



Quarterly Economic Update

August 16, 2011



MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

The Federal Open Market Committee (FOMC) has met twice since our last update, and economic conditions and financial markets have deteriorated. Economic growth has slowed and forecasts have been revised downward. Employment has remained weak and there have been no significant signs of improvement. Energy and commodity prices have retreated some, but have pressured near term inflation and it is yet to be determined how transitory these pressures will be in regard to longer term inflation. Deflationary pressures seem to have somewhat subsided for now. Interest rates and equity markets have fallen rapidly as volatility has increased. There has been little change in policy, but the debate has intensified as to what the FOMC's next move will be.

At the June 22nd meeting, the FOMC left the federal funds target rate unchanged again and agreed that their \$600 billion in securities purchases would be completed at the end of June, bringing the official end to QE2 (Quantitative Easing). They reduced their economic projections and the FOMC minutes revealed differing opinions on the direction of the economy and future policy actions. They acknowledged that economic growth had slowed, but that inflation had ticked up and seemed somewhat divided on the transitory nature of this near term inflation and its implication for longer term inflationary pressures. The committee agreed that the target range for the federal funds rate should remain low for an extended period of time and that further accommodative policy action was not warranted at this time. Some committee members expressed concern that inflationary pressures were rising and the need for tightening policy might be warranted sooner rather than later. However, committee members agreed that no action was needed at this time and that they would continue to evaluate policy action as further economic data was received. The committee did note that in light of elevated energy and commodity prices, overall inflation should be monitored in addition to core inflation for the effects of these prices being passed through to end-user consumer goods.

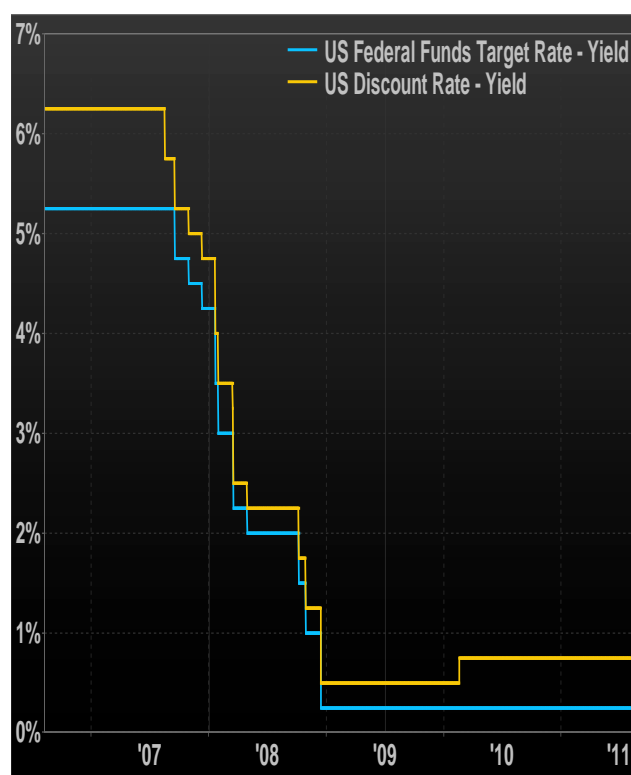
The committee did discuss in greater detail their exit plans to remove accommodative policy when economic conditions warrant it. While this has been discussed in previous meetings, they laid out their specific steps on how they intend to tighten policy for the first time. The committee specified the steps they intend to follow below:

- First, cease reinvesting some or all payments of principal on their securities holdings;
- At the same time or sometime thereafter, modify its forward guidance on the path of the federal funds rate and initiate temporary reserve-draining operations;
- Next, begin raising the target for the federal funds rate, also adjusting the interest rate paid on excess reserves;
- After the first increase of the federal funds target rate, begin the sale of agency securities from the Federal Reserve's portfolio, communicating the timing and pace of these sales to the public in advance with the intent to eliminate their agency holdings over a three to five year period.

The committee stated that these policy actions will be conducted in a manner to promote their statutory mandate of maximum employment and price stability and that they would be prepared to make adjustments to their exit strategy in light of economic and financial developments.

While the committee did decide that no policy action was necessary at this time and did discuss in detail their exit strategy, they did leave the door open to future accommodative policy actions should economic conditions further deteriorate and inflationary pressures subside. This led market participants to speculate whether a potential QE3 was coming to the market. However, it should be noted that some committee members had concerns about inflationary pressures and that the committee has previously expressed concerns about quantitative easing actions being appropriate without a deflationary environment.

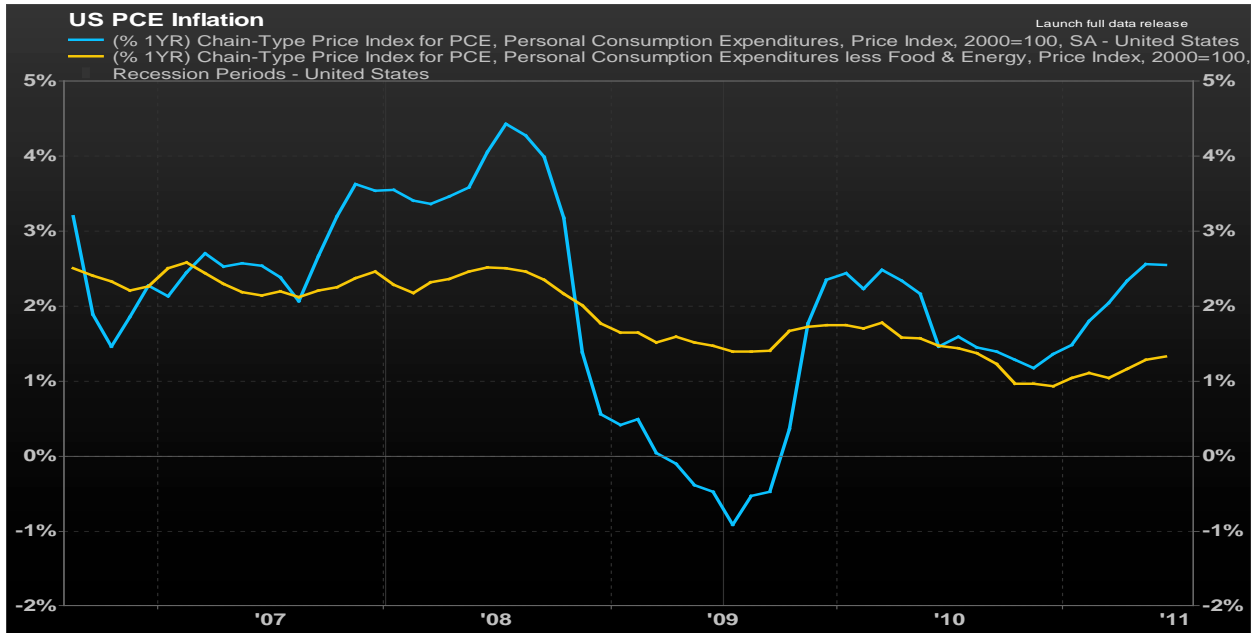
By the time the August 9th FOMC meeting arrived, volatility had significantly increased with interest rates and equity markets sharply declining. The FOMC statement acknowledged that economic conditions had deteriorated stating that “economic growth so far this year has been considerably slower than the Committee had expected”, a change from their previous statement that the “economic recovery is continuing at a moderate pace.” A change in outlook was noted that the committee “now expects a somewhat slower pace of recovery over coming quarters” and “anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate.” The FOMC again held the target range for the federal funds rate at 0 to ¼ percent.



Source: FactSet Research Systems Inc.

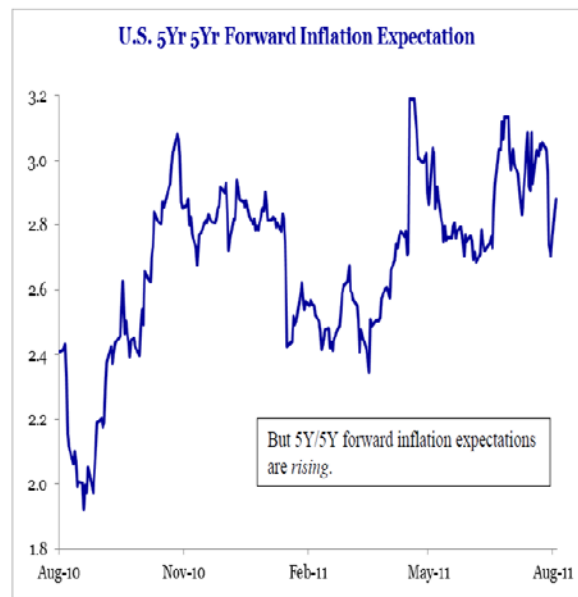
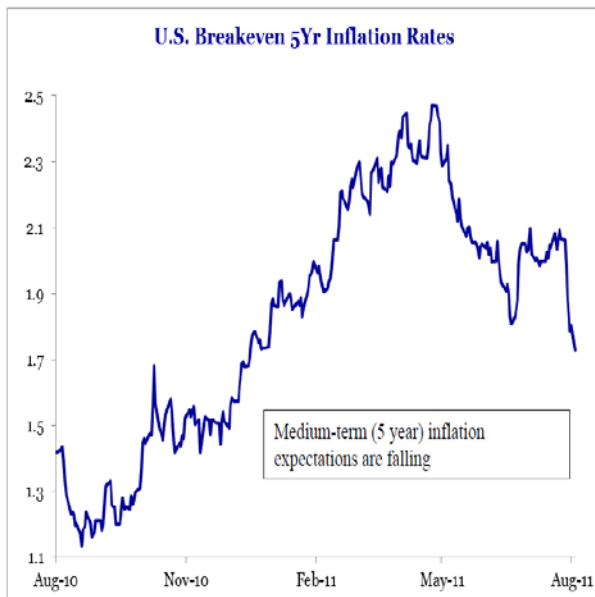
However, the big change in the August statement was the explicit guidance that conditions “are likely to warrant exceptionally low levels of the federal funds rate *at least through mid-2013.*” The FOMC’s decision to quantify the “extended period” timeframe is an attempt to reassure market participants that they will not begin raising the federal funds target rate any time soon. It is not necessarily additional accommodative policy, but it is reinforcement that accommodative policy will remain in place for longer and it removes a degree of speculation from the market concerning near term tightening. It is also their attempt to influence the shorter end of the curve and keep short term interest rates lower for longer. This action does not necessarily influence longer term rates and

could further concerns about rising inflation and inflation expectations, pushing longer term rates higher. The committee has expressed concern about near term inflation and the effects of higher energy and commodity prices being passed through to consumers; however they have stated they believe these effects will be transitory and that inflation expectations continue to be stable. The chart below does show that PCE inflation has ticked up recently, but the FOMC believes this will subside as energy and commodity prices have come down over the past several months.



Source: FactSet Research Systems Inc.

The FOMC points to medium term inflation expectations that have been falling however, longer term inflation expectations have risen recently as the charts below exhibit.

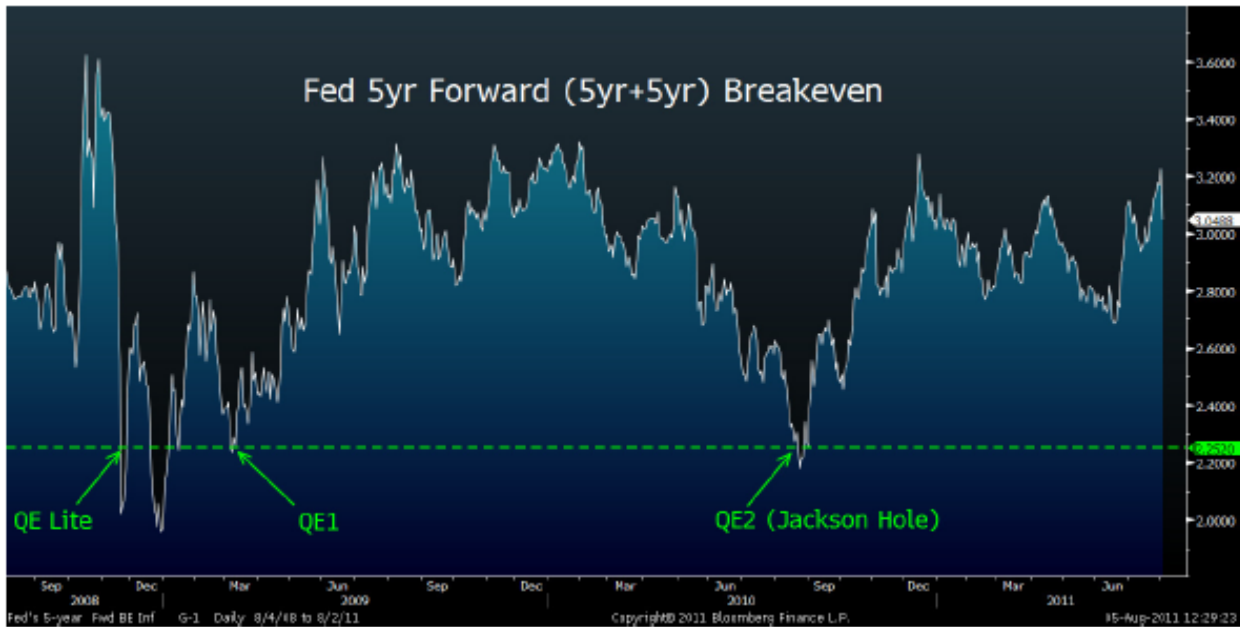


Source: Strategas Research Partners, LLC

It should be noted that three voting members of the FOMC voted against the policy action to quantify the “extend period” timeframe. FOMC members Fisher, Kocherlakota, and Plosser stated they preferred to continue to describe economic conditions as “likely to warrant exceptionally low levels for the federal funds rate for an extended period.” This is likely due to their concerns about inflation and inflation expectations and their desire to remain flexible to tighten policy sooner if inflation expectations continue to elevate. Their votes signify a debate between FOMC members about the current and future course of policy action and that additional accommodative policy action is likely to be challenged internally. According to International Strategy & Investment, this is the first time in nineteen years there have been three dissents coming out of an FOMC meeting. While the internal opposition and disagreement may represent a more difficult effort to implement future policy action, it should be noted that Chairman Bernanke and the committee chose to push forward with the change in policy language over appeasing the dissenting members. This may indicate Chairman Bernanke’s willingness to push forward with additional accommodation despite opposing views within the FOMC.

The fact that the FOMC felt the need to quantify the “extended period” of an exceptionally low federal funds rate should be met with mixed feelings. While it is reassuring that the accommodative rate will remain for another two years to promote economic recovery and employment, it is concerning that the FOMC’s outlook on the economic recovery has weakened and communicates that they see increased risk and uncertainty persisting into 2013.

The FOMC has not shut the door on additional accommodative policy and the potential for a third round of quantitative easing. However, their options are much more limited at this point. They maintain they still have the flexibility to provide additional stimulus, but at this point their arsenal is much smaller. It would be difficult to further increase the size of the Federal Reserve’s balance sheet with additional quantitative easing. With near term inflation and longer term inflation expectations at somewhat higher levels, the risk is higher and the FOMC’s mandate of price stability must be considered. Chairman Bernanke and other committee members have stated the risk of both recession and a deflationary environment must be present for the FOMC to consider further quantitative easing. The chart on the following page shows inflation expectations over the past several years and the levels where prior quantitative easing programs have been initiated. Based on current inflation expectations, a third round of quantitative easing appears unlikely in the near term.



Source: Bloomberg Finance LP, Cowen International

Many market participants continue to look for additional quantitative easing, but there are other policy actions that seem more likely in the near term. Chairman Bernanke discussed some of these potential actions in his July Semiannual Monetary Report to Congress. In addition to providing more explicit guidance on the extended period of a low federal funds rate, which has now been implemented, he discussed shifting the average maturity of the Federal Reserve's securities holdings further out. The FOMC has stated they will continue to reinvest principal payments, keeping the balance sheet elevated. They could begin reinvesting principal payments in longer dated securities or even implement a shift to longer securities to move the average maturity out. This would serve to pressure longer term rates down without increasing the size of the balance sheet. He also discussed reducing the interest rate paid to banks on excess reserves to put additional downward pressure on short term rates. These policies remain likely options that may be considered in the near term and may be met with less resistance by some FOMC members.

While the FOMC did lay out detailed steps to remove accommodative policy in their June meeting, the current weakness in the economy and equity markets support the opinion that these will not be implemented in the near term. The FOMC's statement that the federal funds rate will remain low at least through mid-2013 reinforces this opinion. In the near term, the focus will be on whether they will provide any of the additional accommodation discussed above. If inflation and inflation expectations remain elevated, it will make the implementation of further policy action much more difficult and likely lead to further division within the FOMC.

Fiscal Policy

By Michael McNair

Lies, Misconceptions and Reality

This past quarter has been extremely eventful and fiscal policy has taken center stage.

In June interest rates on Greek debt skyrocketed over fears of an imminent Greek default. These fears quickly spread to other European nations as investors believed a Greek default would create massive systemic risk in the fragile European banking system that could force other nations into bankruptcy. In order to avert contagion spreading to core European nations, EU policy makers agreed on a plan that allowed the ECB to buy Greek debt and substantially lowered Greece's borrowing cost without having to resort to a technical default. Markets initially rallied after the deal was reached but quickly attention was turned to a brewing fiscal crisis across the Atlantic.

However, the fiscal crises in the U.S. was self-inflicted by the completely unnecessary, self-imposed constraint that is the debt ceiling. The debt ceiling debate in the US became a circus that held the world's financial markets hostage to political gamesmanship. Politicians already voted on the budget which created the need to borrow; yet, then threatened to unnecessarily force the United States into default by not allowing the government to issue the debt needed to pay for the agreed upon spending. This is akin to financial vandalism and severely damaged the U.S.'s reputation, consumer sentiment, and economic growth.

The debt ceiling debate has spurred a national conversation on the proper role of government fiscal policy in our economy. Unfortunately, this debate has become dominated by lies and misconceptions that have greatly distorted the fiscal and macroeconomic reality. This report hopes to dispel some of the myths surrounding the current debate, as well as predict the impact fiscal policy will have on the economy as a result of the current political landscape.

The U.S. Fiscal Situation is not like Europe

The first lie being spread throughout the media is that the U.S. could end up in a situation like Europe, where fears of insolvency have caused interest rates on their debt to rise to unsustainable levels that may eventually force a default. This myth could not be further from the truth.

Member nations of the European Union, such as Greece, have several key differences to the United States that makes the comparison completely invalid. Governments of the EU:

- 1) Effectively spend in foreign currency because they gave up currency sovereignty when they entered the EU.
- 2) Do not have the ability to issue their own currency. Therefore, they must rely on taxes and debt issuance to pay for government spending.
- 3) Do not have control over interest rates because they do not control their central bank.

Economist Bill Mitchell says that, “In such a system the term structure of interest rates – which describes the spread of rates from the short-term policy rate (set by the European Central Bank) to the long-term interest rates – is determined by the combination of the ECB policy decisions at the short-end of the yield curve and private investment market expectations about inflation and default risk at the longer maturities.”

In other words, the interest rate EU countries pay on their debt is based on the private sector’s view of the country’s ability to repay the debt obligation and their inflation expectations. These countries face a difficult problem of rising borrowing costs when investors begin to question the country’s solvency. This rise in rates makes it more difficult for the country to service their debt and thus the solvency concerns become greater, which causes rates to go up even more. This feedback loop continues until the country either takes large steps to ensure the market that they can repay the debt or until it forces the country into default and much of their current debt load is wiped away.

The characteristics of the European monetary system stand in stark contrast to countries such as the U.S., Japan, UK and most other non-European developed nations who borrow in their own currency and have floating exchange rates. Since 1971, when the U.S. got off the gold standard and developed a fiat currency system they now have:

- 1) An exclusive monopoly over the issuance of their currency.
- 2) The ability to fund deficit spending (spending in excess of tax revenue) without having to issue debt.
- 3) Control their central bank and its interest rate setting and/or asset purchase setting decisions.

Mitchell says, “In this type of monetary system – the fiat currency system – it is the government that rules always. The central bank sets the interest rate at the short-end of the yield curve and the term structure (rates for longer maturities) follows expectations of inflation risk rather than default risk.”

In a recent interview on CNBC, former Fed Chairman Alan Greenspan explains why there is no default risk in U.S. debt saying, “The United States can pay any debt it has because we can always print money to do that. So there is zero probability of default.” It must be emphasized that this is not the case for European government debt. The recent S&P downgrade of U.S. debt gives us a real time case study of what drives U.S. treasury rates. During the debt ceiling debate certain politicians and the mainstream media continually stated as fact that, “the U.S. must avoid a debt downgrade because it will raise the cost of borrowing for all Americans.” The reality is that rates have done just the opposite of what they predicted. This should highlight the fact that the debate on fiscal policy in this country is being driven by people who don’t have a sound grasp of what they are talking about.

The chart below is the best illustration of the differences in the monetary system in the EU and in countries such as the U.S. and Japan. It shows the US, Japan, and a couple of EU countries’ interest rate on their 10yr government debt as well as their respective Debt/GDP ratios:



Over the past month there have been numerous articles in various publications essentially asking the question, “why Italy and why not Japan (or the U.S.)?” It is a perfectly valid question to ask, why are U.S. interest rates under 2%, while Ireland, with a smaller debt load, has to pay over 14%? And how can Japan, with the highest debt load in the world and more than double that of Ireland, have the lowest 10yr interest rates in the world at 1%? The simple answer: it’s all about having currency sovereignty.

Countries with currency sovereignty have much more flexibility to run the deficits necessary to support growth and incomes when private sector demand wanes. An example of the flexibility is highlighted in statement #2 above: the government has the ability to fund deficit spending without even issuing debt. While the U.S. Treasury is technically required to issue treasury debt to match all deficit spending, this has become a mere accounting gimmick ever since we left the gold standard. The reality is that much of the debt issued never leaves the government’s hands and only moves to different branches of the government. As of March 2011, the federal government owns 42% of its own debt, much of it held by the U.S. Federal Reserve. When the U.S. government deficit spends, the Treasury issues debt and the Fed buys whatever amount needed to ensure that the interest rate stays at their target rate. At the end of each year, the Fed returns the interest payments the Treasury makes on this debt back to the Treasury. This return of funds to the Treasury is actually a major source of government revenue, which in turn reduces the deficit. This is just one example of how the U.S. government gets around the self-imposed constraint of issuing debt to fund the deficit, which is unnecessary in a fiat currency system. This is not a new phenomenon; central banks around the world have been doing this for decades. This fact may be surprising to some, but this is what it means to have a fiat currency. Nevertheless, the fact that the U.S. government owns 42% of its own debt is just another reason why the debt ceiling standoff was an artificial crisis created entirely by politicians to push their political agenda.

It should be noted that while there is no risk that the U.S. government will have the capacity to pay its debt, that does not mean they will always be willing to pay the debt. Had the debt ceiling not been raised, the U.S. may have been forced into technical default (although there are ways the President could have circumvented the debt ceiling) because

politicians chose not to pay despite having complete ability to do so. Since this would have been completely irrational and akin to financial suicide, this risk is not priced into rates.

Do not Fear Government Budget Deficits

Through lies, misconceptions and fear mongering, mainstream media and politicians around the world are on a crusade to convince citizens that government deficits are morally wrong. It has become commonplace to hear people say “the U.S. government must stop spending money they don’t have” or “they must stop living beyond their means.” Politicians on both sides of the isle used the debt ceiling debate as a stage to tell Americans that government deficits are causing our economic problems. However, this is a lie and highlights the incredible lack of understanding of macroeconomics by our leaders in Washington.

It is understandable that Americans watching the fiscal crisis unfold in Europe are worried that the US could be next. But as we described above, the U.S. is in a completely different situation. Admittedly, these differences can be difficult to understand, but for that reason certain groups have been able push their agenda by using the European crisis to scare and mislead American’s into believing that all budget deficits are bad.

While Europe’s problems are partially a result of a fiscal crisis, in the U.S., the financial crisis and subsequent weak recovery was NOT a result of government deficits, but all about a lack of effective demand from the private sector. The growth that precipitated the recession in 2007 was the result of an unprecedented rise in household leverage. When asset prices eventually fell, so did the credit fueled spending. In typical recoveries demand returns back to pre-recession trend as the private sector stops saving and eventually make up for delayed expenditures; however, the financial nature of the most recent crisis is unique to any U.S. recession in the post WWII period. This means that private demand has been slow to recover as the private sector must first increase savings and reduce the massive amount of debt on their balance sheets.

Not only did government deficits not cause the recession but they were actually the most important factor in arresting the contraction and allowing the economy to recover. When aggregate demand contracts, the private sector cuts jobs, which decreases incomes and causes lower spending (i.e. lower aggregate demand), which in turn creates a feedback loop between lower incomes and lower spending. The paradox of thrift, popularized by John Maynard Keynes, says that in recessions, individuals take seemingly rational steps to protect themselves by saving more and spending less but when done at the national level, these attempts are actually self-defeating because they cause a decrease in consumption which perpetuates the economic contraction. As a result, incomes go down as unemployment rises and ironically the economy ends up saving less. For this reason, counter-cyclical government deficits are essential to reverse this recessionary feedback loop.

The “fiscal contraction expansion” crowd mistakenly believes that government spending is crowding out the private sector from borrowing, by increasing borrowing costs, and the

private sector is just waiting for the government to stop spending before they start borrowing again. However, this theory is completely devoid of reality. The government is currently in deficit yet interest rates are at all-time lows and corporations are issuing as much debt as they wish at the lowest rates ever. As an example, Procter and Gamble just issued \$1 billion of 3 year debt for 0.7% and \$1 billion of 5 year debt for only 1.45%! The Fed loan survey tells us the real reason that banks are not lending is because there is no demand for credit from credit worthy individuals. Businesses are not spending because they already have too much capacity and too little demand. Reducing the budget deficit will decrease demand further and businesses will respond to this lower demand level by cutting jobs and investment spending.

Much of the fears over government budget deficits arise because of a lack of understanding in the sectoral balances. The sectoral balances describe how the different sectors of the economy fit together. The basic accounting identity of the sectoral balance says:

$$\text{Government Balance} + \text{Private Balance} = \text{Trade Balance}$$

(If the sector is in surplus, the balance is positive, and vice versa)

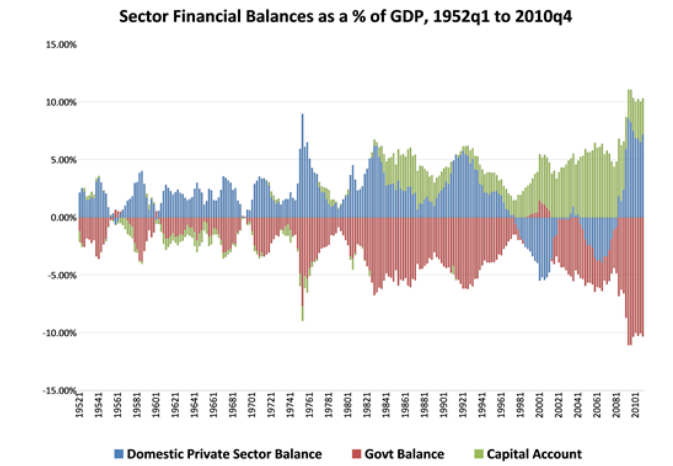
For structural reasons related to supplying the world's reserve currency, the U.S. must continually run trade deficits. Therefore, if either the U.S. government or U.S. private sector are in surplus, the other must be in an even larger deficit.

We can use the current sectoral balance in the U.S. as an example:

-10% of GDP government deficit + 7% of GDP private sector surplus = -3% of GDP trade deficit

When any nation runs a trade deficit of 3% while the private sector is running a surplus (saving) of 7%, the government will always run a budget deficit of -10% of GDP. This should help solidify in your minds that the government deficit is NOT an exogenous variable. Because it cannot be viewed in isolation, any attempts to control the budget deficit must also consider the impact it will have on the other sectors of the economy.

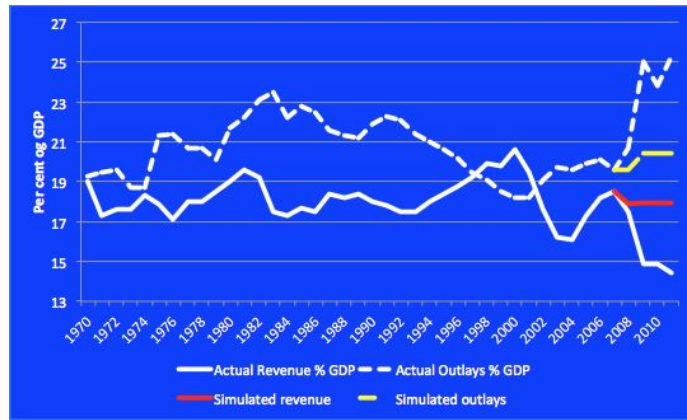
The chart below illustrates the point that the government balance, the domestic balance, and the capital account (i.e. the trade balance) are all interconnected and must balance.



While the consensus believes that we need to return to the budget surpluses of the Clinton years, this chart shows that the government surpluses' (in red) during the 90's, were only possible because the private sector was running the biggest deficits (in blue), and subsequently accumulating the largest amount of debt, in the history of our economy. Yet, it was this accumulation of debt that the private sector is now trying to paying off. However, the chart above shows that in an attempt to restore their balance sheets, the private sector has made an unprecedented move into surplus and by extension forced the government into an unprecedented deficit. So when you hear people say that the U.S. government needs to run a surplus, know that by extension they are saying that the private sector needs to borrow and run a huge deficit. Since the real cause of the financial crisis was the private sector taking on too much debt, why would anyone suggest that the solution is to force the private sector to accumulate even more debt?

In a speech on June 7, 2011, New York Fed President William Dudley discussed the sectoral balances and expressed his concern over the government's attempt to move the deficit from -10% to -3%. He acknowledges that should the government do so, the private sector would be forced to decrease their savings by 7% of GDP in order to compensate. In other words, the private sector would no longer be able to save and repair their over leveraged balance sheet.

In other words, the only way that the private sector can save (be in surplus) is for the government to run a budget deficit. After consistently being in deficit over the past two decades, the private sector has accumulated a massive amount of debt which they are currently trying to pay down. This propensity to save is the lack of demand that is causing the economy to contract. As the economy contracts, this automatically, via the natural stabilizers like unemployment benefits, causes the government budget deficit to grow. The point is that without any discretionary change in fiscal policy, private spending decisions can drive the government budget into deficit. Furthermore, when the private sector is trying to save, it is up to the government to run a large enough deficit to keep the economy from contracting. Economist Bill Mitchell produced the chart below, which shows where government spending and tax revenue would have been natural stabilizers not kicked in as the economy went into a recession:



This chart shows that the size of the current budget deficit is almost entirely due to the recession, which was the result of an unprecedented increase in private sector savings (and decreased spending). In order to increase growth while the private sector is saving the government must increase its deficit above the current level. The anemic 0.4% and 1.8% GDP growth in the first and second quarter, respectively, tell us that the budget deficits are currently not large enough to compensate for the massive increase in savings by the private sector.

It must be made clear that the U.S. government currently has the ability to run large deficits, while the private sector does not. This is because the U.S. government's borrowing costs are at an all-time low, inflation is low, and deflation remains a larger risk. More importantly, the private sector actually is carrying a larger debt load than the government despite the private sector having much larger financial constraints (i.e. the government can issue its own currency)

This is not to say that the government should continually run deficits. The major constraint on government deficits occur when the economy is operating at full capacity. In this scenario government deficit spending will cause demand to exceed the capacity of the economy to respond at current prices, which will be inflationary. However, in the current environment of persistently high unemployment and massive excess capacity, increased government spending will simply increase output at current prices (i.e. will not be inflationary). Therefore, we believe that the most appropriate policy action is to allow the government to increase their deficit and support growth and incomes until the private sector can deleverage their balance sheet (which they are currently doing at the fastest pace on record).

It is a travesty that the mainstream media has convinced the public that the current problem is government spending, despite interest rates and inflation being at historic lows, while putting the millions of unemployed Americans back to work has become an afterthought. The obvious problem is a lack of aggregate demand, which manifests itself through a historically high output gap and unemployment rate. Cutting budget deficits now will only decrease demand further. Politicians are now telling us that "we tried running deficits and it didn't work", so now they think cutting deficits is the answer. This flawed logic is akin to suggesting a student should stop studying because he only got a B on the last test. As we move into a Presidential election year, I suggest some candidate quickly trademark the phrase, "It's the unemployment rate, stupid!"

How will fiscal policy impact future growth?

It is important to remember that the situation in Europe and the U.S. is very different. Europe no longer has the ability to pursue supportive fiscal policies, while the U.S. no longer has the will to do so.

European governments face a true fiscal crisis because these governments made the egregious mistake of giving up their monetary sovereignty and effectively returned to the gold standard when they joined the EU. Just as in the gold standard, the current monetary union is inherently deflationary and has significantly limited their governments' ability to use fiscal policy as a tool to push the economy towards growth.

The biggest travesty is that the U.S. government has the ability to run even larger deficits to support growth; yet, the current political landscape changed in such a way that there is simply no willingness to run deficits. The politicians have simply given up on creating growth and they will not be disappointed.

Governments cannot "save" when the private sector is contracting, because it will only serve to lower spending, and hence incomes, in the economy. In the current environment, attempts to cut the budget deficit by decreasing spending or increasing taxes will continue to be unsuccessful because these cuts decrease demand and cause the economy to contract, which reduces tax revenue and causes government spending on natural stabilizers to automatically increase and overwhelm any effort to close the deficit. This is the phenomenon that Greece, Ireland, and Portugal are already encountering and despite their efforts to increase taxes and decrease spending; the budget deficit continues to get larger.

Now European governments are taking even more drastic steps to reduce their deficits. Italy, for example, is in the process of putting a balanced budget amendment into their constitution while Greece is being forced to cut government spending by 10% of GDP. While the measures may eventually be successful in reducing their budget deficits, the consequence of cutting 10% of GDP out of the economy will be an economic depression.

The only time nations have been able to grow while making massive cuts in government spending was when they were doing it in isolation and the rest of the world economy was strong. This allowed these countries to devalue their currency and substitute domestic demand with export demand. Unfortunately, the countries of the European periphery do not have this option, as the global economy is weak and they cannot devalue their currency because they gave up currency sovereignty when they entered the European Union. Therefore, their currency will continue to be massively overvalued and pegged to their main trading partners (i.e. Northern European countries) and the hope of export-led growth will fade as the reality of an economic depression sets in.

The most important concept to understand is that European governments are now running **pro-cyclical** fiscal policy. Unlike Greece, most European countries have been expanding for the past 2 ½ years; therefore, the effects of these pro-cyclical policies had largely gone unnoticed. However, now that growth in almost all European countries is contracting, the significance of these disastrous policies will soon be realized. Fiscal policies most valuable

role is to provide the essential counter-cyclical spending needed to stabilize the economy and reverse the recessionary feedback loop. Under Europe's new pro-cyclical fiscal policies, the government will actually be helping to fuel this vicious cycle. It is difficult to imagine how the European crisis can end in anything other than a disaster. Austerity will likely push their economies into deep recessions, which will cause widespread defaults that the weak European banking system can ill afford. The austerity measures put in place in an attempt to avoid debt restructuring will be for naught, as a European banking crisis will almost guarantee several sovereign defaults among the European periphery.

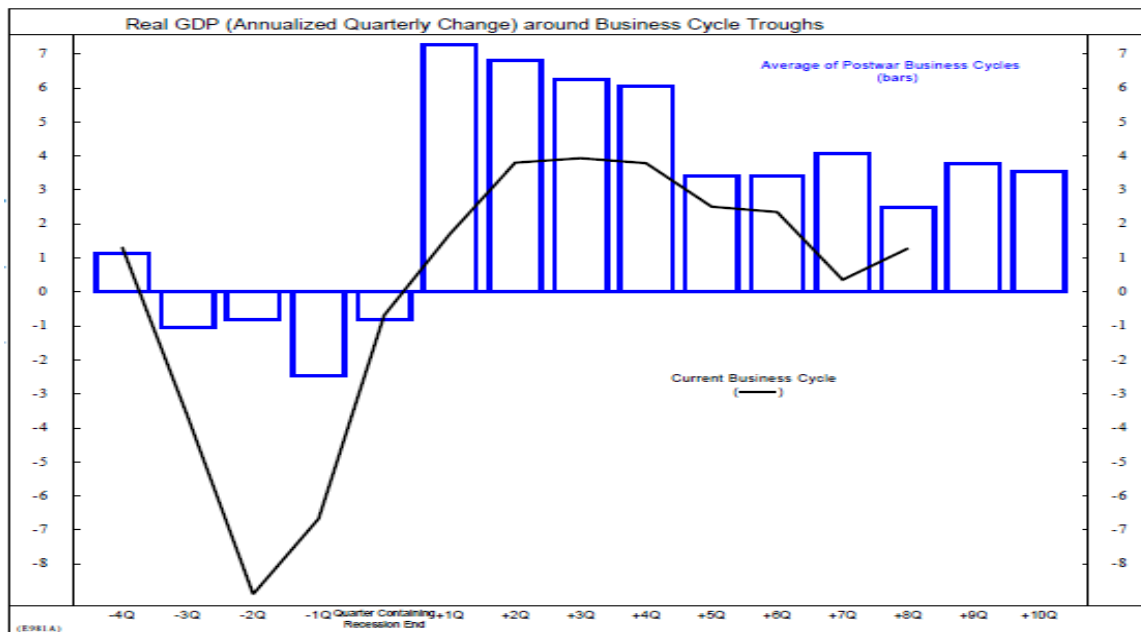
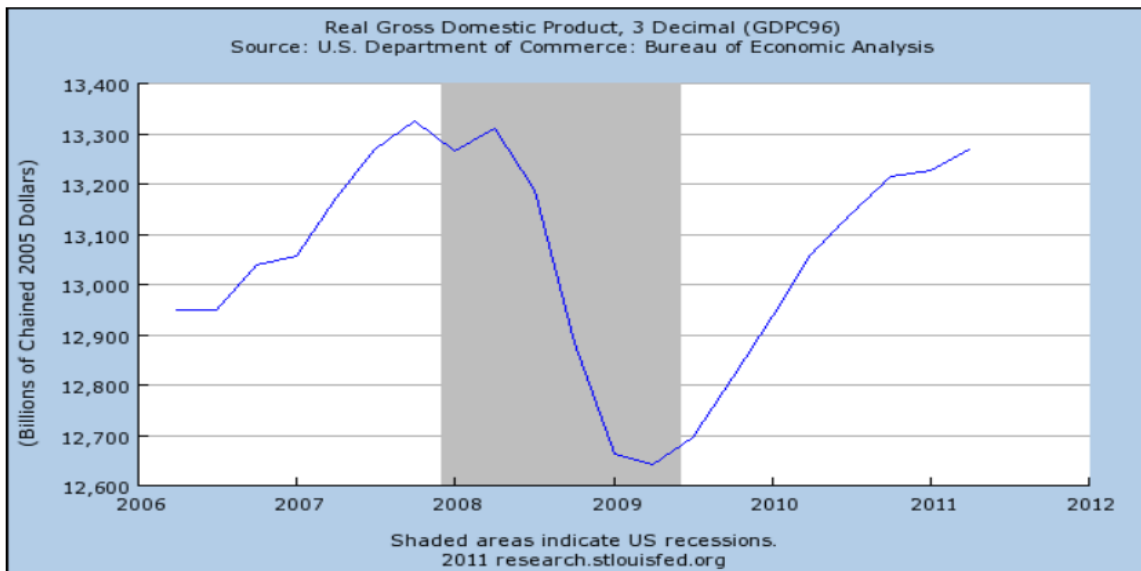
The most significant aspect of the debt ceiling debate was that it left no doubt on investors' minds of the direction in which fiscal policy is headed towards in the U.S. In my opinion, the recent drastic fall in the market was largely a result of investors finally realizing that not only are the days of supportive fiscal policy over but we are now entering a period of fiscal austerity. If the economy cannot even grow at 2% when fiscal spending was supporting growth, then how can the economy grow once fiscal spending becomes a headwind? We will soon find out, as the economy will be up against a massive \$280 billion fiscal drag in 2012.

The United States and Europe have the largest bilateral trade in the world and together they account for over 50% of world GDP. With both regions simultaneously pushing austerity, the entire global economy will feel the effects.

Economic Outlook

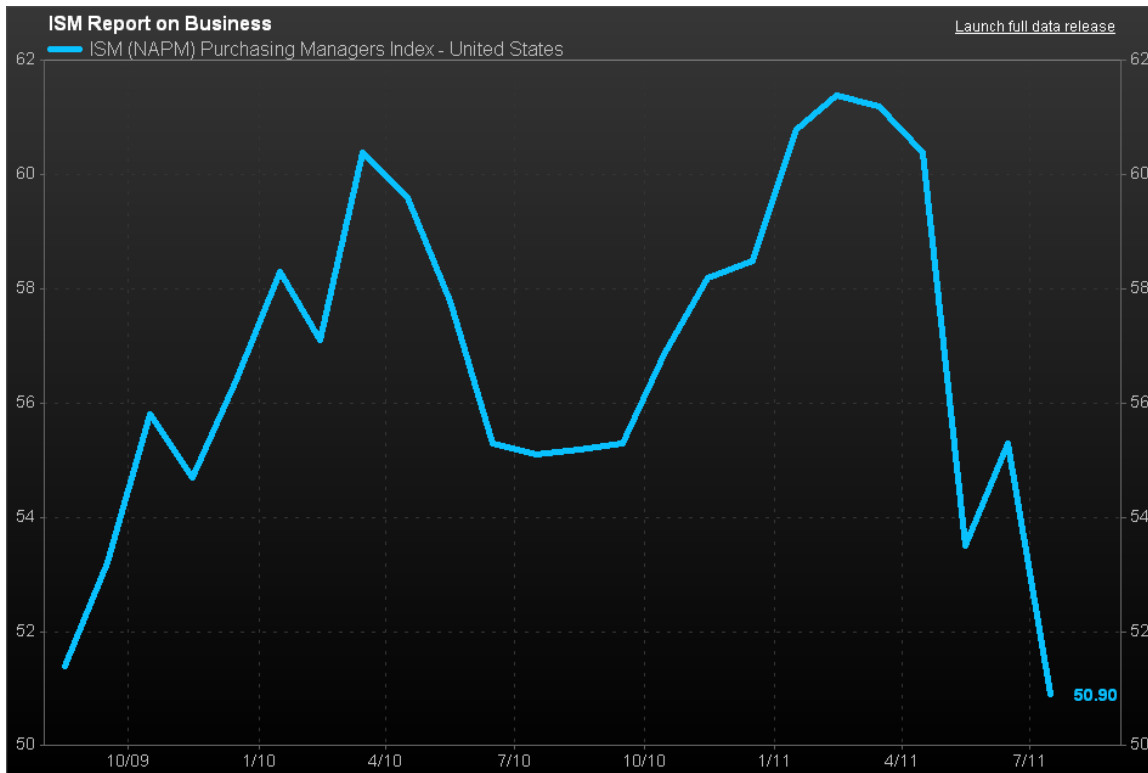
By Adam Rogers

The economy has begun to stall as evidenced by the very disappointing second quarter GDP estimates which were released on July 29th. The consensus last May was for 3.3%, which was later revised down to 2.7% and the number came in at a disappointing 1.3%. During this point of a normal recovery cycle we are growing on average around 3.6%. Perhaps even worse, was the revision of first quarter estimates from 1.9% to 0.36%. The fourth quarter of 2010 was also taken down from 3.1% to 2.35%. David Rosenberg notes *“going back to 1947 and never before have we seen this dynamic of the level of overall economic activity lower on the second birthday of the recovery than it was at the prior cycle peak. Typically two years into a recovery, real GDP is already 9.5% above the pre-recession high.”*



While the weakness in the GDP data is certainly concerning, it got less attention than it deserved over the weekend as the debt deal talk dominated the headlines. Once the deal was complete, attention immediately returned to the economy which with each successive data point looks weaker and weaker. The next headliner was the ISM manufacturing index released on Aug 1st which slumped to 50.9, the lowest since July 2009, from 55.3 a month earlier. Figures less than 50 signal a contraction. The report showed the new orders measure dropped to 49.2 in July from 51.6 the previous month, while orders waiting to be filled fell to the lowest level since April 2009. The measure of production in July decreased to the lowest level since June 2009 and inventories contracted.

The next day, Aug 2nd, provided further reason for concern with the consumer spending report printing -0.2%. This was an unexpected drop for the first time in almost two years. The lack of jobs combined with wage gains that have not kept pace with the price at the pump or grocery store has hurt consumer confidence, causing an increase in the savings rate, and lowering overall demand. Auto dealers are also seeing a slump. Cars and light trucks sold at an average 11.41 million annual rate in June, the slowest in a year, rebounding slightly to 12.2 million in July.

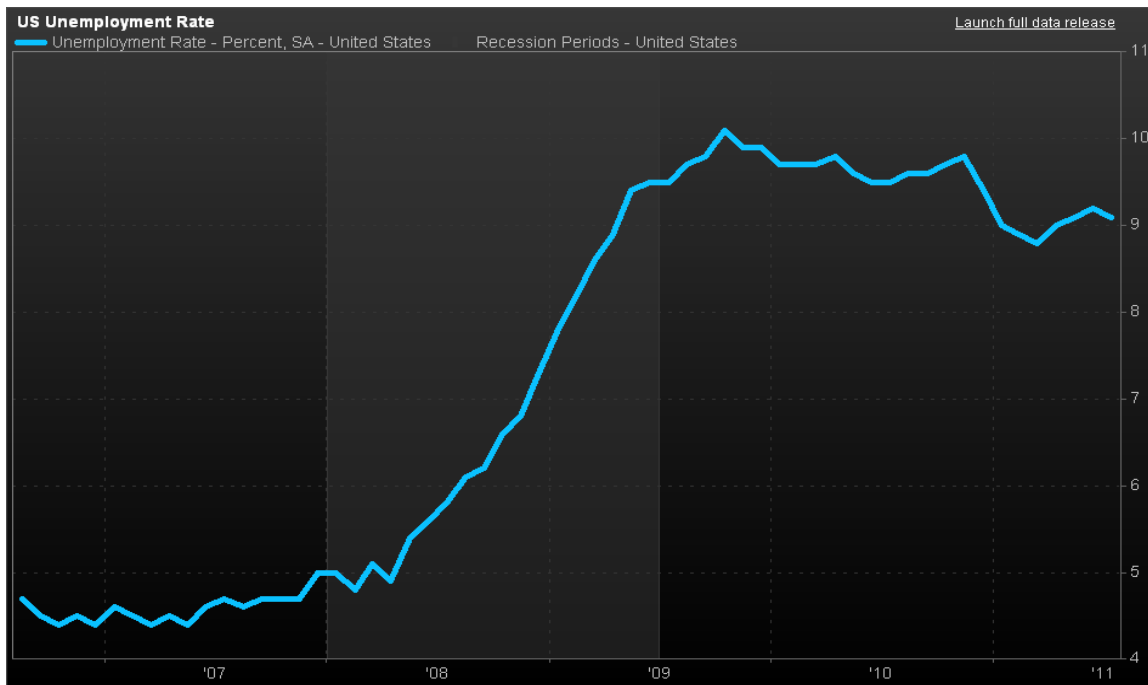


These data points have been sobering to say the least. The backward revisions have been negative across the board for many measures of economic activity. Some view this fact alone as reason for alarm. The best quote regarding this I've heard so far came from Keith McCullough of Hedgeye who said, "I don't know what's worse: that the numbers are bad or that they've just been making them up." I doubt that economic data points are "just made up", but we certainly feel free to view initial releases with a certain amount of skepticism.

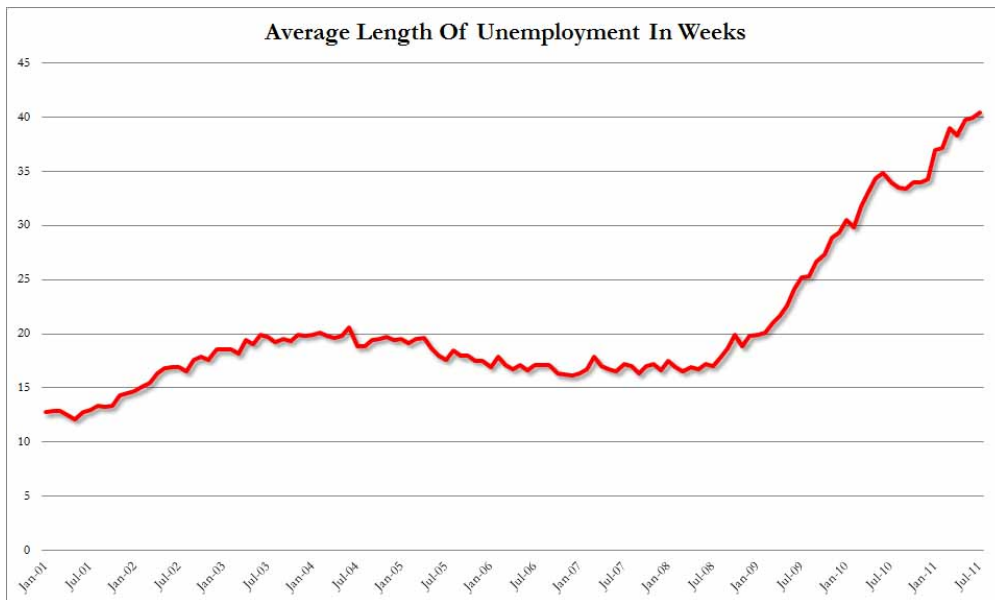
The ultimate frustration during this recovery has been the lack of job creation. Corporate profits are at all time highs, taxes are relatively low, corporate balance sheets are heavy with cash, but no one is hiring. In fact quite the opposite is happening. Just over the past couple of weeks we've seen headlines of companies reducing their workforce. The number of planned layoffs at U.S. firms rose to a 16-month high in July. Following are some of the companies that have recently announced layoff plans:

<u>Company</u>	<u>Announced Job Cuts</u>
Barclays	3,000
HSBC	30,000
Merck	13,000
Borders	10,700
Lockheed Martin	6,500
Credit Suisse	2,000
UBS	5,000
Goldman Sachs	1,000
Cisco	6,500
Research In Motion	2,000

While each company making cuts has its own story, the fact that layoffs are coming from a diverse group of industries is a troubling sign. State and local governments are not helping the matter. States laid off 23,000 workers in July and local governments 16,000. State governments have been cutting jobs since November, and their current payrolls of 5.06 million are the lowest since March 2006. Local government employment stands at 14.14 million, the lowest since June 2006. So we unfortunately have a compounding problem of private and public sector layoffs going on at the same time.

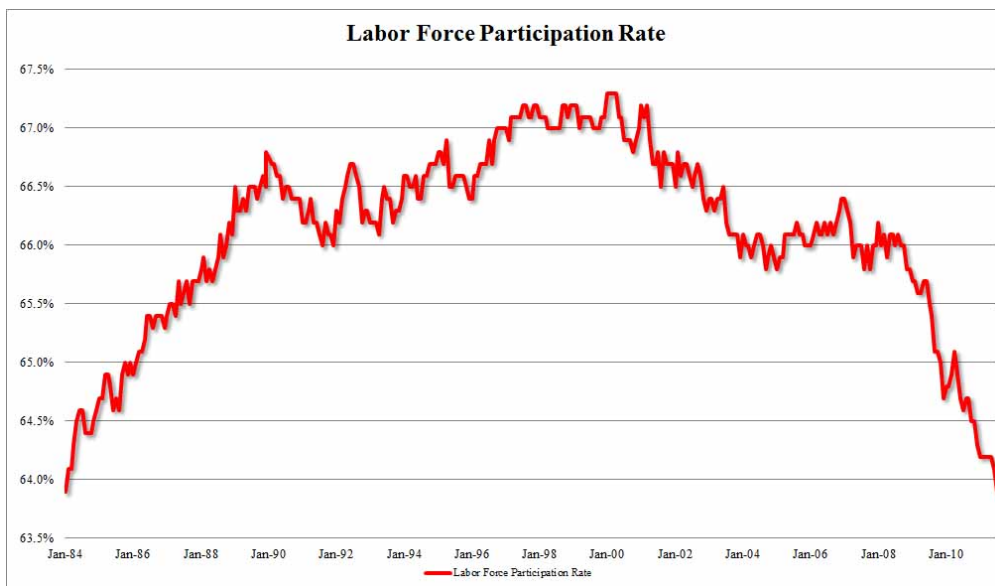


On the surface the unemployment rate at least has been trending down, but to get at the real story of unemployment we have to dig a little deeper. The following two charts depict the average length of unemployment and the labor force participation rate. What they reveal is that on average it currently takes us a little over 40 weeks to find a new job.



Source: BLS

More and more people are being classified as “discouraged workers”, and are no longer a part of the calculation of the unemployment rate.



Source: BLS

Whether or not people pay attention to these shadow statistics is irrelevant. The point is that the number of people working in this country is continually declining and until this trend is reversed we cannot have any assurance that our economy is healing.

At this point the consensus remains that we are undergoing a “soft patch” and growth will rebound in the second half. But we are aware that recession risk is rising. One of the best leading indicators is the market itself. A downward move such as the one we’ve just experienced has happened only twice without signaling a recession.

We are also aware of the parallels between now and the “mistake of 1937”. After the depression reached its full force in 1932, the economy began to rebound and the market gained 370% by 1937. A policy mistake by Washington as well as the Fed cut the market in half over the next five years and it was ten years before the market recovered its 1937 high. The lesson learned is that at zero interest rates, the marginal effect of creating deflationary expectations by signaling tightening (targeting lower future inflation) is much larger than the marginal effect of signaling loosening policy (targeting higher inflation). If a policymaker is uncertain about the nature of the real shocks and wishes to be conservative, it is better to err on the side of allowing some excess inflation. So while Washington creates a fiscal drag on the economy, we expect the Federal Reserve to be extremely accommodative.

RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Lance Lachney

At the time of our last meeting, the treasury market had just posted a solid performance for the month of May as equity markets began to stall and a few economic data points came in weaker than anticipated. Sovereign credit problems within the Eurozone, which have been with us now for well over a year, had also started to resurface. During this time, agency and mortgage-backed securities were not able to keep up with the pace of the rally in government debt. While corporate securities slightly underperformed its risk-free counterparts, credit markets remained open and active throughout the month of May.

For the better part of June, equity markets and treasury yields were headed in the same direction- lower. Investors had concerns on many fronts. What are European policymakers going to do next in regards to Greece, where the country's 2yr securities were trading below 70 cents on the dollar? Will global growth begin to soften substantially as emerging market economies, China in particular, make an effort to combat inflation? There was also uncertainty about the conclusion of QE2 at the end of June. Who will be there to support the treasury market when the Federal Reserve ends its \$600bn program? However, the manufacturing data during this time continued to surprise to the upside, alleviating investors' concern over a slowdown. The Greek government was also able to pass an austerity package that would help secure funding in the short term. By the end of the month, equity markets had stabilized and risen back to high levels. The treasury market handed back all the gains accumulated during the month in the last week of trading. While government securities posted a small loss for the month, corporate securities underperformed for the second month in a row. High yield also delivered its second consecutive month of underperformance, losing over 1.25% versus treasuries in the second quarter. A sign of things to come?

The sigh of relief by investors towards the end of June was short-lived to say the least. In early July, European sovereign problems grabbed the headlines once again after Portugal was downgraded four notches to junk by Moody's. This action came less than two months after the country had received over \$100 billion in financial aid. This in turn drove yields on Spanish and Italian government bonds substantially higher. With all of this going on, policymakers overseas were still trying to determine how and to what extent private investors should participate in any future Greek restructuring. Equity markets and treasury yields once again started to move lower as the risk-off trade reemerged. Ultimately, the European Financial Stability Facility(EFSF) lowered rates and extended maturities on all outstanding and future loans. These provisions were also given to Portugal and Ireland. On the heels of these actions, order had been restored in the global markets and the back up in Spanish and Italian yields came to a halt. For about two seconds. The newly released European rescue package was having trouble getting off the ground as some area members were in opposition. Others questioned the lending capacity of the EFSF as it would clearly need to be expanded if Italy, where the world's third largest government debt market resides, ran

Chart 3: Price action in Spain and Italy suggests ECB has started buying Italian and Spanish government bonds



Source: BofA Merrill Lynch Global Research

into trouble. Needless to say, the package did little to calm fears and the upward movement in European sovereign yields continued.

Inside of our own borders, the debt ceiling debate in Washington quickly became a global phenomenon. In question was congressional approval to raise the government's \$14.2 trillion debt limit by the Treasury Department's proposed deadline of August 2nd. It goes without saying that it was one of the most embarrassing displays on both sides of the aisle in recent memory. Even those few who did reach out and make a bipartisan attempt to reach a deal were scoffed at and ridiculed by their own party. In the end, an agreement was made to cut approximately \$1 trillion now and raise the debt ceiling by roughly the same amount. In addition, a bipartisan commission would be formed to discuss and recommend further cuts to spending. If no agreement is found or the recommendations are not approved by Congress, then a backup sets of cuts would be triggered and the debt limit will increase by another \$1.2 trillion. While the economic ramifications can be debated, taking the debt ceiling debate to the limit, it did little to build confidence at home and abroad. Even though Moody's confirmed the country's credit rating stating that the agreement is "a first step" in maintaining its triple-A rating, there is little argument about the deterioration of country's balance sheet and plenty of concern over its long-term fiscal sustainability.

With the disruption in Washington temporarily behind us, investors' fear about the economy began to grow. The most recent manufacturing data had been softer than expected and the reported GDP numbers for the second quarter were less than stellar. The economy grew at a rate of 1.3% during the spring. In addition, the 1Q GDP numbers were revised down to 0.4% from its previously reported 1.9% mark. These domestic issues coupled with rising sovereign risk in southern Europe put extreme pressure on global equity markets and treasury yields.

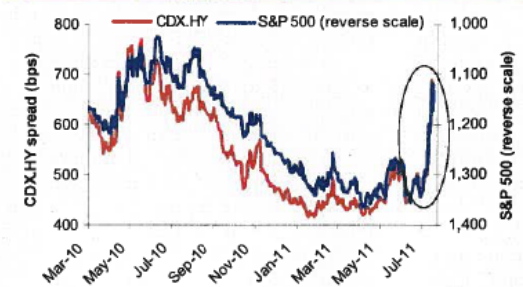
The rumor that had been circulating throughout the day on Friday, August 5th did in fact come to fruition. That evening, Standard & Poor's announced that "we have lowered our long-term sovereign credit rating on the United States of America to AA+ from AAA." Making good on a July warning that absent a major deficit reduction package a downgrade would likely incur, the rating agency delivered the blow. Over the weekend, investors were questioning how markets would react to such an event. While rating actions have taken place throughout history, there really was no precedent due to the country's dominant global economy, its ownership of the world's reserve currency, and its access to the most liquid safe haven imaginable- the U.S. Treasury market. For the purpose of this discussion, we will refrain from comments on the agency's decision and leave that to the politicians. As in life, it is what it is.

Historically, yields have been largely determined by a country's economic outlook. While a downgrade should make treasury securities a less desirable asset in theory, at this juncture it created more uncertainty in an already cloudy economic environment. With the economy growing less than 1% during the first half of the year and the unemployment rate hovering around 9%, a perfect storm ensued. In response to the growing crisis at hand, the European Central Bank implemented its bond repurchase program in order to keep rising yields in Spain and Italy in check. Risk aversion was out in full force as investors sought refuge in gold, Swiss francs, and the most recently downgraded security- U.S. Treasuries.

In the midst of all of this, the Federal Reserve also held its regularly scheduled policy meeting. The FOMC acknowledged that the economic outlook had weakened and downside risks have increased. It was also stated that it expects a slower pace of

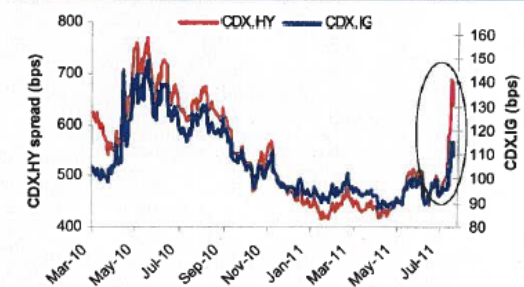
recovery going forward and anticipates that economic conditions are “likely to warrant exceptionally low levels for the federal funds rate at least through mid 2013”. In addition, policymakers did discuss the “policy tools available to promote a stronger economic recovery”. There were three dissenting voices, who wanted to retain the “extended period” language- Minneapolis Fed President Narayana Kocherlakota and the two usual suspects, Fed Presidents Richard Fisher and Charles Plosser. There is no question that the Federal Reserve is willing to use whatever means necessary to promote stability within financial markets. Whether or not any future action is successful is another story.

Figure 1: Stocks and high yield selling off in tandem ...



Source: BofA Merrill Lynch Global Research

Figure 2: ... while high grade has outperformed this time



Source: BofA Merrill Lynch Global Research

During the past few weeks, treasury securities have performed remarkably well as investors have sought shelter in times of stress. Corporate bonds have underperformed by approximately 100 basis points, with high yield and financials leading the way wider. This relative hiccup is understandable given that high yield spreads are highly correlated with stock prices. Financials have also lagged due to their lack of growth prospects and in light of their exposure to sovereign debt. Agencies and mortgage-backed securities have also been unable to match the performance of treasuries. As expected, the government-sponsored entities Fannie Mae and Freddie Mac were lowered by Standard & Poor’s, reflecting the mortgage firms’ “direct reliance” on the U.S. government.

Going forward, we still believe that the treasury curve has no other option but to flatten given that short term rates are firmly anchored on the front end. The demand for current yield and carry will likely lead investors to extend their portfolios out the curve despite relatively low absolute yields. Given that the spread between 5 & 10 year treasuries and 10 to 30 year treasuries is 125bps and 140bps respectively, this compression is likely to take place. While slowing economic growth should lead to wider corporate spreads, we feel a good portion of this move has already taken place. Balance sheets in America are still in very good shape. We expect the financial sector to continue to be volatile until some concrete resolution is found for the European crisis. There is still decent value within some high yield names, but security selection is paramount at this point in the cycle. Lastly, we feel that high quality assets like agency MBS offer an attractive opportunity relative to treasuries as volatility starts to decline. We will continue to pursue trades that fall in line with these guidelines.

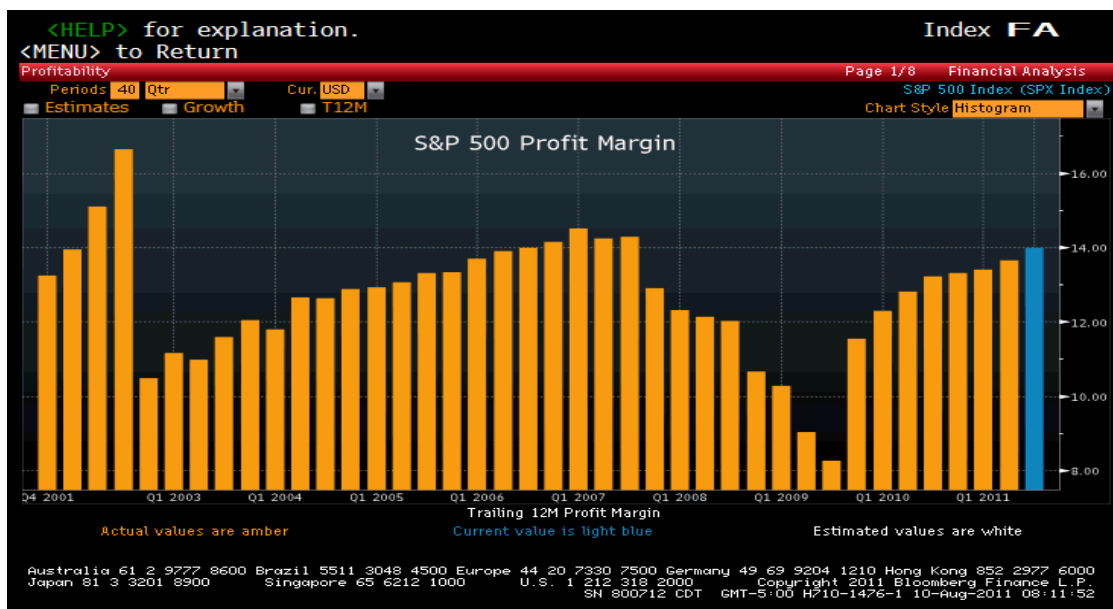
Domestic Equity Strategy

By Keith Buchanan

For two years, market participants viewed the environment for stocks as a glass half-full. We shook off the European sovereign debt crisis. Volatility in the domestic economic data flow was taken with a grain of salt. Our own massive debt accumulation and unsustainable fiscal irresponsibility was ignored as stocks roared back after looking into the abyss of the 2008 financial crisis. However, fear is back in vogue. Fear has way of making improbabilities seem probable and opportunities seem bleak. Improved earnings and attractive valuation has done nothing to take the market's focus away from the economic problems we face.

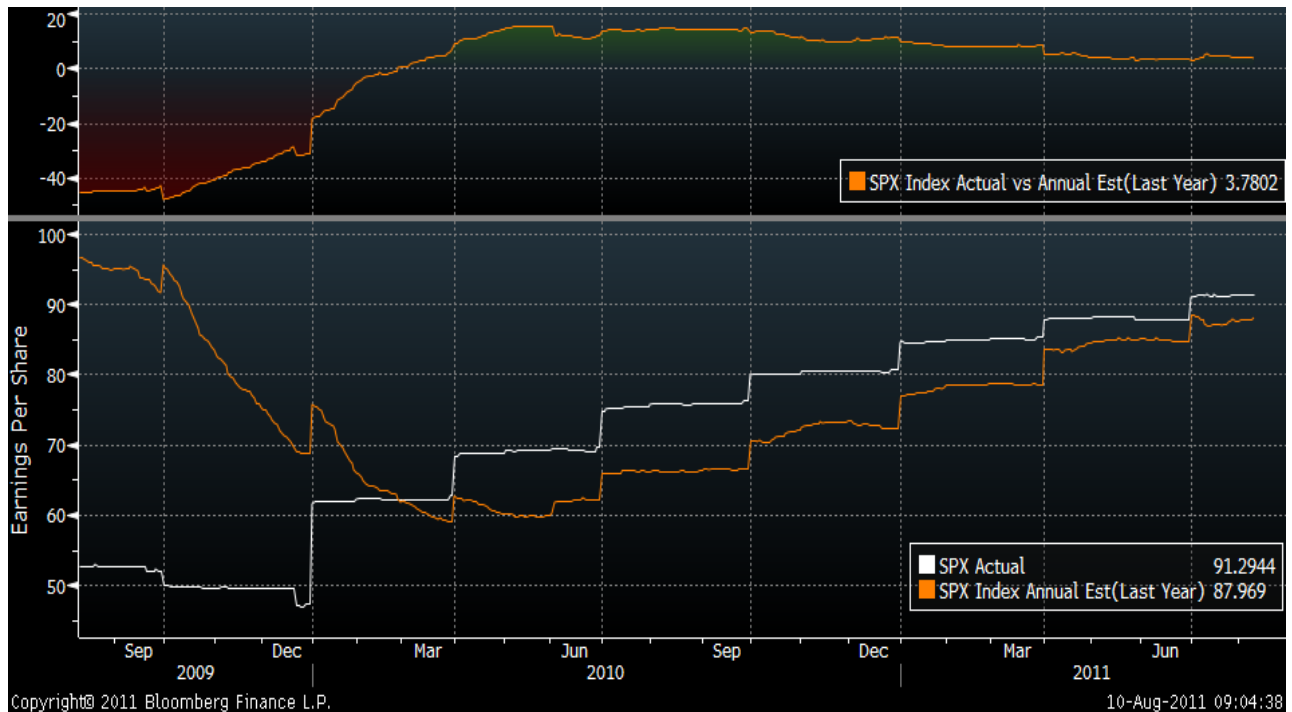
I never lost money by turning a profit. - Bernard Baruch

While everything in this market has been fairly fluid, corporate earnings have been resilient, if not robust. The consensus expectation is for the S&P 500 to earn \$99 in 2011 and \$113 next year. So far in this reporting period, 419 companies have reported their quarterly results. Of those, 319 have surprised to the upside in earnings, and 300 have surprised positively in sales. If expectations are met, we will achieve 9% and 14% earnings growth in the third and fourth years, respectively, of this post-crisis recovery. As seen on the chart below, profit margins have worked their way back to pre-crisis levels, due to cost management and sticky pricing. Nonetheless, this earnings growth begs the question, at what expense does this corporate profitability come? Has earnings growth and profitability been exceptionally strong because companies are reluctant to invest in human or any other capital? In order for the recovery to evolve into an expansion, we have to see employment or wage gains. Thus far, we simply have not seen that.



Source: Bloomberg

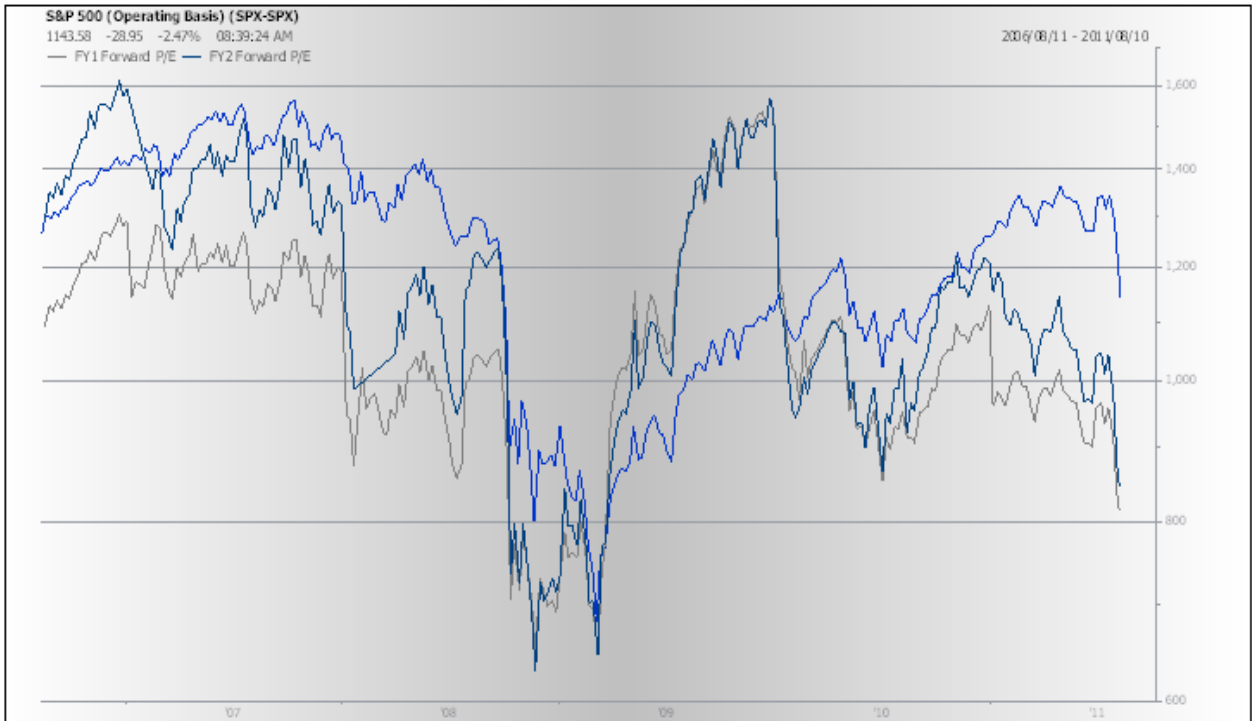
As seen in the chart below, the market has slowed as actual earnings have narrowed the gap on expected earnings. Companies are still ahead of expectations, but without the margin that helped fuel the last leg of the rally. As expectations approach actual results, the market should experience a slowdown in gains until another catalyst comes along.



Source: Bloomberg

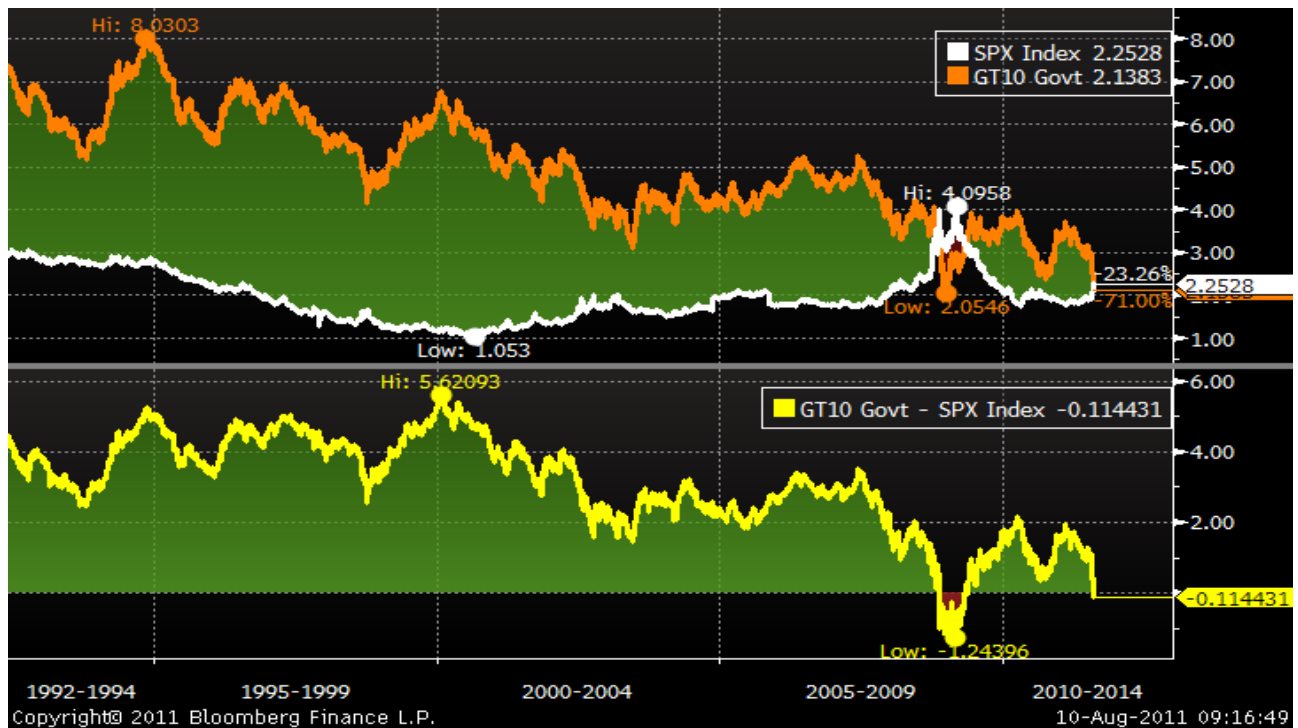
There is but an inch of difference between the cushioned chamber and the padded cell. - Gilbert Keith Chesterton

If one is to attribute the strong rally in stocks to earnings growth and improving economic data, then the weakening economic picture is to blame for the market's disinclination to pay a worthy multiple for even better earnings growth. Depending on one's vantage point, the valuation picture appears either horrifying or extremely attractive. At 12.2 times 2011 earnings and 11.1 times 2012 earnings, the market has not been cheaper on a forward looking P/E basis since March 2009, the month that the stock market bottomed before doubling to recent levels.



Source: Factset

The chart below shows that the market dividend is yielding 2.25% or 11 basis points more than the 10-Year Treasury bond. May of 2009 was the last time stocks yielded more than Treasuries. Although this was two months after the bottom in stocks, it still was a good time to own stocks in retrospect. Keeping in mind the recent Treasury downgrade, this positive yield spread is all the more impressive.



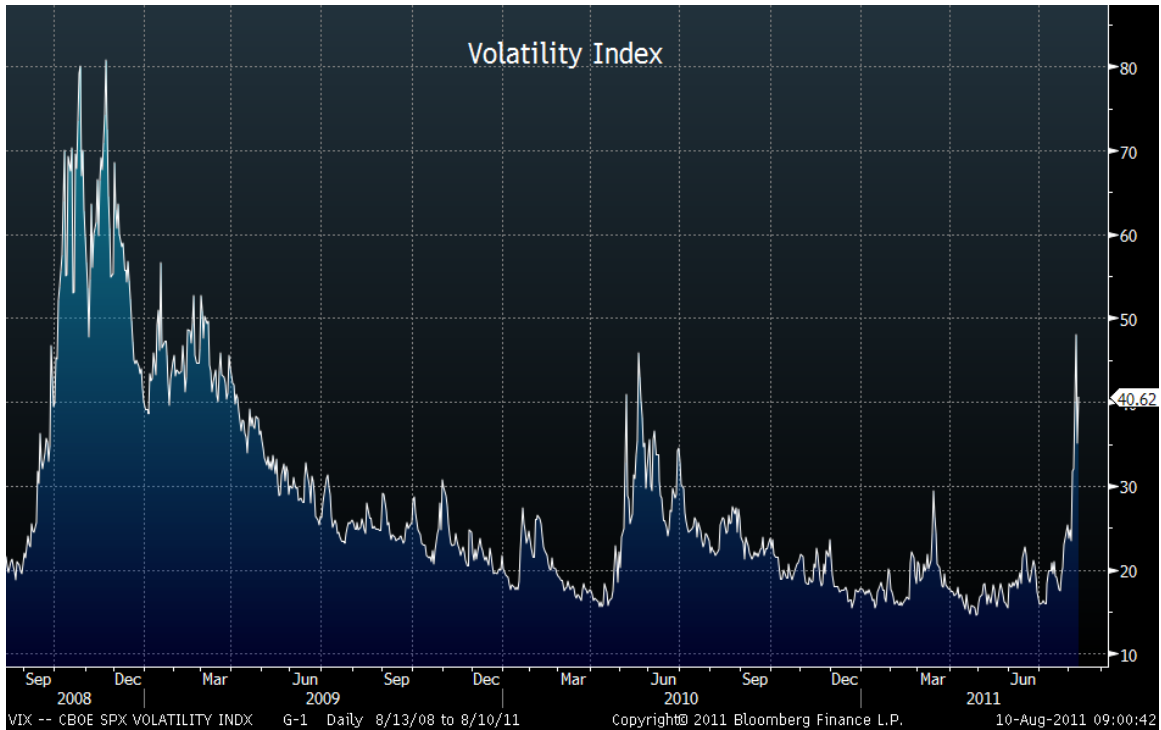
Source: Bloomberg

Valuation alone is never valid justification for buying stocks. However, studying the valuation of the market allows us to keep our perspective and view how asset classes are perceived by the rest of the market. Looking at the price performance of the market would lead one to believe that the market has only begun to discount an economic pullback. Through the lens of relative and historical valuation can one begin to appreciate how much of the worst-case scenario is already embedded in stocks.

It is not death or pain that is to be dreaded, but the fear of pain or death. – Epictetus

We have had our third crash course in behavioral economics in as many years. Every facet of our markets is built on a foundation of confidence. For instance, we have to trust that counterparty risk is properly assessed and accounted for. We also have to trust that each transaction will execute as planned. When a shadow of doubt is cast over any tenet of our marketplace which we usually assume is safe from negative change, fear selling permeates the market. This is not unfamiliar territory. In 2008, the financial markets were rocked by the unknown of how far the tentacles of the housing collapse could reach. Stockholders sold first as the fear of the unknown eroded the confidence in our financial system as a whole. Last summer, the European debt crisis began to rear its head. As investors began to fear default in several countries in the European Union as well as the stability of the European Union itself, stocks sold off sharply. We are at the point again, as a deal reached by Congress and the Obama Administration did little to stave off fears of a debt downgrade and its ripple effects. On August 5th, Standard and Poors downgraded US Treasury debt from AAA to AA+. As the saying goes, fear begets more fear. The downgrade triggered panic selling, which leads to collateral demands from investors. They are forced to sell shares to meet margin calls. The end result on the following Monday was a widespread plunge in equity prices and eroding investor confidence.

We have also seen merger arbitrage spreads in announced but unclosed transactions increase dramatically, signaling a lack of confidence in just closing transactions. No risk premium is safe in a fearful market such as the one we are in. Shares of Temple-Inland, Medco, Dollar Thrifty, and M&F Worldwide fell well below their respective offer prices as investors question whether financing will be available at decent rates given the uncertainty in the debt markets and the willingness of the acquirer. There is a psychological component that impacts managers and their boards as they also become more risk averse. Warren Buffett stated in an interview that "financial markets create their own dynamics", and this phenomenon is definitely at play. At the same time, our domestic economy is indeed slowing, and Europe's sovereign debt issues are still unresolved. There are still real risks, but fear only makes those downside risks seem far more probable. The Volatility Index, which is known as the fear barometer, below illustrates how anxious the market has become in the past two months.



Source: Bloomberg

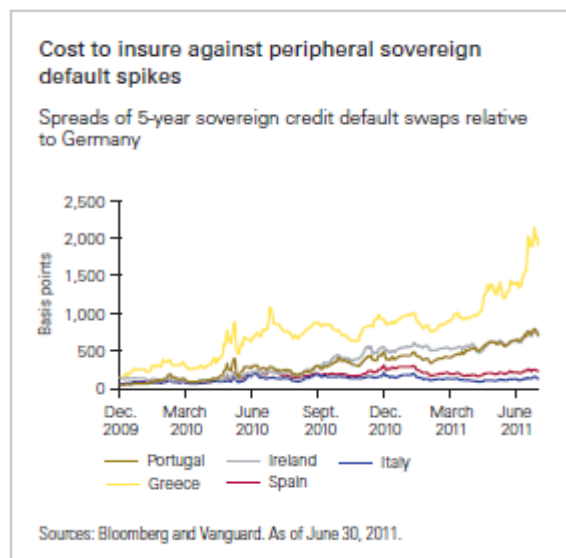
However, in times like these, it is important to keep perspective. This is not 2008, a year when we experienced systemic risk that had our entire financial system teetering on the edge. Nonetheless, those wounds are still very fresh, and the market has a "shoot first" mentality after suffering a 55% decline only three years ago.

In our equity portfolio, we remain with a large cap, quality bias, which should retain value better in times of uncertainty. In our active portfolios, we have been selectively adding to positions which offer the best long-term prospects. Stock selection has not reaped the benefits that we normally expect due to the extreme correlation that comes with these volatile markets. We also participated in a put spread strategy recently. The strategy offers us varied protection if the market sells off up to 16% through the end of the fiscal year. We will participate fully on the upside should the market move higher, and we would be a buyer of the market in the case that the market is down more than 16%. We feel that the increased volatility offered great terms to hedge further losses for the next few weeks.

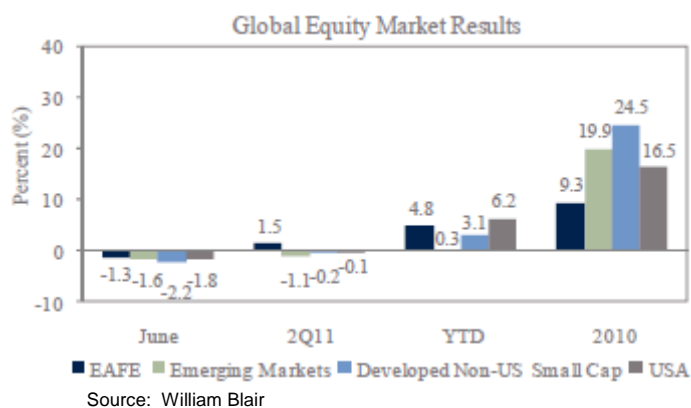
International Equity Strategy

By Steve Lambdin

Though major global equity market indices finished the second quarter not too far from where they started, there was no shortage of macro events affecting investors. European sovereign debt concerns seemed to dominate the news flow on a daily basis. Rioting in Greece just shows how upset the people in this country are with their leadership. Fiscal austerity measures will be affecting most segments of the population in this country as few will be spared. While a Greek bailout barely passed and provides a short term cushion, the long term outlook still looks rather bleak. Unfortunately, we see other European countries that will need some type of a bailout or fiscal reform package over the next year. In addition, the U.S. debt situation is taking center stage as well, as efforts to raise the debt ceiling were caught in the middle of party politics. The world watched as the U.S. averted a default in the “11th hour”. These issues are making investors very nervous and providing for very volatile equity markets around the globe. The global debt saga is not the only issue facing investors today. Inflation continues to be an issue in many emerging markets, energy prices remain elevated, and unemployment levels remain too high in most parts of the world. But the scorecard has a positive side as well. We expect a very robust and healthy second quarter earnings season as earnings as a whole could be even better than many analysts have forecasted. We also still see a good environment for corporate M&A activity, as we have seen a recent flurry of announced deals. As we move into the third quarter, we feel world markets will be set to react to news flow on the European debt crisis as well as developments on the U.S. debt front. Obviously, perceived positive developments on these issues should be good for the markets and provide investors with a bit of comfort. However, the other side of this could be quite painful and detrimental for investors.



The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +1.6% and -1.1% respectively during the second quarter of 2011 vs. +.10% for the S&P 500 Index. Weakness in Japanese equities continues to be a drag on global returns and was the main area of weakness within the EAFE Index for the quarter. The U.S. Dollar continued to weaken during the quarter and was responsible for the slight outperformance of large cap global equities vs. their U.S. counterparts. The European region continued to outperform the Asian region, as core markets in Europe were strong relative to the smaller markets in southern Europe. Within the MSCI Emerging Markets Index, the Asian markets were just a bit stronger vs. the Latin America and European markets, as the Russian, Indian, and Brazilian markets were weak as inflation concerns are rattling investors. From an economic sector standpoint, Discretionary, Healthcare, and Staples performed well, while Financials, Energy, and the Technology sectors were weaker.



So far into the third quarter of 2011, the global equity markets have been completely blasted by several issues posing significant anxiety with investors. The downgrade of the U.S. credit rating by Standard and Poor's, continued European sovereign debt concerns, and rising inflation in many emerging markets have come together to push the world equity markets down significantly. In fact, many equity markets have officially entered "bear market territory", which is a fall of 20% or more from a recent high. From the end of June to August 8th, the MSCI EAFE Index, Emerging Markets Index, and S&P 500 were down -14.2%, -13.2%, and -15.1% respectively. Recently, the U.S.'s debt downgrade and the effect this had around the globe has been the thrust of this downward movement. Global equity volatility readings are at extreme levels as the markets have been in virtual panic selling mode as the world de-risks. Also, recent inflation readings from China were much worse than what many were expecting, putting this region under the gun as well. European sovereign debt concerns continue to worsen by each passing week as a strong response is needed by the ECB and the IMF in order to calm the markets. Obviously, this threatens this region's economic outlook. As we gauge what is happening around the globe, these are some of the scariest times to be an equity investor. It seems like new issues are cropping up each week with a severe negative response by investors. We have seen unprecedented selling of equities around the world while investors have been buying gold and government

securities. At some point, we would expect equities to have to post some type of a rally if we get some news to relieve investor anxiety. Just how strong this rally will be is anybody's guess at this time. We feel news flow on the key issues mentioned above will be the main driver of many global equity markets over the next several weeks.

Asia Update

Despite the devastating impact of supply disruptions and numerous production issues from the Japanese earthquake, tsunami, and nuclear crisis, the Japanese equity market held in very well in the quarter. The MSCI Pacific region posted a virtual flat return in the quarter as most markets returns in the quarter were clustered together. No one market had a huge return and no market completely fell apart. The Asian basin was relatively calm over the duration of the quarter. In general, we continued to see decent growth in most economies during the quarter as the region remained a pillar of growth to the world. Investors still remain watchful on inflation readings in the region as well as how much of a recovery will happen in Japan in the third and fourth quarters of 2011. These two issues could be key drivers over the next few months.

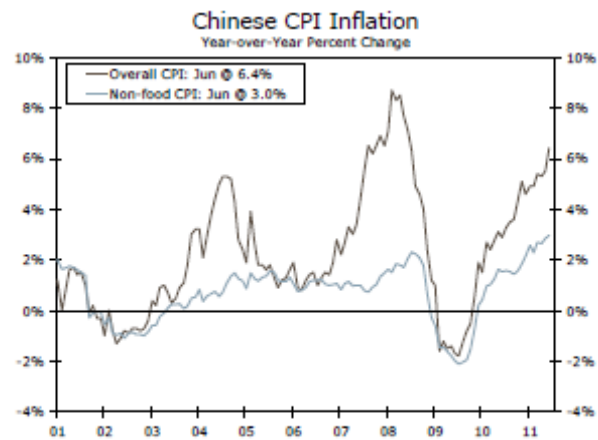
Market Performance

Index Name	Total Return (30-Jun-2011)	MTD % Change	QTD % Change	YTD % Change
MSCI Philippines (PH-MSX)	543.759	1.60	3.27	0.43
MSCI Singapore (SG-MSX)	11140.877	(1.56)	2.04	1.40
MSCI Taiwan (TAMSCI-MSX)	467.052	(4.19)	1.72	(2.60)
MSCI Korea (KR-MSX)	644.136	(1.93)	0.91	8.54
MSCI Japan (JP-MSX)	4419.567	1.47	0.18	(4.68)
MSCI Australia (AU-MSX)	4988.903	(1.03)	(0.56)	3.90
MSCI Hong Kong (HK-MSX)	40735.617	(3.90)	(0.96)	(1.36)
MSCI China (CN-MSX)	100.543	(3.67)	(1.75)	1.09
MSCI Thailand (TH-MSX)	700.329	(4.16)	(1.88)	2.21

Source: Factset Research

The Chinese economy remained a pillar of growth in the Asian region in the second quarter. Chinese GDP growth was reported up +9.5% in the second quarter from the year earlier period. Fears of a complete hard landing in this economy may be just a bit overblown if we continue to see growth near this level in 2011. Industrial output remained strong and was up +15.1% in June from the year earlier. Retail sales were up +17.7% in June as well. Housing transactions were up over +30% in June, even as the government is taking measures to cool this growth. However, investors are very nervous as consumer prices were up +6.4% in July and show little signs of abating.

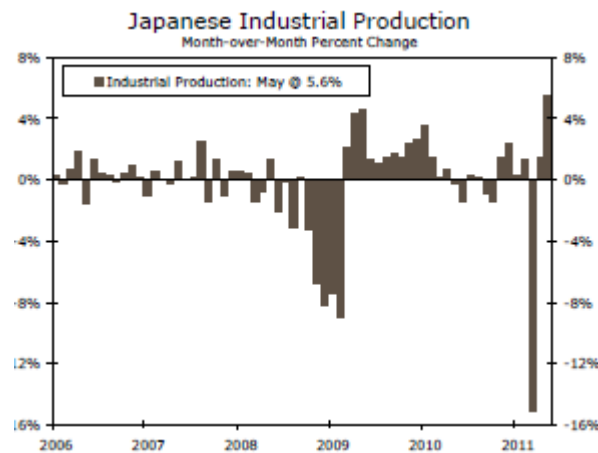
This remains well above the government's 4% target and is the highest rate in three years. This remains the one issue that could derail the outlook here and push equity markets lower. The People's Bank of China (PBC) has responded with raising the one year lending rate to 6.56% in early July. Also, banks are required to hold 21.5% of deposits as reserves, much higher than a year ago. However, we feel even more tightening is in the picture for this region. This is very necessary in order to cool off the property markets and the growth in fixed asset spending. We still believe further increases should have the desired effect on the inflation issue in this country as the government tries to engineer the "soft landing" many hope to see.



Source: Bloomberg LP, CEIC, IHS Global Insight and Wells Fargo Securities, LLC

Coming as no surprise, the Japanese economy continues to be pressured from the recent devastating events in the region. The economy is struggling through too many disruptions in production to mention even as progress is being made. We expect Japan's economy to continue to contract in the second quarter, probably somewhere in the -2.5% level on an annualized basis. This is the third straight quarter of negative growth in the region even though it is an improvement from the previous quarter. The country remains firmly in a recession. Economic readings continue to be a mixed bag for the most part as most would expect in the very early stages of a rebuilding effort. Factory output rose +3.9% in June from May, which was a bit below expectations, but going in the right direction. We expect the trend to continue to get better as many companies are planning output increases as supply chain issues get resolved. This should push exports higher in the very near future. Retail sales continued to get better through the second quarter. April sales fell -4.8% from the year earlier period, but June finished up +1.1% from a year ago. This is certainly trending in the right direction. Consumer confidence also moved slightly upward throughout the quarter.

On the inflation/deflation front, the July Tokyo CPI was reported up +.5% in July, the first month of inflation in quite some time. Fresh food and utilities saw healthy price increases even as household goods and housing continued to deflate. Unemployment held steady again in the second quarter as the jobless rate remained at 4.6%. In addition, the jobs to applicant ratio finished the second quarter at .63, exactly where it was in the previous quarter. We hope to see better employment readings as we head into the latter half of the year as the rebuilding effort kicks into high gear. Just how much of a “V” shaped recovery we will see in this region remains the key issue for investors as we head into the third and fourth quarters of 2011.



Source: HIS Global Insight and Wells Fargo

Most economies in the Asian region seem to be performing fairly well in light of what we see going on in Europe and the U.S. However, investors will be watchful as developments in Europe and the U.S. can certainly affect the export climate of this region. Sovereign credit issues don't seem to be a major issue outside of Japan. We expect to see a better economy in Japan over the next few quarters as the rebuilding effort kicks into a higher gear. China will be a bit of a wildcard with its inflation problem, but this looks very solvable with appropriate government actions. The smaller economies in the Asian basin look to be okay, but will certainly take a follow the leader type of approach to the much larger economies around the globe.

Europe Update

For the second quarter in a row, European equities wound up being the best performing region within the MSCI EAFE Index in the second quarter of 2011, returning +2.85%. We were somewhat surprised of the strength of the equity markets in this region as the world watched the sovereign debt crises

unfold. However, the divergence within this region continues to grow. Equity markets in Germany, France, and Switzerland performed much better than the severely debt plagued markets in Greece and Italy. But most of the gains came from a continuing weakening U.S. Dollar versus the Euro. The stronger core economies are benefiting from a lack of problematic sovereign debt, a stronger export climate for their products and services, and a more stable employment picture. The more problematic countries such as Greece, Spain, and Italy are suffering from debt issues, banking problems, and structurally higher unemployment. Austerity measures are being taken at the expense of suppressing economic growth. As this unfolds, investors are very nervous and equity markets are highly volatile with significant downside risk. Ultimately, we still expect the EU, ECB, and IMF to continue to help these problem countries over the near term in order to prevent a complete implosion of this region's economy. Market valuations and dividend yields still look very attractive, but at this point this is secondary to the macro issues in the region.

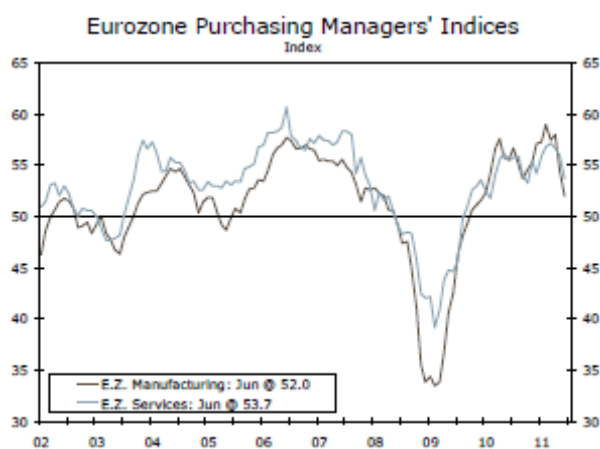
Market Performance

Index Name	Total Return (30-Jun-2011)	MTD % Change	QTD % Change	YTD % Change
MSCI Switzerland (CH-MSX)	10787.455	(4.35)	7.28	9.32
MSCI Germany (DE-MSX)	6323.503	1.99	6.99	15.09
MSCI France (FR-MSX)	6983.976	0.68	5.25	16.38
MSCI Spain (ES-MSX)	5038.755	(0.27)	2.08	16.17
MSCI United Kingdom (GB-MSX)	6460.386	(2.88)	1.74	5.59
MSCI Italy (IT-MSX)	1189.266	(2.85)	(1.82)	11.69
MSCI Greece (GR-MSX)	448.113	(1.13)	(16.25)	(3.56)

Source: Factset Research

We suspect the Euroland economy has cooled off a bit from the first quarter of 2011. Though the actual second quarter number will not be released until later in August, we expect to see pressures building in this region. Supporting this look is the index of executive and consumer sentiment which recently fell to 103.2. This is the lowest reading since August 2010. We see the Euro area cooling as governments in the region are cutting spending in an effort to gain bailout packages to stop the fiscal crisis in certain countries. Unfortunately, this comes at the expense of economic growth. In manufacturing, many companies have recently reported shrinking order books for the first time in a year, which has been supported by shrinking capacity utilization across the region. Also, retail sales in the region fell in May -1.1% from April, which was the biggest decline in over a year. Consumers have cited too much economic uncertainty as it relates to retail sales. In addition, the unemployment situation is still quite disturbing. June unemployment held steady at 9.9% across the Euroland economy as companies are still reluctant to hire more workers. Approximately 15.6 million people are looking for work. Over the near term, it's hard to see this

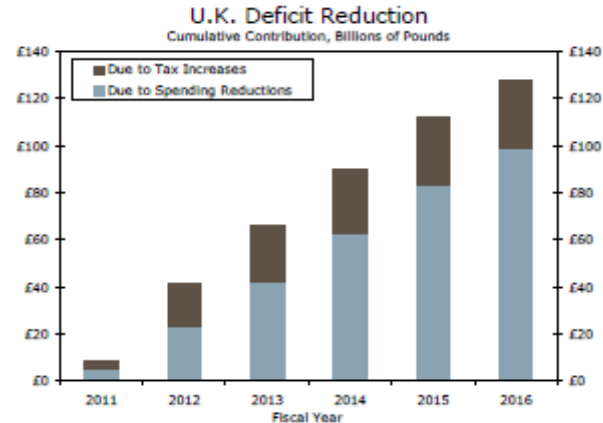
getting much better on the margin. However, on the positive front, producer prices fell in June as crude oil and other commodity costs fell. Also, the inflation rate held steady at +2.7% in June, as recent actions by the European Central Bank may have helped slow down inflation. The ECB did raise interest rates another 25 basis points in July to 1.50%. This was widely anticipated by the investment community as the ECB remains aggressive with respect to inflation. With this move and subsequent weakness we have seen in this region lately, we do not expect more interest rate increases over the next few months. As we move into late summer, we feel the main issue on investor minds' remains the sovereign debt contagion in the region. A coordinated and comprehensive solution needs to be developed to restore investor confidence in the market place. More bailouts will be needed other than Greece, perhaps in Spain and Italy. As events and news flow follow these developments, we expect the markets to be very volatile with a downward bias very possible.



Source: Bloomberg LP, HIS Global Insight, and Wells Fargo

As the world slowed down, so did the U.K. economy. The U.K. economy only grew +.7% in the second quarter from the year ago period. This is the slowest growth in over a year. Consumers are reluctant to spend in the face of persistently high inflation and an overall lack of consumer confidence. Industrial production fell -1.6% from the previous quarter as manufacturing, mining, and utility output were all lower than the first quarter. This drop in economic output appears to be fairly broad based. Even though retail sales were up a bit in June, many see this as just temporary as early summer clothing discounting was very widespread. Inflation was reported at +4.2% in June, still well above acceptable levels by the Bank of England (BOE). The BOE is still playing the balancing act of possibly raising interest rates to combat inflation or keeping them low to try to inhibit economic growth. So far, the BOE has refused to raise interest rates, so the key benchmark rate remains at .50% as the economy is just too fragile at present. Unemployment remained at 7.7% as the number of unemployed fell by 26,000 to 2.45 million. Wage growth remained steady at +2.1% year over year. So while not getting any worse, no significant progress is being made on the employment front in the U.K. Looking forward over the next few months, with what is happening in the Euroland economy as well as in the U.S., we still see a weak outlook

in the region. Inflation could get a bit better on the margin as key costs are set to decline.



Source: Bloomberg, LP, IHS Global Insight, HM Treasury and Wells Fargo Securities, LLC

Other Regions

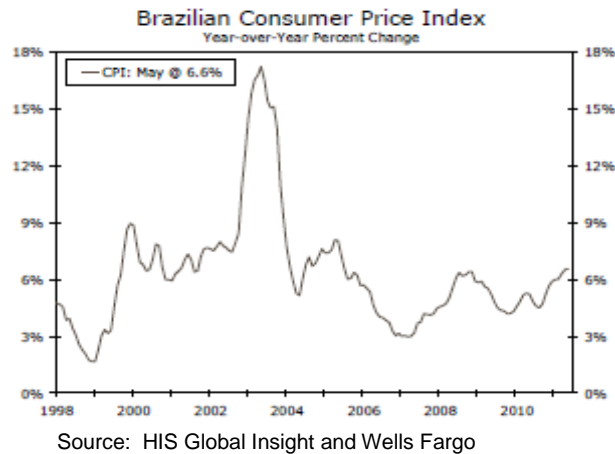
As we have mentioned before, a recurring theme of concern across many of the emerging markets has been inflation. This continues to be the case in China, India, Brazil, Russia, and several other countries. Food inflation hurts these countries much more than what we see in the developed markets. Persistently high inflation threatens the economic growth of these regions and makes investors nervous and leads to weak equity markets. But another issue worth noting is the heavy reliance on commodities in many of these markets. Countries such as Russia, South Africa, and Brazil depend on various commodities for economic growth. Sometimes this can be beneficial depending on the movement of the commodity and its leverage. On the other hand, it can work the other way if commodity prices begin to fall substantially and a country's economy is more reliant on this commodity. In our opinion, these two factors probably explain the recent underperformance of emerging market equities relative to large capitalization developed market global equities.

Market Performance

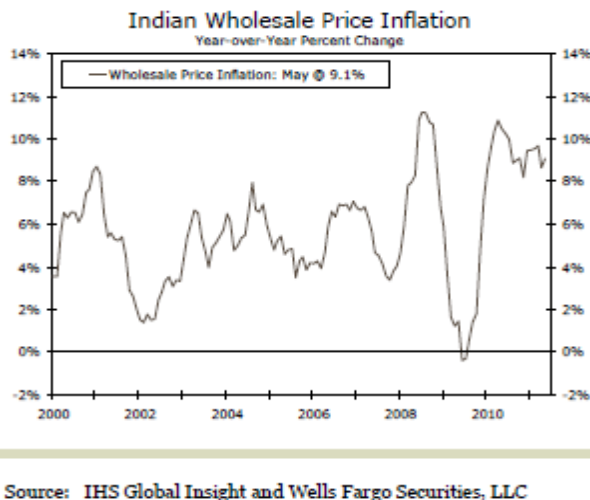
Index Name	Total Return (30-Jun-2011)	MTD % Change	QTD % Change	YTD % Change
MSCI South Africa (ZA-MSEX)	1002.449	(1.75)	(1.97)	(3.80)
MSCI India (IN-MSEX)	680.308	1.77	(3.55)	(8.48)
MSCI Brazil (BR-MSEX)	8944.239	(0.31)	(4.04)	(1.49)
MSCI Russia (RU-MSEX)	1291.313	0.46	(5.35)	10.07

Source: Factset

Although the second quarter GDP report has not come out, we expect to see Brazil's economy expand at a pace less than the first quarter rate of +4.2%. This is consistent with the weak readings we have seen with industrial production in the quarter as commodity demand has waned a bit. In no surprise, inflation is still running in the +6.6% area year over year. But more importantly, inflation does not appear to be getting any worse as past interest rate increases may have had the desired outcome. Perhaps this could even pave the way for an interest rate decrease later in 2011 or early 2012.



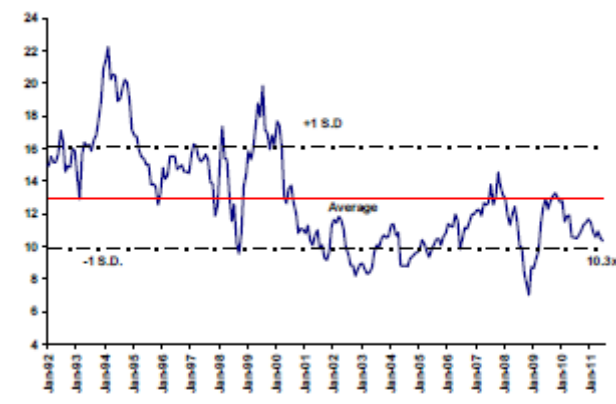
In India, inflation remains the real issue. Food inflation was recently reported above the 8% level, a significant burden on a country with the population India has. We expect to see further interest rate increases over the next few months in an effort to push inflation down toward the 5% level. According to a recent report, bond yields have climbed more here than any other Asian economy in 2011. This probably explains the poor performance of Indian equities in the second quarter. However, over the longer term, the potential of this economy is tremendous.



International Equity Activity/Strategy

Investors do not have a shortage of issues facing them as we head into late summer/early fall. In Europe, needed austerity looks to be coming at a high price as debt issues continue to dominate the scene. Budget cuts and higher taxes will obviously cut the growth outlook of this region. Opinions on this are quite wide at the moment. We feel the region could fall into some type of recession as this unfolds. To what degree, we do not know. We just hope it does not turn into anything worse than this. In Asia, we continue to look for a cyclical rebound in the Japanese economy as this region will be moving ahead with its rebuilding efforts. This alone will provide for some level of stimulus to this economy and perhaps equity markets could respond positively. On the emerging markets front, we feel inflation data could be a key driver of equity returns going forward. Sharp increases in these reading could be followed by weak equity markets. We look for measures to be taken to bring down inflation while not curtailing the good growth prospects of many of these countries. At this point, we hope what we have seen recently in the markets will not dampen the capital spending plans of major companies. We need these firms to continue to spend and hire more workers on the margin. Obviously, we need to stay out of a global recession which is certainly key at this point.

MSCI EM 12M Consensus Forward P/E – Almost 1 SD below long-run average



Source: MSCI, FactSet, Morgan Stanley Research. Data as of June 29, 2011

The significant fall recently of the global equity markets has been very challenging. We feel this has presented us with an opportunity in the emerging markets. We will be adding to our current position in the MSCI Emerging Markets Index (EEM) here in August as the current price of EEM is below our August put strike prices for the first time in well over a year. Therefore, provided that EEM does not rally significantly over the next week, we will be adding approximately \$150 million to this position. This will put

emerging markets just below 2% of our assets in TRS, ERS, and JRF. This is still well below what we see in a typical pension plan comparable to our size. We feel it is prudent to use the recent market action as a long term opportunity to add to this asset class. *(Charts provided by Factset, William Blair, IMF, IHS Global Insight, MSCI, Morgan Stanley, Wells Fargo, Bloomberg, Vanguard, HM Treasury, CEIC)*

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING June 30, 2011



STATE STREET

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
<u>U.S. EQUITY</u>										
TRS CORE FUND	1,607,747,262	-1.51	0.27	6.24	17.09	30.91	2.90	3.07	2.43	Oct-94
TRS West Street Trust Certificates	733,101,247	-1.62	0.24	6.29	17.91	31.39				Jan-10
TRS S&P 500 FUND	4,062,767,833	-1.66	0.11	6.03	17.38	30.63	3.40	3.01	2.82	Oct-94
TRS MID CAP INDEX	938,991,428	-2.03	-0.71	8.57	23.36	39.64	8.05	6.74	8.13	Oct-94
TRS S&P SMALL CAP INDEX	506,253,240	-1.77	-0.02	7.72	25.11	37.19	8.81	5.05	7.65	Mar-01
TRS SMALLCAP ACTIVE FUND	142,897,123	1.05	2.85	12.33	23.77	35.93	7.49	5.71		Jun-06
TRS SPECIAL SITUATIONS	595,731,936	-1.20	1.10	10.92	23.61	41.32	9.40	6.74	7.13	Oct-94
TRS TOTAL DOMESTIC EQUITY	8,587,490,070	-1.60	0.17	6.89	18.93	31.85	4.08	3.57	3.68	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		-1.74	-0.07	6.58	18.97	32.63	4.37	3.64		
S&P 500		-1.67	0.10	6.02	17.43	30.69	3.34	2.94	2.72	
S&P 400 MIDCAP		-2.04	-0.73	8.56	23.22	39.38	7.82	6.60	7.94	
S&P 600 SMALL CAP		-1.81	-0.16	7.54	25.00	37.03	8.16	4.61	7.79	
<u>INTERNATIONAL EQUITY</u>										
TRS ISHARES TR	209,744,973	-0.97	-1.29	0.88	8.22	29.82				Sep-09
TRS INTERNATIONAL EQUITIES	2,521,255,500	-1.04	1.87	5.51	12.61	31.12	-1.21	2.03	6.25	Nov-94
TRS TOTAL INTERNATIONAL EQUITY	2,731,000,473	-1.04	1.62	5.14	12.26	31.02	-0.77	2.60	6.55	Oct-94
MSCI EAFE (NET)		-1.25	1.56	4.98	11.92	30.36	-1.77	1.48	5.66	

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING June 30, 2011



STATE STREET

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TRS TOTAL GLOBAL EQUITY	11,318,490,543	-1.47	0.52	6.46	17.23	31.62	2.79	3.33	4.27	Oct-75
TRS CUSTOM GLOBAL EQUITY INDEX		-1.63	0.32	6.19	17.17	32.04	2.75	3.08		
FIXED INCOME										
TRS DOMESTIC FIXED INCOME	2,602,955,717	-0.32	2.42	3.05	1.60	5.00	7.77	7.39	6.45	Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		-0.50	2.21	2.70	1.10	4.45	7.26	6.80		
TRS TOTAL FIXED (ex. Private Placements)	2,602,955,717	-0.32	2.42	3.05	1.60	5.00	7.77	7.38		Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		-0.50	2.21	2.70	1.10	4.45	7.26	6.79		
BC AGGREGATE		-0.29	2.29	2.72	1.39	3.90	6.46	6.52	5.74	
TRS PRIVATE PLACEMENTS	2,058,104,312	0.74	2.10	21.08	26.74	15.44	-2.40	4.81		Aug-99
TRS CASH ACCOUNT	98,689,058	0.01	0.05	0.10	0.17	0.24	0.62	2.40		Sep-03
TRS TOTAL FIXED INCOME	4,759,749,086	0.15	2.21	10.10	11.10	8.85	2.44	6.02	5.69	Oct-93
ALTERNATIVE INVESTMENTS										
TRS PREFERRED STOCK	224,575,021	-1.74	5.92	18.78	20.21	4.62	-43.18	-23.81		Sep-03
TRS REAL ESTATE	1,899,628,220	0.00	0.00	0.00	0.00	0.46	-0.24	1.79		Oct-03
TRS INTERNALLY MANAGED	419,454,809	0.03	0.09	0.17	0.26	0.36	1.34	2.87		Oct-03
TRS OPTION COLLATERAL	7,698,600	0.00	0.00	0.00	0.00	0.00				Sep-03
TRS TOTAL ALTERNATIVES	2,551,356,649	-0.14	0.49	1.44	1.54	0.78	-9.85	-3.51		Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,311,105,736	0.04	1.62	7.03	7.71	5.93	-1.49	3.02	3.89	Oct-93

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING June 30, 2011



STATE STREET

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
<u>TOTAL PLAN</u>										
TRS TOTAL PLAN	18,629,596,279	-0.87	0.95	6.68	13.21	20.18	0.95	3.14	4.29	Oct-88
TRS TOTAL PLAN POLICY		-1.22	0.58	4.77	11.84	21.55	3.73	3.67		

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING June 30, 2011



STATE STREET

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
ERS CORE FUND	867,081,347	-1.52	0.29	6.27	17.14	30.94	2.91	3.12	2.38	Oct-94
ERS West Street Trust Certificates	332,504,305	-1.62	0.24	6.29	17.91	31.38				Jan-10
ERS S&P 500 FUND	1,838,487,140	-1.66	0.11	6.03	17.39	30.63	3.40	3.01	2.85	Oct-94
ERS MID CAP INDEX	415,226,536	-2.03	-0.71	8.57	23.36	39.65	8.05	6.75	8.15	Oct-94
ERS S&P SMALL CAP INDEX	208,202,327	-1.77	-0.02	7.72	25.11	37.19	8.82	5.05	7.64	Mar-01
ERS SMALLCAP ACTIVE FUND	70,464,974	1.04	2.86	12.30	23.74	35.92	7.47	5.70		Jun-06
ERS SPECIAL SITUATIONS	320,569,386	-1.19	1.08	10.90	23.61	41.33	9.43	6.79	7.04	Oct-94
ERS TOTAL DOMESTIC EQUITY	4,052,536,014	-1.59	0.19	6.92	18.90	31.89	4.07	3.58	3.68	Oct-93
<i>ERS CUSTOM DOMESTIC EQUITY INDEX</i>										
<i>S&P 500</i>		-1.67	0.10	6.02	17.43	30.69	3.34	2.94	2.72	
<i>S&P 400 MIDCAP</i>		-2.04	-0.73	8.56	23.22	39.38	7.82	6.60	7.94	
<i>S&P 600 SMALL CAP</i>		-1.81	-0.16	7.54	25.00	37.03	8.16	4.61	7.79	
INTERNATIONAL EQUITY										
ERS ISHARES TR	100,178,484	-0.97	-1.29	0.88	8.22	29.82				Sep-09
ERS INTERNATIONAL EQUITIES	1,109,341,468	-1.04	1.88	5.53	12.64	31.18	-1.20	2.02	6.23	Nov-94
ERS TOTAL INTERNATIONAL EQUITY	1,209,519,952	-1.03	1.61	5.13	12.27	31.07	-0.71	2.65	6.56	Oct-94
<i>MSCI EAFE (NET)</i>		-1.25	1.56	4.98	11.92	30.36	-1.77	1.48	5.66	

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING June 30, 2011



STATE STREET

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
ERS TOTAL GLOBAL EQUITY	5,262,055,967	-1.46	0.52	6.50	17.29	31.68	2.86	3.36	4.26	Oct-93
<i>ERS CUSTOM GLOBAL EQUITY INDEX</i>		-1.63	0.31	6.20	17.23	32.05	2.81	3.11		
FIXED INCOME										
ERS DOMESTIC FIXED INCOME	1,187,888,465	-0.32	2.42	3.05	1.59	4.98	7.76	7.40	6.42	Sep-99
<i>ERS CUSTOM DOMESTIC FIXED INDEX</i>		-0.51	2.20	2.70	1.09	4.43	7.22	6.79		
ERS TOTAL FIXED (ex. Private Placements)	1,187,888,465	-0.32	2.42	3.05	1.59	4.98	7.76	7.40		Oct-03
<i>ERS CUSTOM GLOBAL FIXED INDEX</i>		-0.51	2.20	2.70	1.09	4.43	7.22	6.78		
<i>BC AGGREGATE</i>		-0.29	2.29	2.72	1.39	3.90	6.46	6.52	5.74	
ERS PRIVATE PLACEMENTS	1,050,730,477	0.69	2.09	20.62	26.21	15.96	-2.52	4.80		Aug-99
ERS CASH ACCOUNT	72,085,730	0.01	0.05	0.10	0.17	0.24	0.62	2.45		Sep-03
ERS TOTAL FIXED INCOME	2,310,704,673	0.15	2.17	10.26	11.38	9.23	2.21	5.98	5.44	Oct-93
ALTERNATIVE INVESTMENTS										
ERS PREFERRED STOCK	190,367,125	-0.84	6.73	27.99	28.58	15.25	-35.92	-17.95		Sep-03
ERS REAL ESTATE	927,514,486	0.00	0.00	0.00	0.00	0.42	-0.26	1.84		Oct-03
ERS INTERNALLY MANAGED	272,690,753	0.03	0.08	0.17	0.26	0.36	1.34	2.86		Oct-03
ERS OPTION COLLATERAL	4,145,400	0.00	0.00	0.00	0.00	0.00				Sep-03
ERS TOTAL ALTERNATIVES	1,394,717,764	-0.11	0.90	3.25	3.33	2.10	-12.13	-4.39		Oct-03
ERS TOTAL F.I. PLUS ALTERNATIVES	3,705,422,436	0.05	1.70	7.61	8.33	6.54	-2.80	2.40	3.32	Oct-93

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING June 30, 2011



STATE STREET

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
ERS TOTAL PLAN	8,967,478,403	-0.83	1.01	6.95	13.34	20.02	0.24	2.82	3.85	Oct-89
<i>ERS TOTAL PLAN POLICY</i>		-1.21	0.56	4.71	11.71	21.22	3.69	3.61		

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING June 30, 2011



STATE STREET

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
JRF S&P 500 FUND	108,220,645	-1.66	0.11	6.10	17.46	30.86	3.52	3.12	2.87	Oct-94
JRF S&P MID CAP INDEX	12,453,162	-2.03	-0.72	8.55	23.29	39.55	8.05	6.68	8.07	Oct-94
JRF S&P SMALL CAP INDEX	4,559,653	-1.77	-0.02	7.72	25.11	37.19	8.81	5.04	7.59	Mar-01
JRF TOTAL DOMESTIC EQUITY	125,233,460	-1.70	0.02	6.40	18.29	31.91	4.20	3.58	3.46	Oct-93
<i>JRF CUSTOM DOMESTIC EQUITY INDEX</i>										
<i>S&P 500</i>		-1.67	0.10	6.02	17.43	30.69	3.34	2.94	2.72	
<i>S&P 400 MIDCAP</i>		-2.04	-0.73	8.56	23.22	39.38	7.82	6.60	7.94	
<i>S&P 600 SMALL CAP</i>		-1.81	-0.16	7.54	25.00	37.03	8.16	4.61	7.79	
INTERNATIONAL EQUITY										
JRF ISHARES TR	3,127,748	-0.97	-1.29	0.88	8.22	29.82				Sep-09
JRF INTERNATIONAL EQUITIES	33,234,720	-1.05	1.89	5.52	12.66	31.25	-0.91			Nov-06
JRF TOTAL INTERNATIONAL EQUITY	36,362,468	-1.05	1.61	5.10	12.27	31.13	0.13			Nov-06
<i>MSCI EAFE (NET)</i>		-1.25	1.56	4.98	11.92	30.36	-1.77	1.48	5.66	
JRF TOTAL GLOBAL EQUITY	161,595,928	-1.56	0.38	6.10	16.86	31.74	3.76	3.66	3.50	Oct-93
<i>JRF CUSTOM GLOBAL EQUITY INDEX</i>		-1.61	0.36	6.02	16.75	31.44	3.12			

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING June 30, 2011



STATE STREET

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
<u>DOMESTIC FIXED INCOME</u>										
JRF DOMESTIC FIXED INCOME	61,378,186	-0.31	2.51	3.22	1.83	5.48	8.10	7.45	4.65	Oct-93
JRF CUSTOM DOMESTIC FIXED INDEX		-0.51	2.19	2.69	1.11	4.46	7.03	6.69		
BC AGGREGATE		-0.29	2.29	2.72	1.39	3.90	6.46	6.52	5.74	
JRF PRIVATE PLACEMENTS	3,633,283	1.90	3.46	7.76	9.58	4.62	0.90	3.41		Oct-01
JRF CASH ACCOUNT	1,164,401	0.01	0.05	0.10	0.17	0.24	0.62	2.26		Sep-03
JRF TOTAL FIXED INCOME	66,175,870	-0.18	2.41	3.28	2.16	5.04	6.82	6.66	4.97	Oct-93
<u>ALTERNATIVE INVESTMENTS</u>										
JRF PREFERRED STOCK	50,593	-17.05	44.18	331.52	479.41	601.58	-44.51			Nov-07
JRF REAL ESTATE	2,569,543	0.00	0.00	0.00	0.00	15.12	6.19	5.96		Oct-03
JRF INTERNALLY MANAGED CASH	4,500,153	0.06	0.13	0.24	0.33	0.43	1.39	2.87		Oct-03
JRF TOTAL ALTERNATIVES	7,120,288	-0.09	0.47	0.93	1.03	7.06	2.71	3.68		Oct-03
JRF TOTAL F.I. PLUS ALTERNATIVES	73,296,159	-0.18	2.27	3.11	2.08	5.20	6.18	6.22	4.69	Oct-93

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

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PERIODS ENDING June 30, 2011



STATE STREET

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
JRF TOTAL PLAN	234,892,086	-1.12	0.97	5.08	11.50	21.50	4.87	4.78	3.90	Oct-93
<i>JRF TOTAL PLAN POLICY</i>		-1.26	0.83	4.86	11.30	21.39	4.15	3.97		