the opportunity to pay back the loans. We believe this will be a problem in our economy over the next four years as wage growth*

The manufacturing sector has been the unshakable pillar of the economy for the past two years. After World War II, the manufacturing sector was roughly 25.6% of the domestic GDP according to the Bureau of Economic Analysis. By the early 1970's it had declined to 22%. Today, the manufacturing sector represents only 11.7% of GDP. We believe the correlated decline in jobs represents a hit to the middle class in America. Until there is a concerted effort to make manufacturing a larger portion of GDP, our economy will be unbalanced and over-weighted to service sector and consumption.

Plan on another Downgrade of the US credit rating

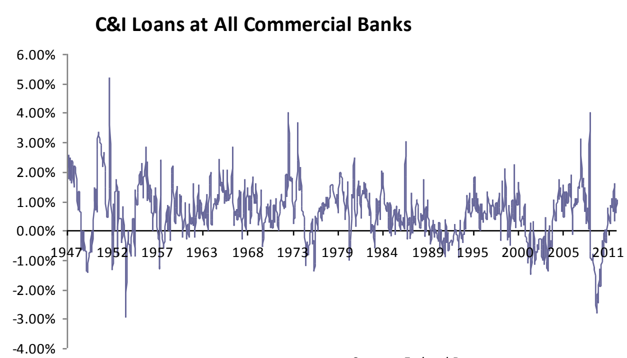
As a country, we need a credible plan that addresses the growing debt burden of our nation. As a society, we are living beyond our means and spending money that we don't have. The result is four straight years of budget deficits in excess of $1 trillion. At every step, Congress has shown the lack of political will to address the problem in a meaningful way. The jostling in Washington D.C. appears to be whether Congress takes on a broad bipartisan budget deal this year, or attempts to do the bare minimum which it has with other budget initiatives. President Obama has been reluctant to address cuts to any entitlement programs in his proposed budgets. The Republicans don't want to raise any additional taxes. These two ideologies will be the battleground for elections this November, and we expect nothing short of a band-aid as it relates to the budget deficit. *In the absence of meaningful economic growth, the consequence of not addressing the $15.5 trillion debt burden and the $1.2 trillion budget deficit is that the credit rating of the United States will most likely be downgraded again this year.*

As Congress dithers, we have expiration deadlines on tax laws coming up at the end of the year that are so severe, Federal Reserve Chairman Bernanke describes them as a "massive fiscal cliff." On December 31st, the payroll tax holiday ends for businesses, the "Bush Tax cuts" end and revert to higher levels, automatic spending cuts are triggered, the estate tax jumps back up to 50%, and the federal debt bumps up against is legal authorized debt ceiling. If these are allowed to expire without being addressed, the impact would devastate the economy and throw the fragile recovery back into a recession. Investors would be prudent to adjust both asset allocation and risk management strategies this year that plan for an additional downgrade in the credit of the U.S. government debt.

Banks are Closed-Distribution Systems

Sustained economic growth cannot exist without private credit expansion. And, we will not have private credit expansion without a healthy banking system. Measured by their capital levels, the banking system in the United States is stronger than it has been at anytime over the past 20 years according to Federal Reserve data. While there is modest improvement in lending, it is still below levels that would be indicative of this stage in a recovery. In part, there are structural problems with the process of regulatory reform that are impacting bank capital and lending decisions. *We maintain that private credit expansion will not occur until there is closure to regulatory reform and there is clarity to rules surrounding proprietary trading and derivatives. However, we also believe that because banks have other avenues to increase non-interest income, management is not incentivized to put capital at risk through its lending operations. This combination of disincentives is pushing the leadership of several banks toward implementing stock repurchase initiatives and increasing dividends to shareholders.*

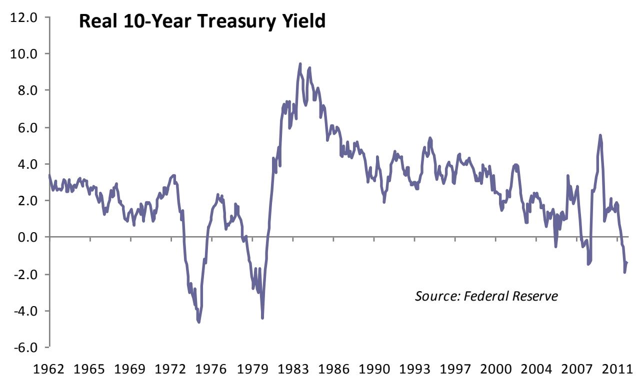
We are seeing an increase in lending from the banks, but it is not clear on its sustainability. In simpler times, banks took in deposits and made loans earning a margin for managing its risk. In the absence of the Glass-Steagall Act, the business models of banks have morphed into closed distribution systems. In this business model, a bank client that is allowed to buy a product that is associated with the bank's capital (such as a loan or a line of credit), is also required to buy several of the other products that the bank offers (such as wealth management or lock box services). Bank employees in turn are incentivized to cross-sell products and services which are mostly commodity in nature.



Source: Federal Reserve

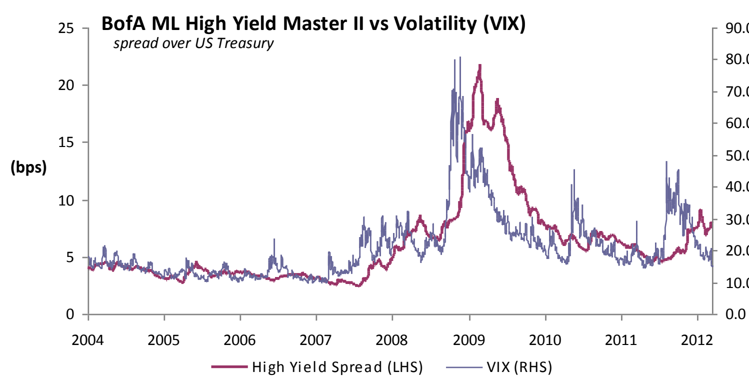
Fixed Income Investment Strategy

The result of the Fed's monetary policies including its massive asset purchase programs is that they have successfully lowered domestic interest rates and provided a huge incentive for households and businesses to refinance their debts at lower rates. A consequence of these initiatives is a negative real rate of return on most US Treasury bonds. At this juncture, the major buyers of US Treasury securities, which include the Federal Reserve, China, US banks and Foreign banks, are actually indifferent to the negative real rates of return; they are not "rational investors" in the market over the long-term. Each has their reasons for buying US Treasury securities with negative real rates of return. The Federal Reserve is supporting its quantitative easing program (look at it as the same pair of pants but different pockets for the US government), China is using US Treasury investments to hedge its currency for global trade, and domestic and European banks are parking capital for the time being. *Yet, at some point these buyers of US Treasuries will go away and new buyers will have to come in to replace them. These new buyers will likely have a higher return on capital requirement which will force interest rates higher.*



Remember, when investing, you are not necessarily wrong – sometimes, you are just early. We have been expecting higher interest rates for some time. And, we've been wrong. Well, maybe we're just early. The truth is we are looking to be compensated for the risk we're taking and the negative real rate of return on many US Treasury bonds doesn't get us there. However, where we have found value is in investment grade and high yield corporate debt.

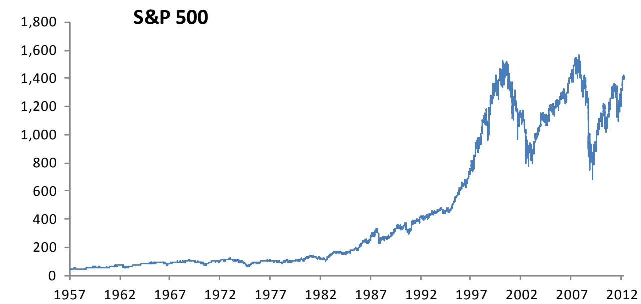
Measured by the Barclays High Yield Index, the high yield bond market posted a total return for the first quarter of 5.34% and a weighted average yield of 7.23%. The high yield market appears to be bifurcated in structure based on yield. A large portion of the high yield market trades substantially lower than the weighted average yield on the Index. While a small component trades at near distressed levels, the BB portion of the high yield index which represents almost 42% of the Index has an average yield of 5.74%. In addition, another 42% represents the B rated portion of the high yield index which has a yield of 7.03%. *Thus, 84% of the Barclays High Yield Index has a weighted average yield of 6.38%.*



Both yields and spreads are near historic low levels as volatility has declined and Federal Reserve policies have allowed borrowers easy access to credit. Investors using ETFs or Index funds to gain exposure to the high yield market should be cautious with measuring risk. A well structured portfolio of individual issuers may offer a better risk/reward for investors even if it results in a lower overall yield.

Equity Investment Strategy

The structural problems affecting the economy and capital markets are also having a profound impact on the relative value of the equity markets. The S&P 500 currently trades at a forward PE ratio of 13.9 times earnings compared with historic measures closer to 15 times earnings. With expected earnings of roughly $100 per share and a PE of 14 times, the S&P 500 appears fairly valued at 1400. We maintain that the increase in equity prices during the first quarter was due to an expansion in the multiple as a result of the decline in tail-risk associated with the Eurozone. Until the structural problems are addressed and investors have better clarity into corporate management decisions, we continue to believe that the equity market is range bound between 1100 and 1400.



Source: Standard & Poor's

The expectation for an increase in share repurchase programs is distorting valuations in the market. The impact of uncertainty of the economy, tax policy and regulation has forced corporate management to accumulate higher levels of cash than in prior years. *Assuming a portion of cash is eventually used for share repurchase programs, we believe the assumed earnings per share on a forward looking basis should increase. In today's financial markets, the ongoing management of a company's share repurchase program has become a larger part of how companies manage earnings expectations.*

At current valuations, the dividend yield of the S&P 500 is roughly 2.14%. There are some investors that believe the S&P 500 is a great value today because the S&P 500 offers a better yield than US Treasury securities with some upside potential. However, any comparison to bonds is flawed given the aggressive Federal Reserve policies have forced rates to historic lowers. In addition, a comparison to historic dividend yields over the past 50 years shows the dividend yield on the S&P 500 is near its lowest level. When we adjust prospectively for potential stock buy-backs, the assumed dividend yield increases to 4.3%; however, the assumption is that corporate management actually executes on stock repurchase programs instead of continuing to hold cash.

As we move into earnings season, we expect that corporate earnings will begin to trend lower as companies struggle to show meaningful growth in revenue in a weak global economy. In addition, margin improvements following the Financial Crisis have likely peaked. Increases in labor costs as well as commodity costs will suppress margins. We believe the financials, consumer discretionary, industrials and technology sectors show the best potential for earnings growth in 2012.