Second Quarter, 2011

Summary
A number of unexpected, exogenous shocks arose throughout the first half of 2011 to temper expectations and actual growth trends. On the whole, U.S. economic growth trends remain well below historical norms, particularly in housing and employment, and have been further challenged by the global disruptions of early 2011. Nevertheless, most forecasters anticipate GDP growth's accelerating into the mid-2% range in the back half of the year.

Financial conditions remain extraordinarily accommodative with historically low borrowing rates available to corporations and individuals. Access to credit among individual consumers and small businesses, however, remains more challenging. Nonetheless, household balance sheets appear to be mending; consumer credit quality scores have improved; and, in May, consumer borrowing increased for the eighth consecutive month. As long as economic growth remains sub-par and unemployment remains high, the Fed likely will continue trying to prime the pump with an accommodative policy, based upon artificially low interest rates.

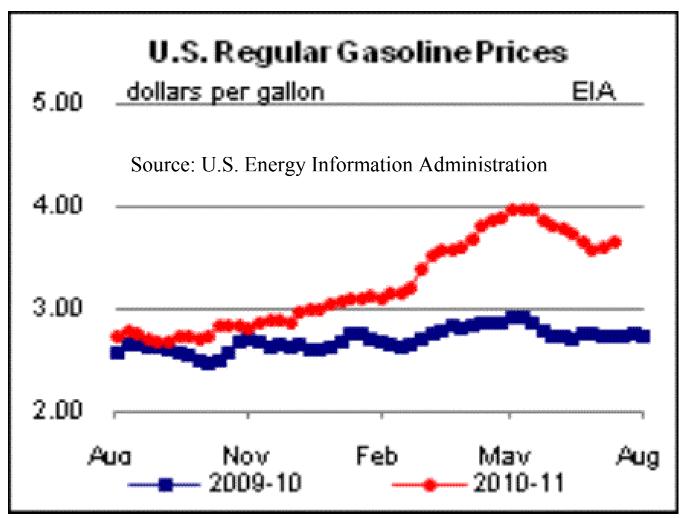
With both expected trends and unexpected events constraining global macro-economic growth, economies generally appear to be addressing numerous challenges and stumbling forward. While the stepping-stones toward future growth may appear less neatly arrayed, generally sound management and improving financial strength of corporations likely continued to drive profits to higher levels, albeit at a decelerating rate of growth. Assuming that recent economic trends and anecdotal data remain supportive, then earnings growth should be able to support current market valuations and, furthermore, drive underlying intrinsic values higher into future quarters.

Navigating the Unexpected
Early 2011 brought the possibility of an advance from economic recovery into economic expansion. These expectations developed as the dust settled on the fourth quarter of 2010, revealing numerous encouraging trends: U.S. domestic spending and manufacturing had accelerated; U.S. final sales to domestic purchasers had risen 5.1%, the highest growth rate since the second quarter of 2007; and, the Federal Reserve had instituted a second round of quantitative easing (QE2) designed to combat the specter of deflation, further stimulate budding growth trends, and achieve a "Goldilocks outcome" (non-inflationary expansion).

Given this backdrop, commodity inflation – as expected – continued to permeate the wholesale pricing structure, and to a lesser extent, finished goods early in the year. As anticipated, the less volatile "core" inflationary measures grew in a more stable uptrend, removing deflationary fears and providing a pricing structure that trended toward the Federal Reserve's implied inflation targets. More volatile commodity inflation pressures, viewed by the Fed as "transitory," were not expected to pose a long-term threat to U.S. economic expansion. In support of the "neither too hot nor too cold" outcome, many rapidly growing economies, particularly in the Asia-Pacific world (Australia, India, China, Korea, Singapore, in particular) had already been lifting interest rates and executing restrictive monetary policies for nearly a year. Economic growth in the U.S. and developed European nations was anticipated to ease in the first half of 2011, potentially dropping from 3.1% in the fourth quarter of 2010 to the mid-to-low 2% range in the first half of 2011, and then pick up in the back half of 2011.

However, a number of unexpected, exogenous shocks arose throughout the first half of 2011 to temper these expectations and actual growth trends. Unrest in the Middle East and Northern Africa brought higher oil (and gasoline) prices, as approximately half of Libya's 1.6 million barrels per day of oil capacity was cut, and the future production capacity of other restless OPEC nations was called into question. Massive flooding in Australia, China, and the U.S. ushered in inflationary pressure on global material and food prices. The tsunami in Japan shuttered industrial production not only in Japan, but also throughout the world as the tap for Japanese parts, chips, etc., shut down. In sum, global economic growth took an unexpected step backward – from the level of deceleration that had already been anticipated.

Economic Trends
First quarter U.S. GDP growth was reported at 1.9%, below initial projections. Heading into the second quarter, the sharp rise in gasoline prices abruptly curtailed discretionary spending. Auto production dropped, due in part to component shortages, and the pace of manufacturing growth slowed along with export orders and order backlogs. By mid-second quarter, fears of economic contraction, talk of a "double-dip" recession, and a "Wall of Worry" had re-emerged.



In spite of this pessimism, GDP growth data for the just completed second quarter point toward positive growth of 1.7%. Additionally, anecdotal evidence suggests that production dislocations created by the tsunami in Japan, once widespread, may be on the mend. Other reasons for optimism can be found in the economic data released during the week of July 8th:

- Retail same-store-sales surprised to the upside; high-end sales were very strong.
- Vacancies at office buildings in U.S. central business districts dropped to the lowest level in two years.
- Southwest Air reported June revenue passenger miles increased 7.5%.
- Both ISM reports (Manufacturing and Service) indicate continuing growth (at a slower pace), reduced pricing pressure, and slowly rising employment.
- Factory new orders rose 0.8 percent, with improvements arising in both durable goods and non-durable goods orders.
- AutoNation reported June retail new vehicle sales increased 3% year-over-year, with operating segments as follows: Domestic, +18%; Import, -9%; and Premium Luxury, +11%.

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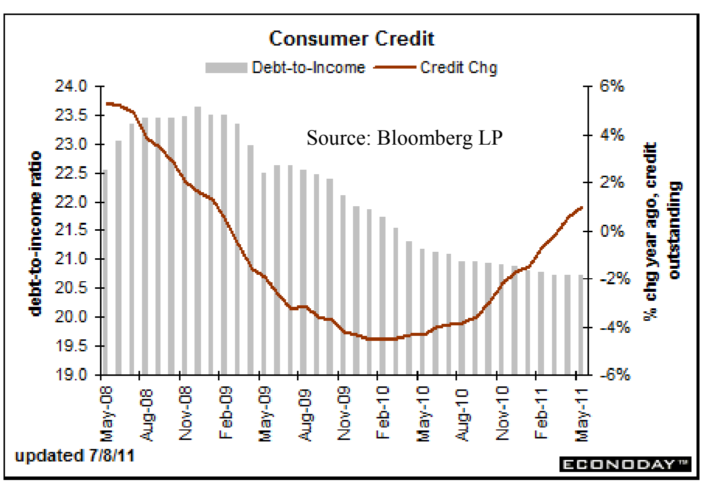
Financial Conditions

Financial conditions remain extraordinarily accommodative with historically low borrowing rates available to corporations and individuals. Growth in bank credit (loans and leases) and commercial/industrial loans appears to have leveled off somewhat; however, with extremely low 90-day borrowing rates of approximately 25-30 basis points (0.25-0.30%), corporate use of commercial paper markets has surged. Since December, non-financial commercial paper outstanding has increased more than 50% to over $200 billion. Another data point indicative of easy credit for corporations can be seen in low LIBOR (London Interbank Offered Rate) rates. Throughout the recent stresses associated with European financial turmoil (e.g., Greece, Spain, Ireland), LIBOR rates have actually declined. In 2010, under similar circumstances, the LIBOR rate doubled.

Access to credit among individual consumers and small businesses, however, remains more challenging – fewer borrowing alternatives, more stringent lending standards than in the past, lower equity value of the collateral, etc. Nonetheless, household balance sheets appear to be mending; consumer credit quality scores have improved; and, in May, consumer borrowing increased for the eighth consecutive month.



Monetary Trends

As of the end of June, the Federal Reserve's $600 billion program of purchasing U.S. Treasuries (QE2) came to an end. Nevertheless, the Fed said on June 22nd that it would continue to buy Treasuries with proceeds from the maturing debt it currently owns. That could mean purchases of as much as $300 billion of government debt over the next 12 months. As of June 30, the Adjusted Monetary Base, the sum of currency in circulation outside Federal Reserve Banks and the U.S. Treasury, totaled nearly $2.7 trillion. MZM, the measure of money available in the U.S. financial system that is readily available with no maturity, totaled $10.2 trillion. Simply put, there is no lack of money in the domestic financial system. The challenge remains in getting these funds into productive channels with enough velocity to stimulate economic growth, job creation, confidence, rising asset values, and wealth. As long as economic growth remains sub-par and unemployment remains high, the Fed likely will continue trying to prime the pump with an accommodative policy, based upon artificially low interest rates.

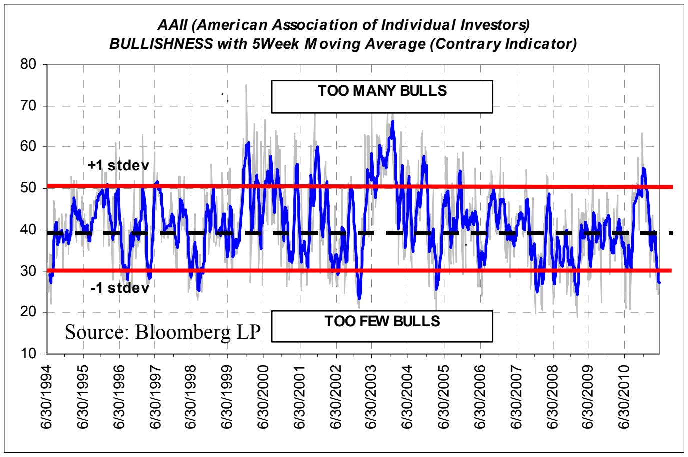
Technical Market Trends

As we expected, short-term over-bought conditions cited in previous commentaries presaged the consolidation, correction, and rotation in the second quarter. Specifically, as easy comparisons dissipated following the first quarter – and other unanticipated events around the globe came into play – uncertainty replaced optimism, and the markets took decisive corrective actions (perhaps more decisive than we anticipated). Companies in more cyclical industries floundered disproportionately, and companies with more defensive qualities, including larger capitalization companies, performed relatively better. On the whole, and on an absolute basis, second quarter equity market returns were negative to paltry. The S&P Mid-Cap and Small-Cap indices and the NASDAQ Index were slightly negative during the three-month period; the S&P 500 Index eked out a +0.1% return; and, the Dow Jones Industrial Average advanced a little over 1% for the quarter. The real winner was the Dow Jones Utility Index, up 4.9% in price alone (excludes dividends). As we head into the third quarter, our review of technical market trends suggests that much of the market price risk has eased, perhaps setting the stage for future gains. Unquestionably, corporate business risks appear to have increased, but assuming that longer-term economic and corporate earnings growth continues, market risks generally appear more favorable today than they did in the prior six-month period. Considering the enormity of the uncertainties that cropped up in the quarter, the exercise in treading water that followed these negative stimuli might be considered normal if not impressive.

Sentiment Indicators (Contrary Indicators)

Sentiment indicators tend to reflect emotional attributes of investors or advisors and, at the extremes, tend to be near perfect contrary indicators. As of December 23, 2010, 63% of the American Association of Individual Investors (AAII) surveyed were "Bullish," the most optimistic reading since late 2004. The accompanying measure of AAII "Bearishness" was only 16%, another extremely optimistic reading last matched in late 2005. It is important to note that this measure of confidence and enthusiasm was registered at a time when our technical market trends indicated over-bought.

Interestingly, bullishness recently plunged to only 24% while bearishness leaped to 48%. This recent extreme measure of pessimism was last matched at the bottom of the equity market in July 2010. Again, we rely upon these tools and indicators with



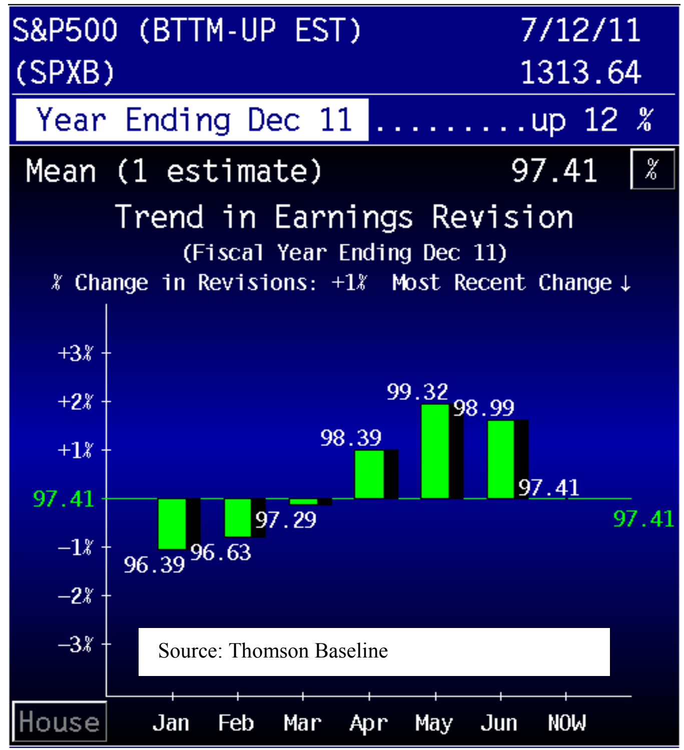
caution – they provide a single (but not the only) filter for attempting to translate current conditions into investable themes. Still, this most recent indication of extreme pessimism is somewhat comforting.

Equity Market Earnings & Valuation

In the first quarter of 2011, the Dow, S&P 500, S&P 400, and S&P 600 delivered impressive earnings results, up 26%, 35%, 21%, and 40% respectively. Second quarter earnings should not be expected to be as impressive but are projected to improve versus last year. As seen in the accompanying chart to the right, economic dislocations have translated into lower earnings expectation for 2011. By early August, the majority of companies will have reported second quarter earnings and provided guidance, setting the tone for the remainder of the year. Assuming that recent economic trends and anecdotal data remain supportive, then earnings growth should be able to sufficiently support current market valuations and, furthermore, drive underlying intrinsic values higher into future quarters.

Conclusion

With both expected trends and unexpected events constraining global macro-economic growth, economies generally appear to be addressing numerous challenges and stumbling forward. In the



U.S., monetary and financial conditions remain favorable; and corporations and individuals appear to be making progress, if only modest in some cases. That progress has not been reflected of late in the equity markets. While the stepping-stones toward future growth may appear less neatly arrayed, generally sound management and improving financial strength of corporations likely continued to drive profits to higher levels, albeit at a decelerating rate of growth. Near-term equity market returns likely will depend more on the forward guidance and outlook provided by companies reporting in the next several weeks.

For an in depth review of our Market Pillars and Charts, visit: http://www.imva.net/market-pillars/.

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