

The bull market that began in the first quarter of 2009, continued unabated into the first quarter of 2011, celebrating its second anniversary with solid returns in most of the major financial markets.

Within the U.S. equity market, the S&P 500 was up 5.9% during the quarter. It has almost doubled since its March 9, 2009 bear market low. The Russell 2000, a small capitalization stock index, was up 7.9% during the quarter. The strong equity performance reflect the market's recognition of healthy corporate earnings growth, recovering operating margins, and rising levels of corporate cash. Much of this good news is now reflected in stock prices, as small capitalization stocks are now trading in line with historic valuation levels, and at a substantial premium to large capitalization stocks. Large cap stocks, as indicated by the S&P 500, are still trading at a discount to their history. Investors should note that the S&P 500's best performing sector in the first quarter was energy stocks. This reflects the reality of higher energy prices, a rise that could eventually put the brakes on the economic recovery.

With the exception of Japan, the major non-U.S. equity markets also delivered positive returns during the quarter. The MSCI EAFE Index, an indicator of the developed markets, was up 3.4%, while the MSCI Emerging Market's index gained 2.0%. This reversed the trend of the emerging markets generally outperforming the developed markets. While developed market equities, like their S&P 500 counterparts, are still trading at a discount to historical valuation levels, the emerging markets are now priced at a premium.

Japan, the world's third largest economy, is suffering from the impact of a massive 9.0 scale earthquake, devastating tsunami, and unfolding nuclear crisis. The Japanese equity market fell 9.1% in March, and was down 4.9% for the quarter. The crisis in Japan began late in the quarter (March 11), so the impact on the Japanese and global economies remain to be seen. Japan is an important component of several global supply chains. At this writing, for example, Toyota has announced that domestic auto production will remain at 50% of normal capacity, and overseas production at 40%, well into this summer, and that full capacity will not be restored until late in 2011.

Within the bond and cash markets, returns also continued to reward riskier investments. While Treasury bills returned a meager 0.05% and the Barclays Capital Aggregate Bond Index was up 0.4%, the Barclays High Yield Bond Index returned 3.9% during the quarter. The strength in high yield bonds reflected continuing flows into the asset class and confidence in the economy. After trading at record premiums only two years ago, high yield bond spreads are now below their long-term average.

Looking forward, known concerns to the recovery include the potential for a

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sovereign debt crisis in Europe, the economic drag of surging energy prices, and the global implications of the crisis in Japan. For now, however, the markets are clearly focused on the relative improvement of the global economy.

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When interest rates change, we may change our assumptions. However, we are cautious about making changes. We have designed our assumptions to be strategic in nature, so they will typically not be adjusted to short-term market spikes. We use our judgment to determine whether interest rate moves are sustainable. In practice, we continuously review our assumptions and work to refine our methodology as we gain additional information relating to the capital markets, but we do not anticipate changes every time interest rates rise in 25 or 50 basis point increments.