Quarterly Economic Update

May 9, 2013

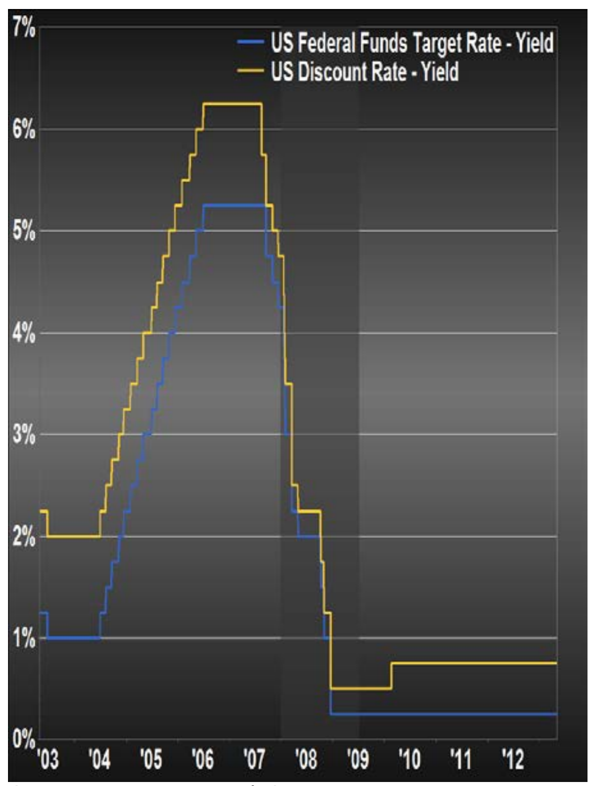
MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

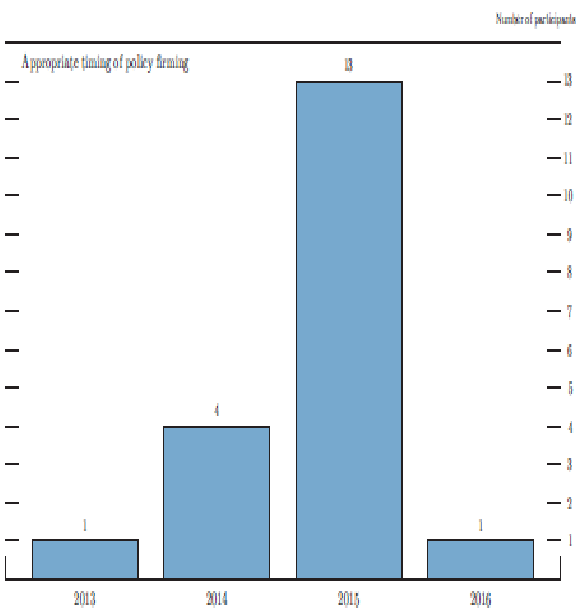
The Federal Open Market Committee (FOMC) met most recently on March 19th-20th and April 30th-May 1st. Both of these meetings resulted in no change to current monetary policy and resulted in statements being issued that were largely unchanged from previous policy statements. The federal funds target rate remains at 0 to ¼ percent and the FOMC has continued to purchase agency mortgage-backed securities and Treasury securities. They have maintained these purchases at a pace of $40 billion per month of agency MBS and $45 billion per month of Treasury securities. They have also continued to reinvest principal payments and maturities keeping the Federal Reserve's balance sheet elevated and rising. Federal Reserve Chairman Ben Bernanke and the FOMC seem somewhat encouraged by improving economic activity, labor markets, and housing. However, they are not satisfied with the pace of improvement and still express concerns around the sustainability of improvement. Unemployment remains persistently high and prolonged unemployment can have long lasting effects on income generation and wealth accumulation. The dampening effect on economic activity from tighter fiscal policy also worries committee members as reduced government spending picks up at a time when the economic recovery remains frail. Inflation and inflation expectations remain low and seem more likely to run below the FOMC's 2 percent objective in the near to medium term. This provides the FOMC some room to continue with their extremely accommodative policy and focus on the maximum employment component of their dual mandate.

With the FOMC's shift to using quantitative unemployment and inflation thresholds as their forward rate guidance, there is greater transparency and less speculation around when the FOMC may begin raising the federal funds target rate. They have said they will continue to hold the target range for the federal funds rate at 0 to ¼ percent and anticipate that this low level for the rate will be appropriate as long as the unemployment rate remains above 6 ½ percent and inflation is no more than a half percentage point above their 2 percent long run objective, with longer-term inflation expectations being well anchored. With the most recent unemployment rate at 7.5 percent and inflation well below their long run goal of 2 percent, we should not expect any change to the target rate any time soon.

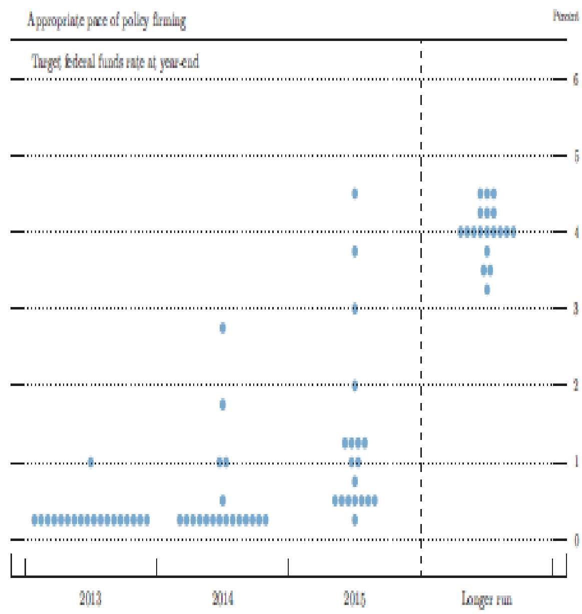


Source: Factset Research Systems

At the March 20th FOMC meeting, the Federal Reserve Board Members and Bank Presidents provided economic projections which included their assessment of the appropriate path for the federal funds target rate in conjunction with their projections on GDP, unemployment, and inflation. The chart on the left below illustrates when participants believe an initial increase to the federal funds target rate will be appropriate. While a few participants believe conditions dictate an increase in the rate this year or the next, the chart indicates a majority, thirteen of the nineteen participants, believe 2015 will be the appropriate timing of an initial tightening of the rate. This is in line with their prior calendar date guidance and in agreement with unemployment projections of 6.0 to 6.5 percent in 2015. The chart on the right shows the expected appropriate pace of tightening and shows the majority of participants expect only modest increases in the level of the rate in 2015.



Source: Federal Reserve



Source: Federal Reserve

While some consensus exists around the appropriate level of the federal funds target rate as the charts above indicate, much wider opinions exist around the benefits and costs of the asset purchase programs. Outside of the inadvertent early release of the March 20th minutes, the most interesting topic on the monetary policy front was the discussion highlighted in those minutes around the asset purchase program. The March 20th minutes indicate that the effectiveness and potential risks associated with asset purchases was discussed at great length amongst FOMC participants with varying opinions. Overall, most participants agree that the benefits of the purchase program outweigh the potential risks. However, varying opinions seem to exist regarding the effectiveness going forward and the degree of risk further purchases carry. Some participants expressed that while they believe the initial purchase programs had a substantial effect, that effect has waned and current and additional purchases would be less effective relative to the increasing amount of risk. Others thought the effectiveness had remained level and others thought it may have increased as credit constraints have eased.

It is agreed that there are costs that exist with their asset purchase program, but opinions vary on the degree of risks associated with these costs. Securities purchases have the potential to create instability in financial markets. As the Federal Reserve's purchase programs place downward pressure on interest rates, there is risk that as they reduce or discontinue purchases it could lead to a rapid rise in interest rates resulting in falling asset prices and losses on certain assets borne by investors. This risk could be managed somewhat through communication efforts and managing the reduction of purchases, but the risk of creating instability exists. Another cost of the purchase programs have been the increase in income remitted to the Treasury from securities held by the Federal Reserve. As they discontinue purchases and reduce holdings, this income remitted will decline. There is risk that this could cloud the independency of the Federal Reserve which could negatively affect their ability to manage policy. Another risk is that additional purchases could lead to the federal funds rate being a less effective tool to manage policy in the event of a rapid rise in inflation. Discussion was held about the effect on market function in mortgage-backed securities markets should the Federal Reserve go from such a large buyer to a seller and whether this could impair their ability to implement a smooth withdrawal of monetary accommodation if necessary.

After discussing the costs and risks associated with the securities purchase program relative to the benefits, most participants viewed these as manageable but thought they should be monitored closely. A few participants who viewed these risks as higher and less manageable noted that curtailing additional purchases was the most direct way to reduce these potential risks. FOMC participants then went on to discuss the continuation of the current purchase program. The minutes indicate much more diverse views on the appropriate direction of the program. The few participants that believe the current costs outweigh the benefits were in favor of ending additional purchases. Others expressed that they did see risks increasing and that the size of additional purchases might need to be reduced soon. The minutes indicate a larger consensus agreed that a continuation of recent improvement in labor markets and activity would prompt them to begin reducing the pace of purchases sometime over the next several meetings. Still a few others thought conditions called for a continued purchase program at the current pace through the end of the year. Members discussed further what conditions would lead them to adjust the size of purchases and that any changes should consider an actual improvement in labor markets as well as the sustainability of those improvements.

Federal Reserve staff presented an Open Market Desk survey at the March 20th meeting that showed most dealers anticipated the Federal Reserve would likely end the purchase program in the first quarter of 2014 with a gradual reduction in the pace of purchases leading to the end of the program. After the release of the minutes, markets adjusted expectations that the FOMC was indeed more willing to begin reducing the size of purchases and eventually ending the program sooner. Subsequently, a couple of weaker economic numbers have tapered those expectations somewhat and a continued fall in inflation has prompted some concerns that continued purchases may be needed to combat deflationary pressures.

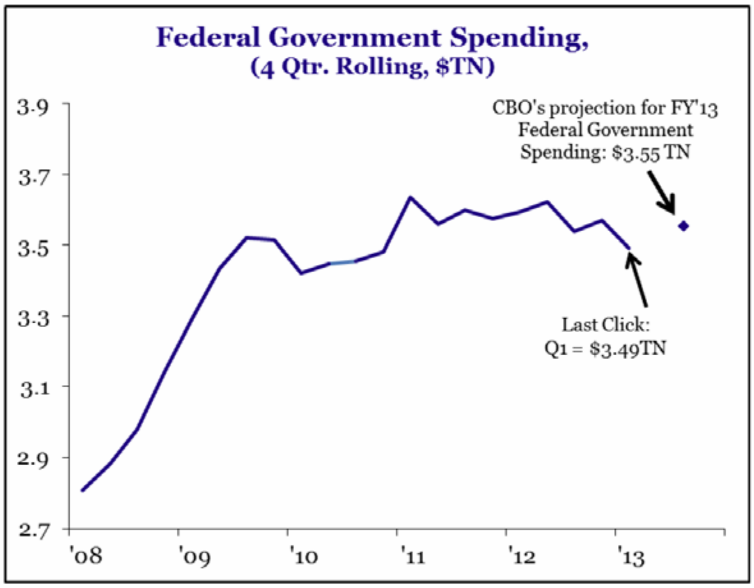
Outside of some minor adjustments to the economic outlook, the only real change to the May 1st FOMC statement was the addition of the following sentence, "The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes." They have always included language that reserves the right to make adjustments to the "size, pace and composition of asset purchases." The insertion of this sentence seems designed to stress that if labor markets and economic activity do continue improving, they may indeed begin reducing purchases sooner. However, the sentence also seems to stress that if the improvement stalls and inflation continues to fall, they still may deem it appropriate to increase purchases as well. Chairman Bernanke seems intent on communicating that either way, the FOMC has flexibility to act accordingly. He may have had some concerns that following the release of the prior meeting's minutes which seemed to communicate more support towards reducing purchases and ending the program sooner, market participants may have discounted their desire and ability to prevent a stall in the recovery and combat deflationary pressures. Looking back to his March 20th press conference immediately following the seemingly more focused discussion on the risks of further purchases and on ending the program, he emphasized that "overall, still-high unemployment, in combination with relatively low inflation, underscores the need for policies that will support progress towards maximum employment in a context of price stability." Market participants and the FOMC members themselves will continue to debate the future of the securities purchases, but Bernanke has been very clear and explicit that "the purpose of the asset purchases is to increase the economy's near-term momentum, with the goal of improving the outlook for the labor market and helping to promote a self-sustaining recovery with price stability." While Bernanke remains at the helm, he is likely to lead the FOMC to err on the more accommodative side especially in light of a lack of inflation.

Fiscal Policy

By Michael McNair

Since our last board meeting the developments in fiscal policy can be described as a "mixed bag". For the sake of being optimistic we will start with the good news first.

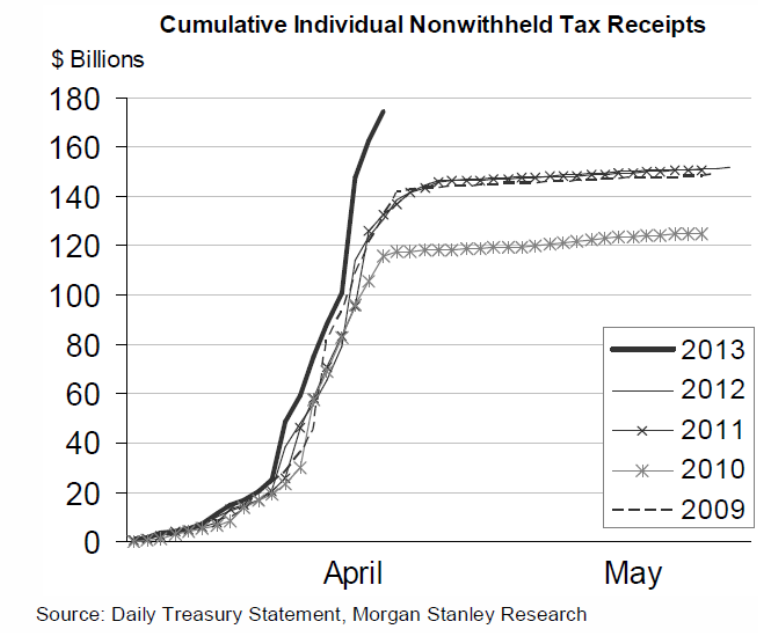
Anyone concerned with excessive government spending will be pleased to know that Federal spending is declining. In fact, it is actually tracking $50 billion dollars lower than the Congressional Budget Office's (CBO) projection and this is even before Sequestion comes into effect.



Source: Strategas

The contraction in government spending is even greater when you include state and local governments. According to Capital Economics, "The contraction in government expenditures that began in 2010 initially reflected the belt tightening by state and local governments which, constrained by balanced budget rules, were forced to cut spending to match the decline in revenues caused by the recession. Over the past couple of years, the decline in general government expenditures has been driven more by the contraction in Federal spending and investment. That reflects the gradual fading of spending linked to the 2009 stimulus package, the withdrawal of troops from Iraq and Afghanistan and the recent congressional efforts to curb the structural budget deficit."

Deficit hawks will also be pleased to know that tax season has been incredible. April individual non-withheld tax receipts are up a staggering 33% or $43 billion more than last year. The magnitude of this move is due to an increase in capital gains taxes collected as many taxpayers pulled forward income into 2012 in order to avoid the 2013 tax hikes; however, the federal coffers are benefiting nonetheless.



With Federal spending declining and tax revenue increasing, the Federal budget deficit has obviously declined. At its peak in 2009, the structural Federal budget deficit was equal to 7% of GDP but today it sits at only 2.5% of GDP and the CBO projects that it will fall to 1% by 2014. The International Monetary Fund (IMF) alternative calculation, which focuses on general government budgets rather than just the Federal budget, shows that the structural deficit in the US has declined from 8.5% of GDP in 2010 to 4.6% of GDP in 2013 and will be at just 3.9% by 2014.

The Bad News

The bad news is that the good news, shrinking budget deficits, is not really good news. Taken by itself, a shrinking budget deficit is a good thing but the magnitude of the decline at a time when the private sector is reluctant to invest has restrained the economy from growing anywhere close to its potential.

Since 2011, government expenditures have declined by an average of 2.6% a year and has subtracted an average of 0.5% of GDP each year, which is a substantial headwind considering that our economy is only growing 2.5% a year. For some perspective, the 7% drop in real government expenditures from 2010 to 2012 is already the second biggest decline in the US since World War II and this is before the Sequester hits.

While government spending has been a drag on the US economy for the past couple of years, the fiscal drag actually accelerated in the 4th quarter of 2012 and it was even worse in the 1st quarter of 2013 when government expenditures contracted by 4.2% and subtracted 0.8% from GDP growth.

Considering the magnitude of the fiscal drag, it should come as no surprise that the US economy has slowed considerably over the last couple of quarters. But in fact the rate at which the US economy has slowed has surprised most economists as economic data has come in below expectations at an alarming rate. Unfortunately the fiscal drag will only get worse in the 2nd quarter of 2013 when it could take as much as one full percentage point from GDP.

Certain politicians must also be shocked by the slowdown in the US economy as they had been arguing that reducing the budget deficit would actually make the economy grow faster. Sadly, it was not just politicians but even some economists tried to argue that reducing government spending would make the economy grow faster. Economists at the IMF advised European countries to implement austerity to combat the crisis because they believed it would "restore confidence to the system." We have long argued that the belief that reducing the deficit in this environment would lead to growth was bogus and completely ungrounded in economic reality. Unfortunately, US and European politicians instead decided to push austerity and we now have the economic results that show it was the wrong decision.

The results out of Europe make the case against austerity even stronger. Austerity has allowed the Europeans to reduce their combined budget deficits from 6.4% in 2009 to 3.7% in 2012 but this has not been a good thing because it has caused their economies to spiral out of control. It may seem somewhat counterintuitive but the austerity measures and "success" in reducing the deficit have actually caused Eurozone government debt to <u>grow</u> from 80% of GDP in 2009 to 90.6% currently.

Long time readers of this piece should not be as surprised by this result because it is exactly what we predicted two and half years ago saying,

"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; their debt burden will continue to get larger."

Paul DeGrauwe, of the London School of Economics, and Yuemei Ji, of the University of Leuven, recently released a comprehensive study entitled "Panic Driven Austerity in the Eurozone and its implications." Based on the economic data, the study concludes, *“**The more intense the austerity, the larger is the subsequent increase in the debt-to-GDP ratios.** This is not really surprising…those countries that applied the strongest austerity also saw their GDP (the denominator in the debt ratio) decline most forcefully. Thus, it can be concluded that **the sharp austerity measures that were imposed by market and policymakers’ panic not only produced deep recessions in the countries that were exposed to the medicine, but also that up to now this medicine did not work.** In fact it led to even higher debt-to-GDP ratios, and undermined the capacity of these countries to continue to service the debt.”*

The evidence against austerity is now so clear that even the IMF, the most staunch advocate of austerity, recently came out and reversed their position due to the findings in their own study on the effects of austerity in Europe. As the Washington Post writes:

“Consider it a mea culpa submerged in a deep pool of calculus and regression analysis: The International Monetary Fund’s top economist today acknowledged that the fund blew its forecasts for Greece and other European economies because it did not fully understand how government austerity efforts would undermine economic growth.”

The head of the IMF, Christine Lagarde, even came out and urged countries to “put a brake on austerity measures” because she now believe that it is inhibiting growth.

In short, after reviewing the evidence (i.e. economic data) the IMF realized that their understanding of how the economy works was wrong and countries should not have followed their advice because it actually caused the economy to get worse.

While it is unacceptable that an institution in a position to influence policy, like the IMF, could have such a fundamental misunderstanding of basic economics, there is no excuse for the politicians to have recklessly followed their advice when the vast majority of economists were advising against it. But as Stevie Wonder said, “when you believe in things that you don’t understand then you suffer.”

A more cynical view is that those politicians only used the IMF’s faulty logic and advice to scale back government spending in order to support their own preconceived ideology. While mounting evidence eventually forced the IMF to realize their misunderstanding and change their position, political ideologues will be much more inclined to ignore the facts and continue with their current policies. Therefore, it could take the electorate, who are the ones suffering from these misguided policies, voting these politicians out of office in order for public policy to change course. Fortunately, this is exactly what we are beginning to see. Italy’s recent election was seen as a rejection of austerity and just days ago Italy’s incoming Prime Minister said “European policies are too focused on austerity, which is no longer sufficient.”

We are actually seeing anecdotal evidence that even some of the most ideological politicians are now realizing their mistaken beliefs. German Finance Minister, Wolfgang Schaeuble, was one the most ardent believers in austerity saying just last year, “deficit spending is the wrong way to bolster economic growth. People who believe you can generate growth without pursuing budget consolidation have learned nothing from the experience of the crisis.” However, he recently signaled to his fellow CDU party members that the economic results are making it evident that he was wrong in pushing for the austerity measures and was quoted saying, “You have to react to economic developments–we do so in Germany. We are not bureaucratic; we are not stupid.” This is about as much of a public acknowledgement of his ignorance as you will get from the shrewd Finance Minister but the message is clear nonetheless: the support for austerity is dwindling in Europe.

Unfortunately the same cannot be said for the US where austerity is just beginning. It has taken almost three years of severe pain for Europe to realize that pushing austerity is a mistake. How much pain will it take for the US to come to the same realization?

Unless Congress votes to remove the Sequester, the total fiscal contraction, in the US, from 2010 to 2014 will be equal to 4.6% of GDP, which will be larger than the 3.5% contraction Europe has been able to manage. The private sector is in better shape in the US; therefore, we do not expect the fiscal drag to pull down the US economy to the extent that it has in Europe. However, the headwind from the fiscal contraction in the US will still be very strong and it makes our economy highly susceptible to a recession should a relatively small demand shock, like an oil price spike or an inventory destocking cycle, hit the private sector.

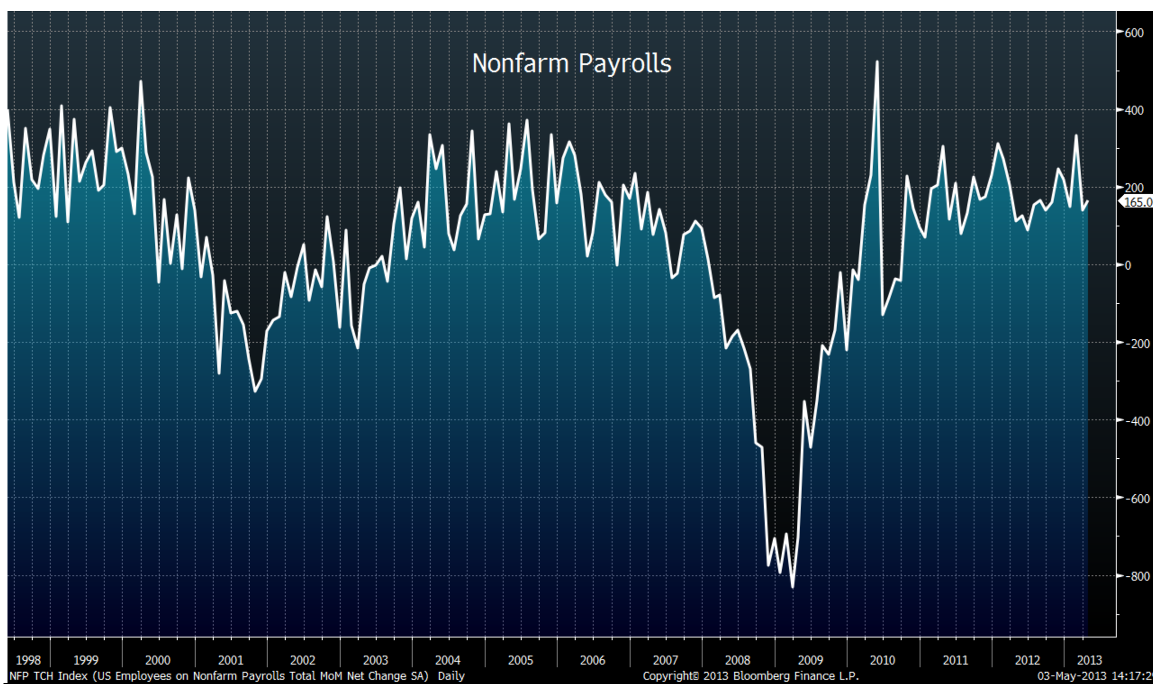
Unfortunately, we do not believe political support to remove the Sequester currently exists absent an unexpected event or recession. Further, we believe that the market might be underestimating the risk that the fiscal drag is putting on the US economy in the near future because In order to try and gain support for avoiding the Sequester, many politicians painted the picture that the spending cuts would be front loaded and immediately throw the US economy into a recession. Since the Sequester hit and the economy has not been thrown into a recession, investors might be lulled into a false sense of security believing that the worst of the fiscal drag is behind us. However, the reality is that the spending cuts from the Sequester were designed to ramp up over time; therefore, the worst of the fiscal drag is likely to hit this quarter.

Economic Outlook

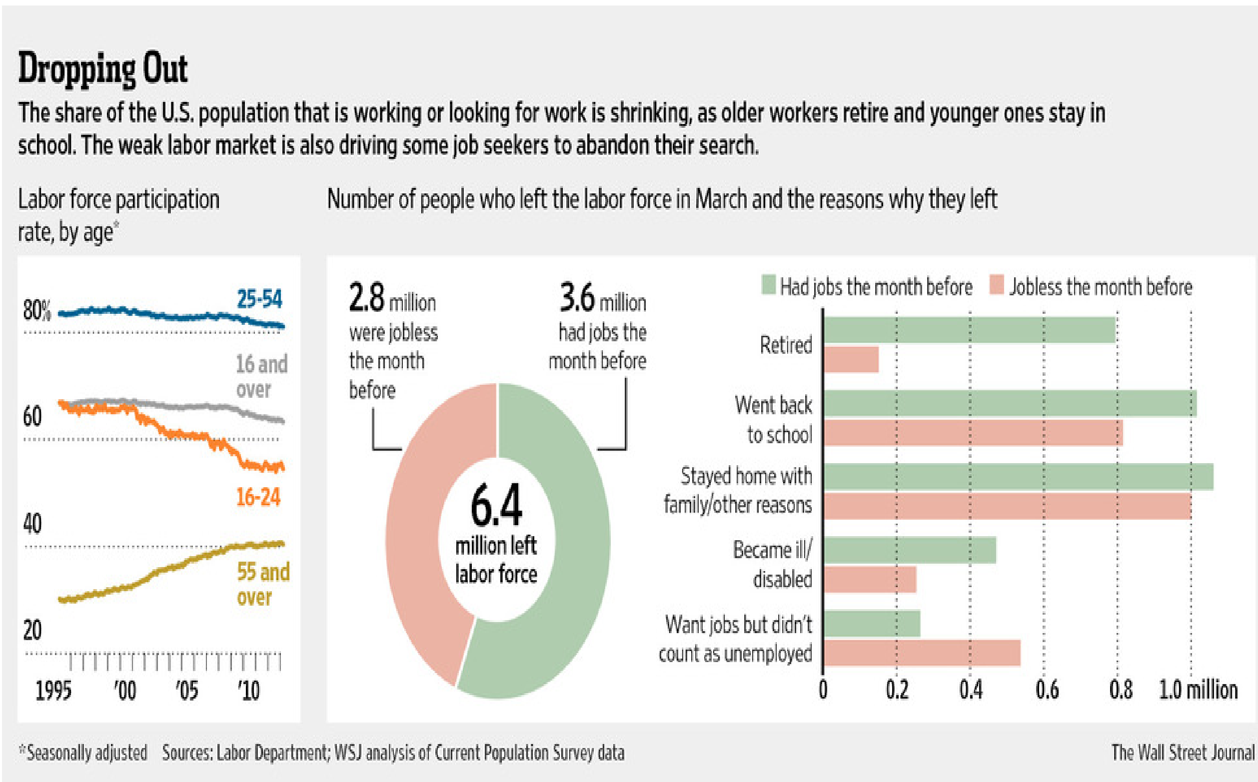
By Keith Buchanan

Economic data over the past two weeks has taken a turn for the worse. Vehicle sales, ISM, Construction spending, ADP Employment, Dallas Fed Manufacturing Activity, Gross Domestic Product, Durable Goods Orders, Leading Indicators Existing home sales, Philadelphia Fed have all disappointed since our last board update in March. This string of very lackluster economic news has done its part to slow the momentum in global markets.

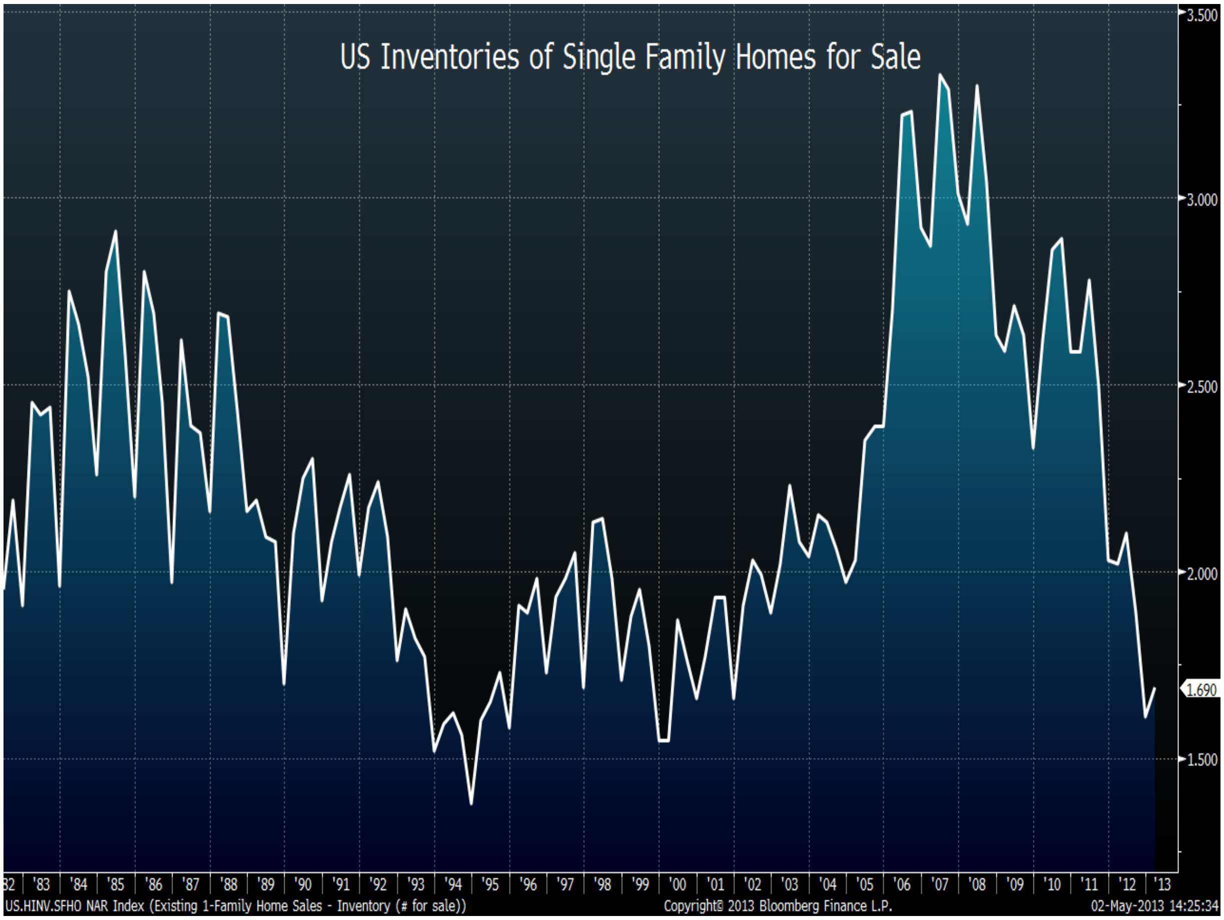
In April, American employers added 165,000 jobs and revised March jobs to 114,000 as the unemployment rate fell to 7.5 percent. It looks as though employers are still gradually shifting back to hiring mode as private payrolls increased by 176,000. Government employment dropped by 11,000 as public entities continue to suffer from fiscal constraints.



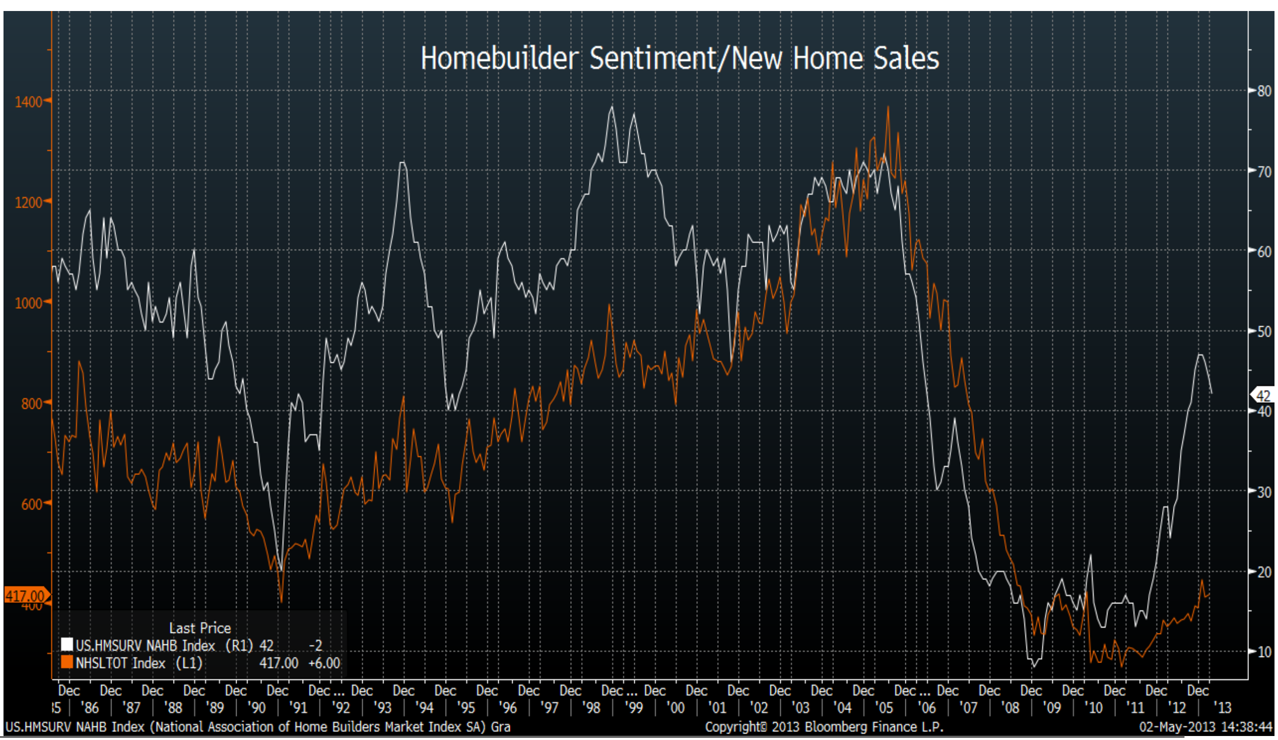
The labor market has been improving by most metrics. However, the labor force participation rate has been in a steady decline through the recession and recovery. It recently fell to its lowest level since 1979. With this in mind, the labor market looks as though it is in worse shape than appears. If these seemingly discouraged workers who dropped out of the workforce were to return to search for a job, the unemployment number would bounce. Put another way, the decline in labor force participation has artificially deflated the unemployment rate. However, the labor force participation rate has been in decline for a decade prior to the recession. In the Wall Street Journal, Ben Casselman explains that the main culprit is demographics. The fastest growing demographics are outside of the ages of 25 and 54 years old, when Americans are most likely to work. As a result, you have seen college enrollments explode along with a bolus of retirees. Neither of these are necessarily negative for the economy. One could even argue that a better trained workforce bodes well for productivity.



As most economic conclusions are debatable, the recovery in the housing market seems to be growing less and less so. The housing recovery continues to gain momentum as inventory clears and, consequently, prices firm. We are back to 2001 inventory levels in the housing market and nearing a 30-year low, which is remarkable. In five years time, there are half as many homes for sale per capita in the US.

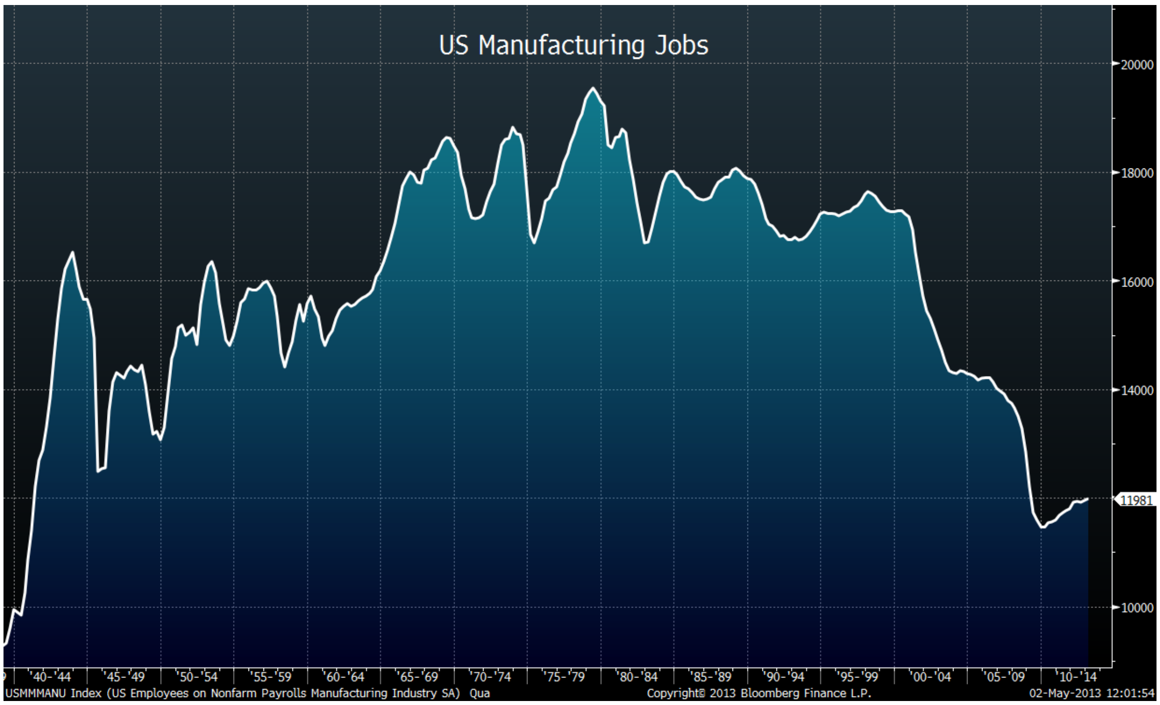


New home sales have perked up, and homebuilders have taken notice. As you can see in the chart below, if history is any guide, there is plenty of upside to new home sales in the coming months and years.



Given the debacle in the housing market from 2005 through 2008, market watchers are very eager to jump on positive news as a sign of the return of the housing market that was a true economic engine for two decades prior to the collapse. While the latest momentum in housing data is welcomed, housing still only added 0.3% to GDP last quarter. We have a long way to go before we can expect significant contributions to growth.

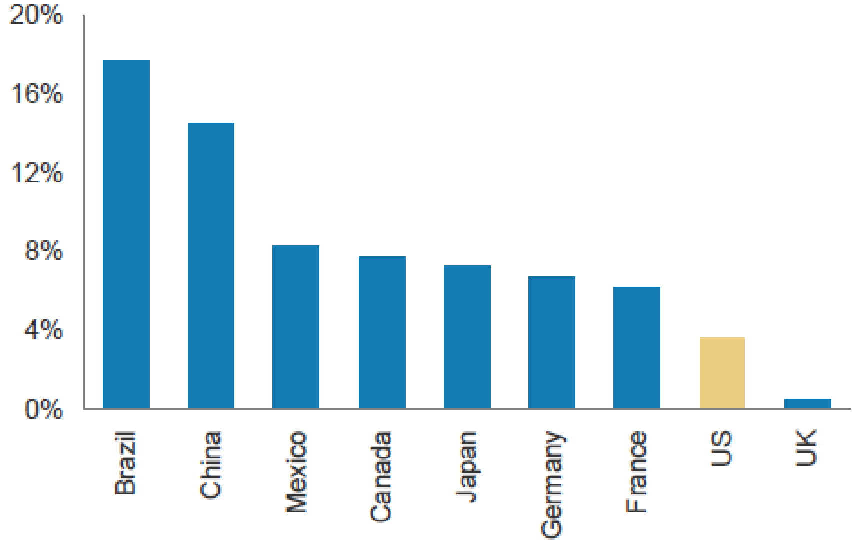
Many prognosticators look to a return of domestic manufacturing as a reason to be optimistic for the US economy going forward. Manufacturing jobs peaked in 1979 and suffered a precipitous decline for the next 30 years.



The domestic energy resurgence not only bodes well for the energy industry itself and the resulting jobs created, but it also helps to keep energy costs low which benefits energy consumers. Wage inflation abroad and our stagnant labor market have helped to close a portion of the labor cost differential between the US and the emerging market economies.

Exhibit 23

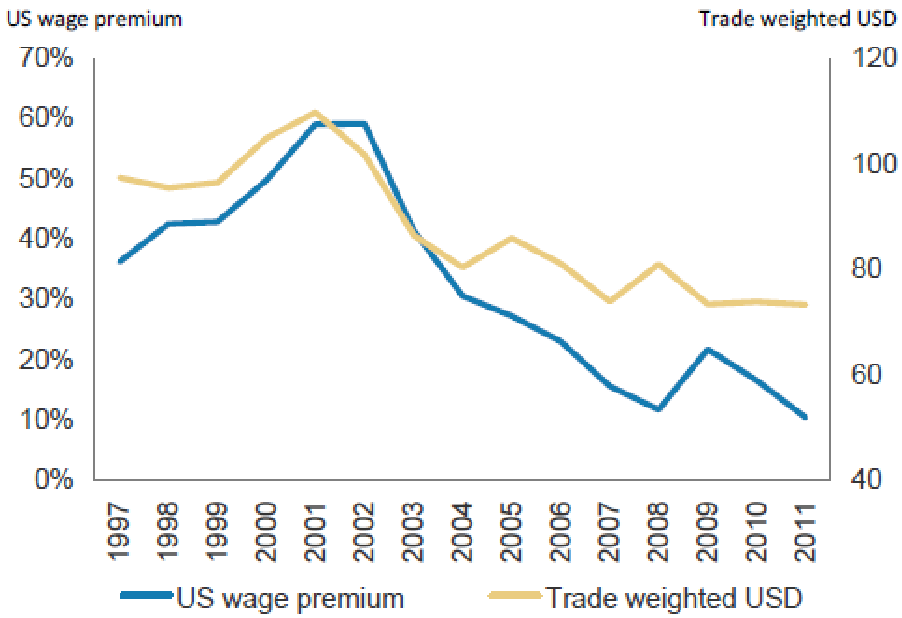
Average Annual Growth in Hourly Manufacturing Compensation (USD 2006-11)



Source: BLS, Morgan Stanley Research

These elements make the decision to outsource new manufacturing capacity more difficult as the economics have tipped the scales more to our favor rather than the no-brainer "expand elsewhere" conclusion that had plagued American manufacturing for decades.

US Manufacturing Wage Premium vs. OECD Has Been Declining since 2002, Aided by a Weaker USD



Source: BLS, Bloomberg, Morgan Stanley Research, OECD average is trade weighted

In writing in the Harvard Business Review in December, Jeff Immelt, CEO of General Electric, walks through the thought process of re-sourcing some of his appliance manufacturing from Korea back to Kentucky.

> "About 30 years ago, as the business became less profitable, GE began moving manufacturing out of Appliance Park to low-cost countries in a combination of joint ventures and outsourcing. The decision was relatively simple. We had strong brand recognition and customer loyalty—two things we believed would continue whether our products said "made in Kentucky" or "made in Korea." We reasoned that if we could lower our costs enough, we would quickly reverse the slide in profitability. We weren't alone: Many other businesses saw outsourcing in emerging markets as a solution.
>
> But for our appliances business, emerging markets eventually offered something else: competition from former suppliers of whole products, particularly in Asia. As these competitors improved their lines and lowered their prices, even customers who had grown up with and knew only GE refrigerators and dryers began to explore alternatives. Other forces were at play as well. Shipping and materials costs were rising; wages were increasing in China and elsewhere; and we didn't have control of the supply chain. The currencies of emerging markets added complexity. Finally, core competency was an issue. Engineering and manufacturing are hands-on and iterative, and our most innovative appliance-design work is done in the United States. At a time when speed to market is everything, separating design and development from manufacturing didn't make sense."

The State of Alabama has seen firsthand what can happen when the global economy realizes the opportunity available in expanding in the US and government acts as a positive force in receiving new industry. We have also witnessed the snowball effects of derivative suppliers locating closer to the OEMs in order to make their supplies more competitive.

Many dispute the premise that we are going into a new age of American reindustrialization. Morgan Stanley's Gerard Minack had an extensive research note on the logic of a manufacturing renaissance and whether the market should be optimistic about it coming to pass. Minack's work culminates in four key points:

- Global manufacturing economics no longer suggest offshoring capacity as strongly as they did for the better part of two decades. Their survey work suggests that supply chain shortening, rather than labor costs and energy prices, has been what most decision makers give as the reasoning behind stopping their offshoring or re-shoring capacity.

- The US corporate tax could be a barrier to further "re-shoring" manufacturing capacity. Minack's survey work cited lower taxes as the second most commonly stated factor when determining increasing US manufacturing, second only to improving demand. Even moderate tax reform would remove uncertainty as decision makers reconsider upping domestic manufacturing capacity.

- This increase in domestic production, particularly in energy, would not occur in a vacuum. The impact on currency should be considered. The US Dollar's decline over the past decade has improved our exports' appeal in the global competitive landscape. US dollar appreciation as a result of increased investor demand would undercut some of the manufacturing cost benefits. Also, a re-industrialization of the US will bring wage inflation, which would be a positive economic development, but may not bode well for stock sentiment as earnings growth has been largely fueled by margin expansion.

- A renormalization of US industrial growth rates toward 4% longer term is feasible, but a step change in industrialization is unlikely.

Even the most recent sequential data has not been all positive, we still view the economy as fully entrenched in recovery mode. We also expect economic data flow to remain somewhat volatile.

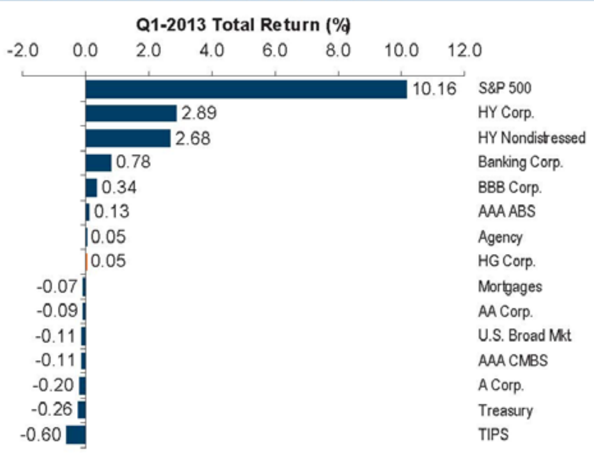
Interest Rates and Fixed Income Strategy

By Julie Barranco

At the time of our last meeting we were approaching the end of the first quarter of the calendar year. After encouraging economic data early in the new year, late March data seemed to hit a soft patch. With the Federal Reserve renewing their commitment to keep interest rates low and a flare up in European fears as the banking crisis in Cyprus ensued, we saw investor sentiment shift away from riskier assets and the flight to quality returned.

The first quarter of 2013 ended with very modest performance; the total return for the Barclay's Aggregate Index, which represents the investment grade bond market as a whole, was roughly -.12% for the quarter. Most of this return can be attributed to the move upward in Treasury rates, particularly on the longer end of the curve. For the quarter, Treasuries returned -.26%, while mortgaged backed securities produced slightly better, but still negative results at roughly -.07%. The agency and high grade credit sectors were the best investment grade performers during the quarter with a slightly positive return; however the high yield sector was once again the stand out performer, returning nearly 2.9% for the quarter. The chart below highlights the total returns for the quarter of different sectors of the bond market as well as the S&P 500, which returned over 10% during this time period.

Figure 6: Broad asset class total return performance, Q1 2013

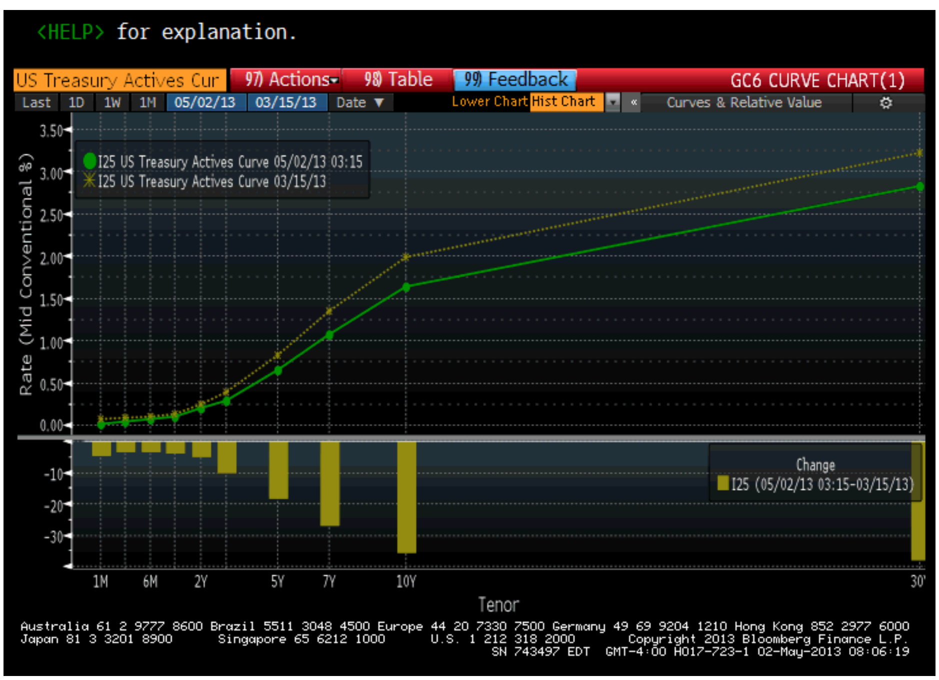


Source: BofA Merrill Lynch Global Research, Bloomberg

April began with a notable slowing in various economic data prints. March employment data, reported the first week in April, disappointed investors as the payroll number of 88,000 was roughly half of the consensus estimate. Other economic data reported during the month including manufacturing and consumer confidence gauges, inflation data and retail sales, all came in below expectations as well. First quarter GDP was reported late in April and while results were stronger than the previous quarter, the 2.5% print was still below expectations and disappointed the market.

The release of the minutes of the Federal Reserve's March meeting appeared to catch the markets a bit by surprise as well as we saw repeated suggestions that the flow of purchases could be decreased soon, and possibly stopped altogether by the end of the year as some members were concerned about increasing risks to the markets. By the time this report was released economic data had already weakened, therefore the expectation for the May 1st meeting was for the Fed to stand pat with the pace of asset purchases. This was in fact the case, however they added the statement that "The Committee is prepared to increase or decrease the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes." This means that there will be no tapering to the current pace of QE3 until deflationary forces have clearly subsided and labor market conditions have significantly improved.

Within the bond market, yields have reacted to the weaker economic data as one would expect. Through mid-March yields had been trending higher as economic data continued to improve and equity markets were rising. Then as data started to weaken and concerns about the Cyprus banking crisis and bailout surfaced, the rise in yields came to a halt and began to reverse course. Since mid-March the yield on the ten-year Treasury note has declined from a high of 2.05% down to 1.65% currently. The 30-year Treasury yield has experienced a similar decline, moving from roughly 3.26% down to 2.85%. Over this same time period the 5-year Treasury yield has declined slightly less, from .90% to .67%, thus narrowing the spread of the 5y/10y yield curve from 115 basis points to 98 basis points over the past 6 weeks. The chart below depicts this decline in yields as well as the slight flattening of the yield curve.



April was the best performing month of the fiscal year thus far for the fixed income markets, returning just over 1%. Within the investment grade sector, corporate bonds performed the best with roughly a 1.7% return for the month. Treasuries returned just over 1% while agency debt and mortgages returned roughly .5%. High yield continued its hot streak with a 1.86 % return for the month.

One of the biggest concerns within the fixed income markets right now is low yield levels and how much longer they are going to exist i.e. when is the bond bubble going to burst?

The short answer is not likely in the near term, but at some point the move higher in yield levels will come. Yields across the globe have been declining and are near all time lows, which is not surprising as breakeven inflation expectations and realized inflation have declined along with investor sentiment. Even with subdued inflation and sluggish GDP growth, one could argue that interest rates should be at somewhat higher levels than they currently are given how these factors have moved together in the past. Yet with all the liquidity that the central banks are providing to the markets the demand for Treasuries has remained strong; this should likely continue for the next several months, especially if we experience another “soft patch” in economic growth during the second quarter. Therefore we would not expect to see a meaningful move higher in rates until nominal growth makes a significant move higher.

Given the decline in yields and low volatility levels present in the fixed income markets, our actvity within the portfolio over the past couple of months has been somewhat subdued. Within the corporate sector we initiated a position in Wells Fargo subordinated debt. This name is one of the stronger credits in the financial sector and we received a very attractive spread versus the senior notes by moving down the capital structure. We also executed a swap with a portion of our GE Capital notes. We sold 2018 notes and purchased 2019 notes to pick up and additional 50 basis points of yield for a small extension in maturity. We used a similar strategy with a portion of our Freeport McMoRan holdings, by selling our position in the 2017 issue and adding to our 2018 holdings for an additional 50 basis point pick up in yield. We believe that swaps like this where we can add incremental yield with minimal interest rate risk make a lot of sense and will continue to look for similar opportunities. We are still overweight this sector versus the Index and while we are comfortable with this overweight, we do not plan to increase this weighting much further at the current time given that spread levels are fairly tight.

In the agency debt sector we have seen spreads bounce around a little bit but overall they remained fairly stable and tight. We executed one swap early in the month, selling a short dated, very low yielding note and swapping into a six year note with one year of call protection. By moving out the yield curve only a couple of years and adding the call feature, we were able to pick up an additional 75 basis points of yield, again for very little interest rate risk. We also purchased a 7 year bullet issue with a portion of proceeds from a Treasury sale, as we were able to pick up 24 basis points over Treasuries for essentially the same credit quality. We have kept our weighting about equal to that of the Index as we do not see any value in being overweight this sector given the small additional spread offered over Treasury securities.

Spreads have also remained fairly stable and tight within the mortgage sector. The narrow spread level coupled with low volatility has limited the attractive opportunities within this sector. We did add two 15-year pools in April using a portion of proceeds received from a Treasury sale early in the month as well as from prepayments received during the month. We were a bit underweight 15-year pools versus the index; additionally these shorter duration pools will provide a hedge if rates start to move higher. We have kept our weighting stable within this sector and currently the duration is a little shorter than that of the Index.

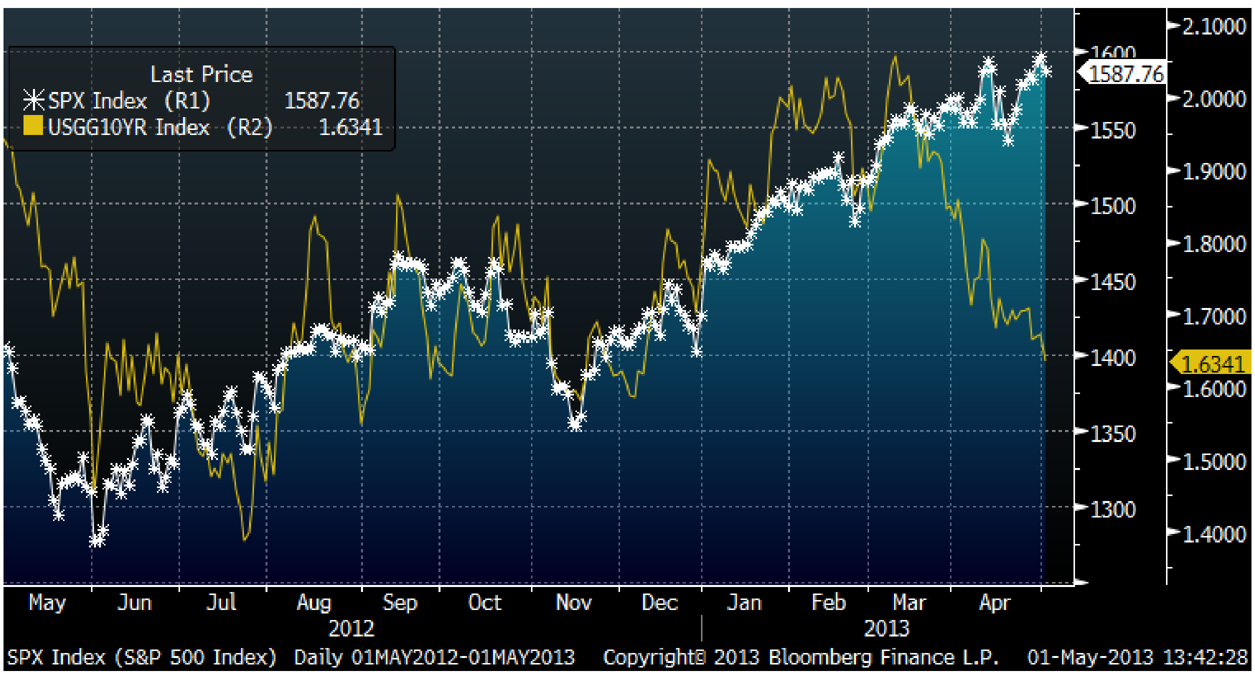
Lastly, we sold a small portion of our Treasury holdings within the intermediate part of the curve. As yields declined late in March and into April we felt that levels on these maturities had likely gotten close to their lows and that any additional moves lower would be realized at the longer end of the curve. We invested the proceeds of this sale into higher yielding spread sectors including agencies, mortgages and credit where we felt that total return prospects were more attractive.

Domestic Equity Strategy

By Marc Green

There has not been much change in the equity markets since our last meeting six weeks ago. The broad domestic market as measured by the S&P 500 is up about 2 ½ % over that time frame. Earnings season as of this writing is nearly 80% through and results were marginally better than expected, while earnings guidance was reigned in about 2% for next quarter. Economic data for the most part has been softer than expected, not just in the United States, but globally. Considering we have had growth scares around this time the past three years, it is reasonable to assume that the same situation could easily unfold this year as well. Looking at the market from a very short term perspective, we have seen a large divergence between the stock market and the 10 year treasury yield as shown on the chart below. This has been a fairly good leading indicator of an economic soft patch in recent years, but this time is different in that both investment and non-investment grade credit have continued to rally with stocks. Basically, the risk-off scenario that usually coincides with a rally in treasuries has not materialized this time.

<u>Chart 1</u>



A few possible reasons why it may be different: Scarcity value is one, the treasury has been issuing less debt and redeeming more as tax collections have spiked ahead of expectations temporarily; new investors (mainly Japan) being forced into buying as they have devalued and have ramped up their own quantitative easing; continued money flows into bond funds. What corrects this divergence? Our thought is that treasury bond prices correct up to risk assets.

Another issue that we have talked about before but is still in play is corporate profitability and its correlation with the economy. As we talked about in the quarterly update from last August, what has been good for corporate profitability has not necessarily been good for the economy, and vice versa. With suboptimal GDP growth and continued macro uncertainties, companies have been rather averse to ramping up their capital spending plans like you would expect in a normal business cycle. They have been slow to hire employees as is shown by the slow ramp up in employment and the continued strong profit margins they display. Some of this is a function of the real time picture they have on channel inventories, sales, and customer sentiment that is a result of the computer age we live in. In other words, they are more able to quickly adjust up and down their spending better than they used to. As we mentioned earlier, earnings have been growing, but managements have become very adept at keeping forward expectations at low levels. This is a game that works well for the capital markets over the long haul, but can cause short term setbacks as the bar is reset. We view this as healthy for the markets, though it doesn't really help improve the overall economy as we never see a true ramp in hiring that spurs growth in GDP.

In addition to that, large corporations have somewhat seen the light as far as returning capital to shareholders. Thinking back to the go-go years of the 1990's, I remember on every quarterly Cisco call everyone held their breath on whether John Chambers would stick to his mantra that the company was going to grow the top line 35%. They did it for years and years and finally the law of large numbers, the dot-com bust and ensuing recession blew that plan out of the water. It took years of bad acquisitions and repeated disappointments before they finally got it that they weren't going to grow at some crazy multiple of GDP. Now the company is buying back stock at a good clip and has ramped the dividend up to 3.3%. Another company that has changed their stripes recently is Apple. Apple is sitting on well over $100 billion of cash on their balance sheet, which has been a multiple crusher for the stock. They have recently announced a debt offering of $17 billion(largest ever) and using the proceeds to buy stock and boost their dividend. The announced plan is to use $100 billion for those purposes by the end of 2015. Over time these actions should greatly enhance shareholder value. The following chart provided by Citigroup shows the combined buyback and dividend yield for the S&P 500 over the past 14 years. As you can see, equity shrinkage is running just north of 3% annually, and the yield on the market is 2.2%. Corporations have been the marginal buyer of stocks as retail investors have run into bond funds since the Great Recession.

Chart 2

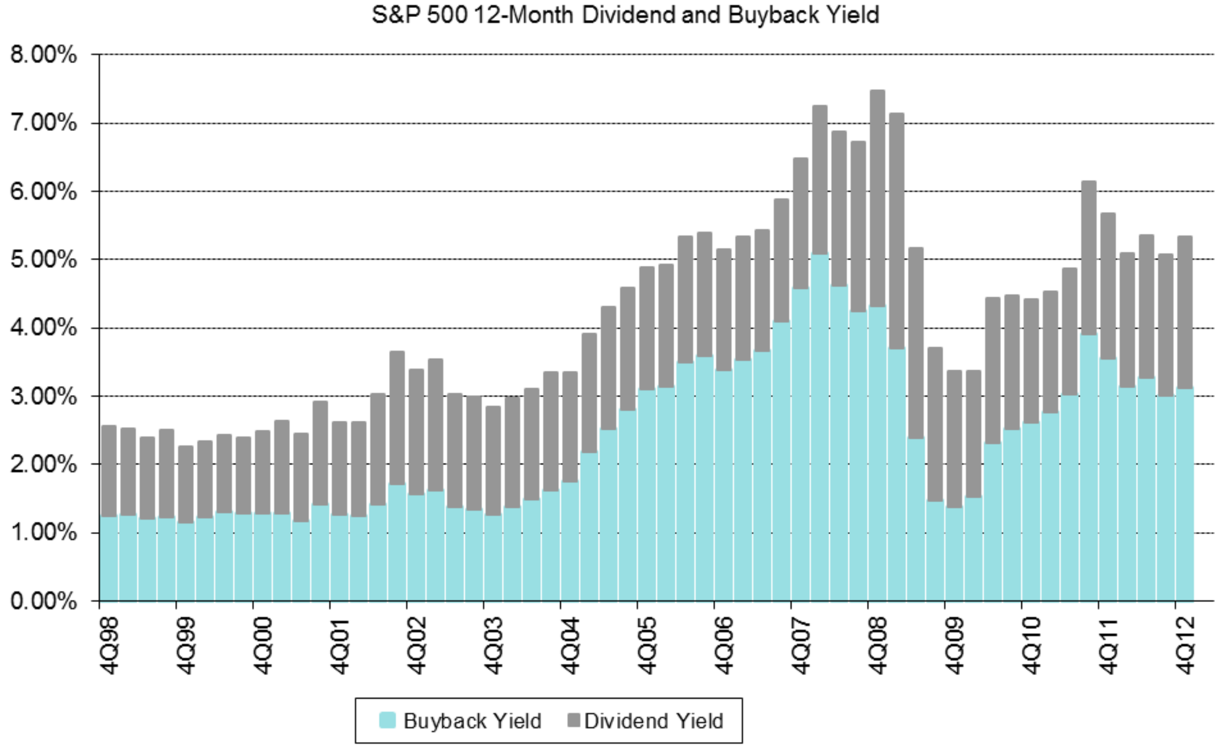


Chart provided by Citigroup

In addition to what companies have been doing, it goes without mentioning that the big sloshing sound of money flooding into the economy is having some of its intended effect, mainly forcing investors into risk assets. We have had QE1-2-3, Japan has now jumped on board with their own quantitative easing, and as bad a shape as the European economy is in, one has to consider that they may soon jump on the QE bandwagon at some point. Understanding that there is no grand exit strategy, in the mean time there is no reason to believe that this scenario doesn't continue to unfold globally. At least one can surmise that any type of concerted central bank tightening is far off, and every recession that we have experienced since WWII has been a result of central bank tightening. Investors are rightly concerned about the run that we have had out of the low in 2009, but we don't see the recipe for a recession barring some type of exogenous shock to the system. With that said, it isn't out of line to think that average returns should continue for the foreseeable future. The following chart provided by Deutsche Bank shows market returns for the past 75 or so years.

Chart 3

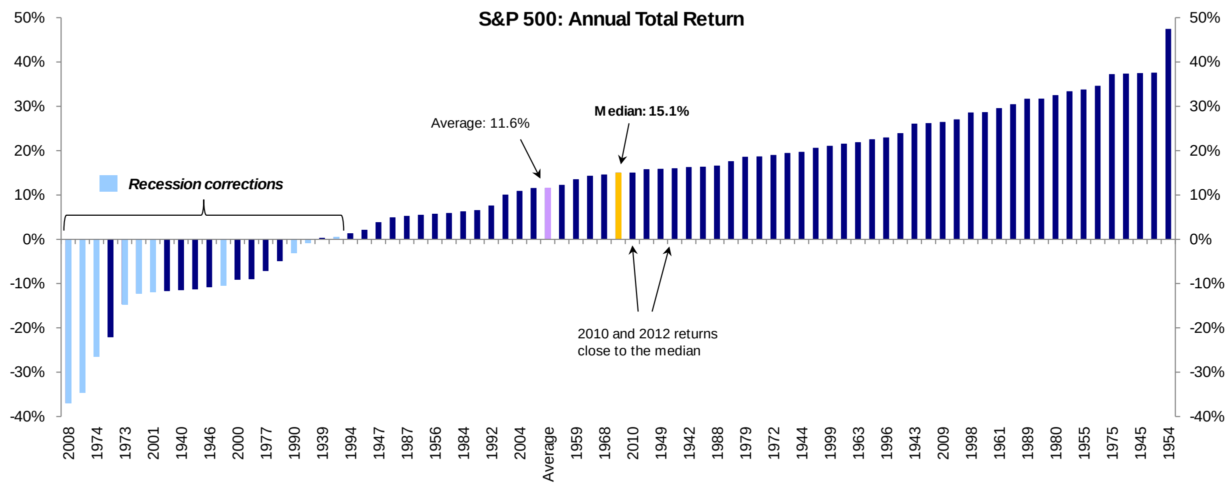


Chart provided by Deutsche Bank

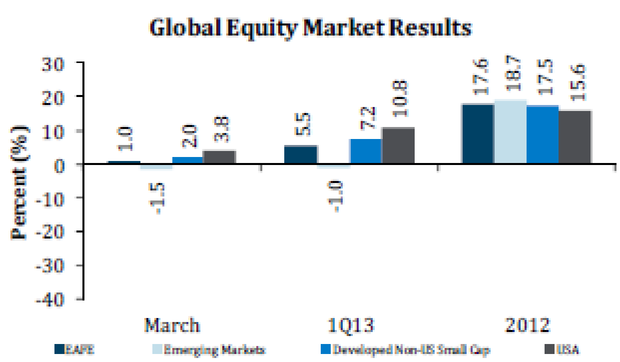
Given the run that we have seen coming out of the correction we experienced in the first quarter of our fiscal year, a pullback of some sort would probably be a healthy thing for the market at this point. It always feels terrible when it is happening, but it is part of the normal process. As we have mentioned countless times, the market climbs the "wall of worry." There are obviously many macro concerns that we have dealt with since the lows of 2009, and undoubtedly there will be more. Structurally some things that we have been positive on have continued to improve. Last May we focused on the rebound in the housing market, and that has played out pretty well. Housing prices have rebounded nicely (up 9.3% for the 12 months ended February 2013), which bodes well for consumer confidence and net worth. Banks' willingness to lend to corporations has continued to hold up well, though consumer lending is still somewhat slow. One wildcard that we are watching is the ramifications of the Affordable Care Act, as that program rolls out in full force. We don't see a whole lot of positives for corporations as this unfolds. Other positives are the increasing likelihood that the U.S. is gaining more energy independence as a result of shale fracking. Energy prices have been in decline as the U.S. continues to ramp up production, and companies are using this newfound resource to bring production back onshore. This also puts more discretionary income back into the pockets of consumers if they aren't having to spend it at the gas pumps.

As for what we have been doing, we have held allocations fairly steady. Given the nice run we have seen in the markets year-to-date, we have continued to roll out put-spread collars on a portion of our passive index funds. Currently we have about 10% of our equity exposure hedged in some capacity. Given the low volatility environment we are operating in, the terms are not great, but we feel that protecting some of the gains is prudent. We have about half of our protection out with June maturities as we felt you weren't being paid enough to take a longer view, meaning going out to the end of our fiscal year. Some of those collars have surpassed our caps on the recent run, and we will look to possibly roll them out to September closer to maturity if the pricing is acceptable. The other half of our collars that we have recently put on have September maturities, and the caps allow for around a 15-16% total return for the fiscal year. They are currently about 4.3% away from our upside caps. We will continue to roll out collars opportunistically. On the active fund side, we have also put in place collars on a large part of the small cap fund as we view the valuation disparity between large cap and small as unusually wide. We are sticking with the view that large cap stocks represent much better value than small caps. Value has outperformed year-to-date, and our value bias has allowed for some outperformance in the Core fund. We are seeing more volatility around earnings beats and misses than we have in some time, which hopefully means correlations are coming down and stock picking again adds value.

International Equity Strategy

By Steve Lambdin

Equity market returns around the globe were generally considered very good in the first quarter of 2013, as risky assets performed well during this time period. We find this quite surprising as investors shrugged off weak economic readings, the crisis in Cypress, crazy Italian elections, and the constant pressure of geo-political risks in certain parts of the world. If we roll back time just a year or so ago, what we saw unfold in Cypress would have pushed the global equity markets significantly downward. It seems the coordinated actions of the central banks around the globe to flood the world with cheap money pushed investors to embrace a “risk on” bias toward equities in the quarter. Investors also seem to have embraced the recent reformative fiscal and monetary policies going on in Japan, as this market was up substantially in the quarter. However, economic data points around the globe still point to a weak recovery going on in many regions. In China, questions began to arise surrounding steps being taken to tighten housing market policy which seem to dampen the potential for a property recovery. As a result, Chinese equities were weak in the quarter and this helped Emerging Market equities post a negative return in this time period. As we think forward from here, we still see many things to worry about. What is the next country in Europe to experience some type of financial meltdown? When will stimulus actions begin to wane and be cut back? Will the European region begin to recover in the second half of 2013? Will geo-political risks affect the equity markets? These are just a few of the questions investors are grappling with at this time. But until any of these become a major focal point, equity markets can continue to rise, as fund flows into global equities thus far in 2013 have been very robust.



Source: William Blair

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +5.13% and -1.62% respectively during the first quarter of 2013 vs. +10.61% for the S&P 500 Index. U.S. stocks benefitted from significant fund flows from overseas investors, as many feel the U.S. is better positioned for a recovery over the near term. The U.S. Dollar Index rose by approximately 4% in the first quarter, and therefore was a detractor of performance for non-hedged global equity investors. The Asian basin performed better than the European region, as the Japanese equity market was very strong in the quarter. From an economic sector standpoint, Healthcare, Staples, and Discretionary led the way, as Materials, Energy, and Utilities were weaker on a relative basis.

So far into the second quarter of 2013, equities have continued to move upward as many markets around the globe are trading near all-time highs. Investors continue to push funds into equities as central banks remain very accommodative in their respective outlooks. In addition, investors seem to be sensing a better growth environment as we move through the balance of 2013. The MSCI EAFE Index, Emerging Markets Index, and the S&P 500 Index posted returns of +5.00%, +.85%, and +1.00% respectively through early May. As we look out in the mid part of 2013, we still see a questionable recovery going on around the globe and feel many markets could be just a bit ahead of themselves at the present time. However, up to this point, global equity returns thus far into our fiscal year have been most impressive.

Global Economic Forecast

	Real GDP			Inflation			Stock Market Earnings[1]		
	2011[2]	2012	2013	2011[2]	2012	2013	2011	2012	2013
US	1.8%	2.0%	1.7%	3.1%	1.7%	2.5%	15%	7%	10%
Euro Area	1.5	-0.7	0.5	2.7	2.0	1.5	-6	0	10
UK	0.9	0.0	2.0	5.3	2.0	2.0	13	-4	7
Japan[2]	-0.5	1.8	0.6	-0.3	0.0	-0.2	-14	19	36
China	9.3	7.5	7.8	5.4	2.9	3.4			
World	2.9	2.4	2.7	3.5	3.0	3.1			

[1]FactSet, based on IBES estimates
[2]Consensus Economics
Sources: Wellington Management, Consensus Economics, FactSet

Source: Wellington Economic Outlook

Asia Update

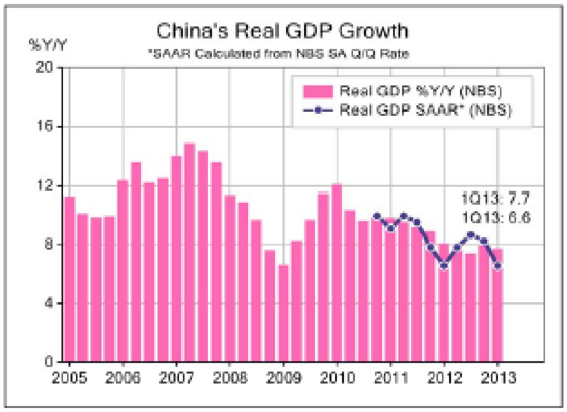
Equity market returns in the Asian region were outstanding in the first quarter of 2013. The MSCI Pacific Basin was up +9.8% in USD. The Japanese equity market was strong as aggressive actions on the monetary and fiscal policy front pushed investors toward this market. As with the previous quarter, Japanese equities would have been stronger had it not been for the significant gain (+9.3%) in the U.S. Dollar vs. the Yen in the quarter. We expect to see an improvement in business conditions in Japan as these actions begin to take hold. Chinese equities had a rough quarter as actions in the real estate sector as well as economic data points coming in below expectations made investors nervous.

Market Performance

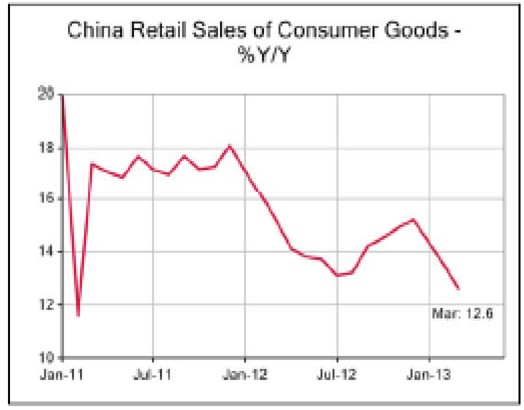
Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Philippines	1.31	18.64	18.64
MSCI Japan	4.88	11.63	11.63
MSCI Australia	-0.51	9.06	9.06
MSCI Hong Kong	-1.61	3.49	3.49
MSCI Singapore	1.40	3.01	3.01
MSCI Taiwan	-0.84	-0.21	-0.21
MSCI China	-4.57	-4.54	-4.54

Source: Factset

The Chinese economy experienced a soft patch in terms of growth in the first quarter of 2013. Gross Domestic Product (GDP) rose +7.7% from the year earlier period, which was slower than the previous quarter, and below most analysts' expectations. This is a good piece of evidence the global recovery is weak and will force many growth projections downward. This will put a bit of pressure on China's new leadership to deliver on growth targets. Industrial production only rose +8.9% in March, the weakest month of the quarter, and well below most outlooks. Chinese consumers cooled off as well, as retail sales rose only +12.4% in the first quarter. This is well below the pace of late 2012. Exports fell in March for the first time in four months, and were reported up only 10%, significantly below the pace of the January and February. Exports were particularly weak to the U.S. and to the European Union. Fixed asset investment was also surprisingly weak, and only up +20.9% in March, below the pace of early 2013. However, with a decline in most growth measures in March, it came as no surprise that we did see a decline in consumer prices in March, rising only +2.1% from the year earlier. This should give plenty of opportunity for further stimulus actions here with little risk of problematic inflation. At this point, we clearly see a Chinese economy that is weaker than many have expected, including us. This puts global growth at risk, since China accounts for a large part of global growth. We would not be surprised to see the International Monetary Fund (IMF) cut its global growth outlook. This has put pressure on equity markets here and is a big reason for the underperformance we have seen in this market. The economic situation looks to remain fragile here for the next few months and should provide clues for many investors as to economic conditions in other parts of the world.

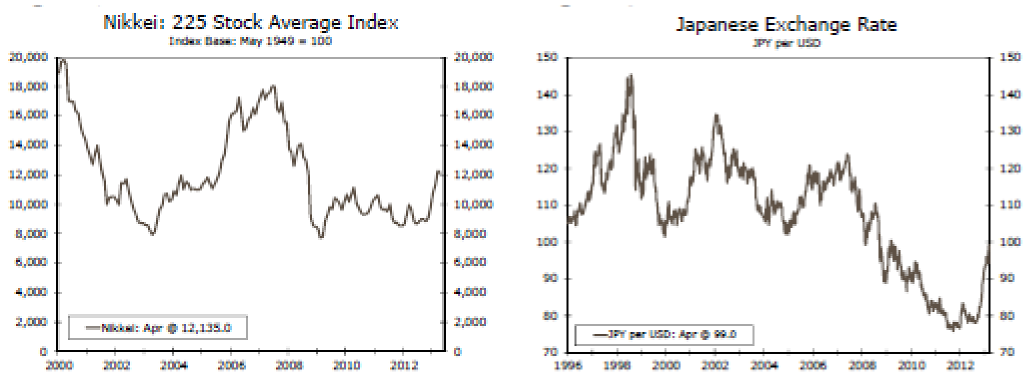


Source: ISI



Source: ISI

The euphoria surrounding the Japanese economy recently is as strong as we have seen it in quite some time. This has also pushed investor sentiment toward Japanese equities higher as well. The new administration's plans should result in asset reflation and an end of deflation. We expect first quarter GDP to rise approximately +.7% from the previous quarter, or +2.8% from the year earlier period, as this economy starts to display some growth. We expect to see strength in exports, as the continued fall of the Yen against the U.S. Dollar should provide a nice backdrop for Japanese exporters going forward. Machine orders picked up in February from a dismal January, which is a good business climate indicator. In addition, industrial production rose +.2% in March from February, as this is the fourth month in a row of increased production. In addition, the Small Business Confidence survey was reported at its highest level in over a year in April, which is another good signal to point toward. The consumer seems to be responding as well, as consumer confidence rose to 44.8 in March, another multi-year high. In addition, large-store retail sales were up +2.1% in March, the second month in a row we have seen decent increases. On the inflation front, the National Core CPI was actually up +.2% in March from February, which is perhaps an early signal the deflation fight is beginning to turn. The unemployment rate continues to get better on the margin as March unemployment was reported at 4.1%, the lowest rate we have seen in some time. In addition, the jobs to applicant ratio edged up to .86 in March, from .85 the month before. This is also at its best reading in quite some time. At this point, we see the economic outlook improving in this region. We believe the actions of the new administration are beginning to be felt by businesses and consumers alike. With this in mind, this should be most helpful for the equity markets over the near term and we remain upbeat with our short term outlook, even as long term secular challenges remain in the region.



Source: IHS Global Insight and Wells Fargo Securities, LLC

Europe Update

We thought it was quite remarkable that European equities posted a positive return in the first quarter of 2013, as the Cypress bailout seemed to garner most of the attention in the latter half of the quarter. We thought this would bring some significant pressure to equity markets across Euroland and rattle investors psyche. However, investors shook off the situation in Cypress rather quickly, and European equities actually finished up +2.7% in the quarter. On the economic front, the Euroland economy remains one of the weakest regions around the globe, as most economic data points are signaling a slow growth environment. However, the European Central Bank (ECB) continues to be supportive to the region as financing conditions have improved greatly and as credit spreads continue to shrink. This makes it easier and cheaper to access the credit markets. This gives investors more comfort on the margin and makes them feel a bit better toward "risk-on" assets, such as equities. Over the next few months, we expect the Euroland economy will garner the bulk of attention by investors, as they will be looking for early signs of a recovery. We expect the markets to be very volatile around these developments.

Market Performance

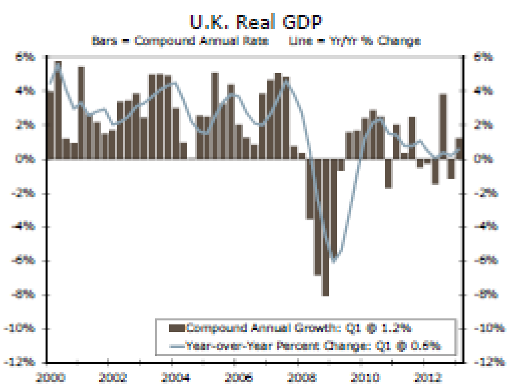
Index Name	MTD % Change	QTD % Change	YTD % Change
MSCI Switzerland	1.56	11.24	11.24
MSCI United Kingdom	1.19	2.48	2.48
MSCI Netherlands	1.49	2.40	2.40
MSCI France	-1.43	0.55	0.55
MSCI Germany	-1.04	0.18	0.18
MSCI Spain	-5.95	-5.58	-5.58
MSCI Italy	-5.23	-9.77	-9.77

Source: Factset

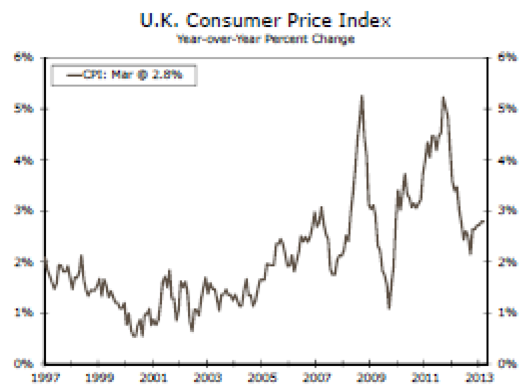
Even though first quarter GDP won't be released until mid-May, we expect Euroland GDP will fall again in the first quarter of 2013, but not to a large degree. This should mark the fourth quarter in a row of negative growth. At present in the early part of 2013, we see very little to get excited about from this region. But perhaps, the first quarter of 2013 will mark the low point in this regions' economy. Industrial production did manage to rise +.4% in February from the month earlier, as Germany and France registered decent gains in manufacturing. We just don't know if this is sustainable at this point. The index of executive and consumer sentiment fell to 88.6 in April, from 90.1 in March. Many companies just have not seen much improvement in business conditions and demand across their respective markets. Backing this up has been weak readings in the PMI Manufacturing and Services Composites, as both indicators remain below key expansionary levels. As a result of these weak readings, companies continue to cut earnings forecasts and wind up shedding workers. Retail sales continue to be dismal and fell -.3% in February from a month earlier. It seems no one has the confidence to spend and support the economy. Unemployment seems to worsen with each new report. The Euroland unemployment rate was reported at 12.1% in March, another new record. The latest estimate puts approximately 19.2 million people out of work in this region. The situation in Spain continues to defy most of us, as the nation suffers from a 26.7% unemployment rate, the highest in 37 years. However, if we are getting near the bottom in economic growth, then it would seem we would be near a bottom in unemployment. We can just hope at this point. Inflation has fallen significantly over the last couple of months and was reported at +1.2% in April, the lowest level in over three years. This rate remains well below targeted levels by the ECB. The ECB has responded to low inflation by cutting its key refi rate to .50% at its early May meeting. Even though a cut from these levels may not be significant, any actions taken to lower interest costs across an economy should be beneficial on the margin. While the outlook remains tough over the near term, we do feel better about this regions' outlook as we move deeper into 2013. We feel financing will be cheaper as interest rate spreads continue to contract and fiscal deficits continue to shrink. This could pave the way for a return to growth in this region later in 2013.

Source: IHS Global Insight and Wells Fargo Securities

Even though recovery prospects still look subpar at the present time in the U.K economy, GDP in the first quarter of 2013 did manage to grow +.1% from the previous quarter, or +.4% from the year earlier period. It looks like the economy here has dodged another dip into recession territory at the current time. However, output still remains well below peak GDP established in 2008 for this economy. Net trade continues to be in a slump as its main trading partner, the Euroland economy, remains stuck in a no growth situation. Industrial production is beginning to show a little life, and was up +1.0% in February from the previous month. Most of this increase was from strength in mining, increases in electricity and gas due to cold weather, and a surprise in manufacturing output, as many had expected to see a contraction. However, colder than expected weather did play havoc on retail sales in the period. Retail sales fell -.7% in February, which is the third month in a row for this data point. Wage growth remains very weak, providing little incentive for households to spend. Inflation has surprised us just a bit lately, and actually edged up slightly in March to +2.8% from a year earlier. This rate is still above the 2% level sought by The Bank of England (BOE), but we feel this doesn't present any serious problems currently. At its April meeting, The Monetary Policy Committee (MPC) kept interest rates at a record low of .50% and its bond purchase target remained at 375 billion pounds as we expected. The MPC still feels comfortable with its targeted level for bond purchases, even though BOE Governor Mervyn King would like to see an increase in this target. The anemic recovery seems to be putting some pressure on job figures lately. The unemployment rate climbed to 7.9% in the first quarter of 2013, as employment fell by 70,000 in the quarter. Wage growth continues to slip, as wages only grew approximately +1.0% in the first quarter of 2013 from a year earlier. All in all, we see little to be very positive about over the near term in this economy. We need to see the broader Euroland economy begin to turn the corner as well as better growth out of the U.S. economy in order to get more positive on the outlook in the U.K.



Source: HIS Global Insight and Wells Fargo



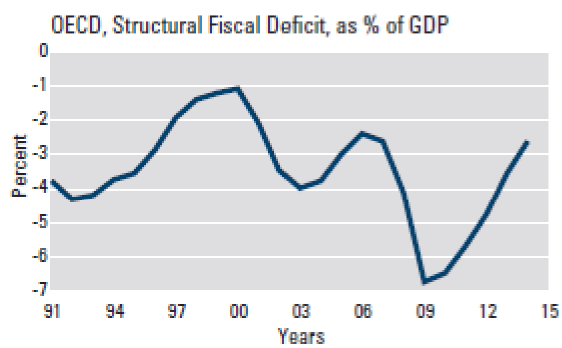
Source: HIS Global Insight and Wells Fargo

International Equity Activity/Strategy

We are a little over four years past our March 2009 lows and equity market returns have been quite remarkable. Most markets have more than doubled off their lows and investors are just now getting aggressive with money flows into equities. We are left just to wonder how long this can continue without some type of significant pause. But as long as the central banks continue with their current strategy, equities seem set to continue to rise. Investors are pointing to a slow, but growing European economy later in 2013, continuing low interest rates, well contained inflation, major change in policies in Japan, perhaps a peak in the European unemployment picture, as a few issues to get more positive toward equities. On the other side of the ledger, corporate earnings growth remains a wildcard, the potential for another "European" shoe to drop remains real, the geo-political climate, China?, and rising equity market valuations are areas of concern we see on the landscape at this time. Any of these issues could easily become the next focal point for investors and lead to a negative outcome. However, at this point, we do acknowledge that investors seem rather content, and this could lead to further equity market gains over the near term.

We did add approximately $11.6 million to our emerging markets equity ETF in mid-March as the price of this ETF moved below our strike price on our written puts. This was a very small addition and we continued to sell put options on this index in an effort to repurchase what we sold in December at a slightly lower price, in addition to adding fresh money to this index at prices even further below this. Premiums for doing this still look attractive in the current low interest rate environment. Our current allocation to Emerging Market equities is approximately 1.5% of total assets and approximately 12.2% for MSCI EAFE equities. *(Charts provided by William Blair, Wells Fargo, HIS Global Insight, Factset, ISI, OECD, and Wellington Management)*

Fiscal Deficits Are Shrinking



Source: Organisation for Economic Co-operation and Development (OECD)

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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.S. EQUITY										
TRS CORE FUND	1,856,631,032	3.94	10.51	10.51	10.90	11.47	10.85	4.81	8.48	Oct-94
TRS S&P 500 FUND	4,896,116,427	3.50	10.31	10.31	9.93	13.85	12.68	5.87	8.60	Oct-94
TRS MID CAP INDEX	1,062,827,009	4.77	13.45	13.45	17.53	18.61	15.19	9.98	12.51	Oct-94
TRS S&P SMALL CAP INDEX	626,065,721	4.27	11.96	11.96	14.72	17.16	15.82	9.89	12.59	Mar-01
TRS SMALLCAP ACTIVE FUND	149,210,075	4.62	9.96	9.96	10.26	12.54	12.00	6.88		Jun-06
TRS MIDCAP ACTIVE FUND (SSF)	709,638,168	4.67	12.68	12.68	15.49	16.52	16.33	9.85	11.99	Oct-94
TRS TOTAL DOMESTIC EQUITY	9,300,488,432	3.89	10.98	10.98	11.68	14.27	13.11	6.22	9.24	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		3.99	11.24	11.24	11.86	14.87	13.28	6.66	9.36	
S&P 500		3.75	10.61	10.61	10.19	13.96	12.67	5.81	8.53	
S&P 400 MIDCAP		4.78	13.45	13.45	17.55	17.83	15.12	9.85	12.45	
S&P 600 SMALL CAP		4.24	11.81	11.81	14.29	16.14	15.18	9.19	12.36	
INTERNATIONAL EQUITY										
TRS EMERGING MARKETS FUND	292,845,607	-0.81	-3.28	-3.28	4.73	2.85				Oct-11
TRS INTERNATIONAL EQUITIES	2,460,221,690	0.86	5.14	5.14	12.07	11.74	5.57	-0.38	10.14	Nov-94
TRS TOTAL INTERNATIONAL EQUITY	2,753,067,298	0.68	4.20	4.20	11.26	10.61	5.26	-0.21	10.34	Nov-94
TRS CUSTOM INTERNATIONAL EQUITY IND		0.55	4.38	4.38	11.12					
MSCI EAFE (NET)		0.82	5.13	5.13	12.04	11.25	5.00	-0.89	9.69	
MSCI EMERGING MARKETS (NET)		-1.72	-1.62	-1.62	3.87	1.96	3.27	1.09	17.05	

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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	12,053,555,730	3.14	9.36	9.36	11.59	13.43	11.18	4.59	9.41	Oct-75
TRS CUSTOM GLOBAL EQUITY INDEX		3.18	9.60	9.60	11.70	13.83	11.17	4.69		
FIXED INCOME										
TRS DOMESTIC FIXED INCOME	2,524,606,752	0.17	0.45	0.45	1.00	5.46	6.70	6.68	6.91	Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		0.06	-0.10	-0.10	0.35	4.89	6.27	6.25	5.44	
TRS TOTAL FIXED (ex. Private Placements)	2,524,606,752	0.17	0.45	0.45	1.00	5.46	6.70	6.68		Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		0.06	-0.10	-0.10	0.35	4.89	6.27	6.25		
Barclays Aggregate Bond		0.08	-0.12	-0.12	0.09	3.77	5.52	5.47	5.02	
TRS PRIVATE PLACEMENTS	2,168,987,161	-0.22	1.14	1.14	2.64	13.60	12.29	2.20	6.80	Aug-99
TRS CASH ACCOUNT	75,774,773	0.46	1.14	1.14	2.95	3.05	1.15	1.13		Sep-03
TRS TOTAL FIXED INCOME	4,769,368,686	0.01	0.77	0.77	1.74	8.82	8.79	4.25	6.67	Oct-93
ALTERNATIVE INVESTMENTS										
TRS PREFERRED STOCK	374,310,907	3.77	4.10	4.10	3.98	17.21	12.38	-23.63		Sep-03
TRS REAL ESTATE	1,966,002,434	0.00	0.03	0.03	0.04	4.91	1.46	0.63		Oct-03
TRS SHORT TERM INVESTMENTS	566,193,061	0.03	0.10	0.10	0.21	0.44	0.40	1.11		Oct-03
TRS TOTAL ALTERNATIVES	2,906,506,402	0.47	0.55	0.55	0.56	5.38	2.27	-4.73		Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,675,875,088	0.18	0.69	0.69	1.31	7.53	6.55	1.34	4.59	Oct-93

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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
TOTAL PLAN										
TRS TOTAL PLAN	19,729,430,818	1.96	5.79	5.79	7.32	11.12	9.18	3.16	7.00	Oct-88
TRS TOTAL PLAN POLICY		2.58	7.64	7.64	9.37	11.99	9.34	5.01		

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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	1,000,120,438	3.94	10.53	10.53	10.92	11.51	10.89	4.83	8.48	Oct-94
ERS S&P 500 FUND	2,215,292,479	3.50	10.31	10.31	9.92	13.85	12.68	5.87	8.64	Oct-94
ERS MID CAP INDEX	470,124,151	4.77	13.45	13.45	17.53	18.65	15.20	9.98	12.53	Oct-94
ERS S&P SMALL CAP INDEX	257,476,554	4.27	11.96	11.96	14.72	17.16	15.82	9.90	12.57	Mar-01
ERS SMALLCAP ACTIVE FUND	73,610,410	4.62	9.94	9.94	10.22	12.53	12.01	6.88		Jun-06
ERS MIDCAP ACTIVE FUND (SSF)	381,410,873	4.65	12.65	12.65	15.51	16.52	16.34	9.88	12.06	Oct-94
ERS TOTAL DOMESTIC EQUITY	4,398,034,905	3.90	10.98	10.98	11.67	14.17	13.05	6.19	9.23	Oct-93
ERS CUSTOM DOMESTIC EQUITY INDEX		3.98	11.23	11.23	11.85	14.87	13.26	6.64	9.35	
S&P 500		3.75	10.61	10.61	10.19	13.96	12.67	5.81	8.53	
S&P 400 MIDCAP		4.78	13.45	13.45	17.55	17.83	15.12	9.85	12.45	
S&P 600 SMALL CAP		4.24	11.81	11.81	14.29	16.14	15.18	9.19	12.36	
INTERNATIONAL EQUITY										
ERS EMERGING MARKETS FUND	139,845,747	-0.81	-3.28	-3.28	4.73	2.86				Oct-11
ERS INTERNATIONAL EQUITIES	1,082,284,235	0.85	5.13	5.13	12.06	11.75	5.59	-0.36	10.12	Nov-94
ERS TOTAL INTERNATIONAL EQUITY	1,222,129,982	0.66	4.12	4.12	11.19	10.53	5.26	-0.18	10.35	Nov-94
ERS CUSTOM INTERNATIONAL EQUITY IND		0.53	4.33	4.33	11.05					
MSCI EAFE (NET)		0.82	5.13	5.13	12.04	11.25	5.00	-0.89	9.69	
MSCI EMERGING MARKETS (NET)		-1.72	-1.62	-1.62	3.87	1.96	3.27	1.09	17.05	

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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	5,620,164,887	3.18	9.42	9.42	11.58	13.38	11.23	4.65	9.42	Oct-93
ERS CUSTOM GLOBAL EQUITY INDEX		3.22	9.66	9.66	11.68	13.87	11.26	4.77		
FIXED INCOME										
ERS DOMESTIC FIXED INCOME	1,149,224,407	0.17	0.43	0.43	0.98	5.45	6.70	6.67	6.96	Sep-99
ERS CUSTOM DOMESTIC FIXED INDEX		0.06	-0.10	-0.10	0.35	4.91	6.29	6.24	5.43	
ERS TOTAL FIXED (ex. Private Placements)	1,149,224,407	0.17	0.43	0.43	0.98	5.45	6.70	6.67		Oct-03
ERS CUSTOM GLOBAL FIXED INDEX		0.06	-0.10	-0.10	0.35	4.91	6.29	6.24		
Barclays Aggregate Bond		0.08	-0.12	-0.12	0.09	3.77	5.52	5.47	5.02	
ERS PRIVATE PLACEMENTS	1,074,870,601	-0.24	1.12	1.12	2.62	13.45	12.42	2.10	6.76	Aug-99
ERS CASH ACCOUNT	47,595,755	0.36	0.87	0.87	1.94	2.05	0.82	0.93		Sep-03
ERS TOTAL FIXED INCOME	2,271,690,762	-0.01	0.76	0.76	1.73	8.84	8.89	4.09	6.66	Oct-93
ALTERNATIVE INVESTMENTS										
ERS PREFERRED STOCK	264,693,628	3.93	4.16	4.16	3.80	19.31	14.34	-18.83		Sep-03
ERS REAL ESTATE	954,837,255	0.00	0.03	0.03	0.04	4.86	1.32	0.55		Oct-03
ERS SHORT TERM INVESTMENTS	420,872,383	0.03	0.09	0.09	0.20	0.43	0.39	1.10		Oct-03
ERS TOTAL ALTERNATIVES	1,640,403,266	0.62	0.69	0.69	0.66	5.86	2.70	-6.12		Oct-03
ERS TOTAL F.I. PLUS ALTERNATIVES	3,912,094,028	0.25	0.74	0.74	1.31	7.64	6.63	0.50	4.23	Oct-93

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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	9,532,258,915	1.95	5.64	5.64	7.08	11.00	9.14	2.70	6.73	Oct-89
ERS TOTAL PLAN POLICY		2.60	7.65	7.65	9.31	11.95	9.28	4.99		

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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	114,613,756	3.56	10.38	10.38	9.99	13.83	12.66	5.92	8.64	Oct-94
JRF S&P MID CAP INDEX	14,097,923	4.77	13.46	13.46	17.53	17.81	15.20	9.99	12.51	Oct-94
JRF S&P SMALL CAP INDEX	5,638,767	4.27	11.96	11.96	14.72	17.16	15.82	9.89	12.73	Mar-01
JRF TOTAL DOMESTIC EQUITY	134,350,445	3.72	10.76	10.76	10.93	14.37	13.13	6.46	9.12	Oct-93
JRF CUSTOM DOMESTIC EQUITY INDEX		3.88	10.95	10.95	11.09	14.45	13.00	6.26	8.97	
S&P 500		3.75	10.61	10.61	10.19	13.96	12.67	5.81	8.53	
S&P 400 MIDCAP		4.78	13.45	13.45	17.55	17.83	15.12	9.85	12.45	
S&P 600 SMALL CAP		4.24	11.81	11.81	14.29	16.14	15.18	9.19	12.36	
INTERNATIONAL EQUITY										
JRF EMERGING MARKETS FUND	4,340,500	-0.81	-3.28	-3.28	4.73	2.87				Oct-11
JRF INTERNATIONAL EQUITIES	32,291,824	0.85	5.17	5.17	12.13	11.79	5.77	-0.20		Nov-06
JRF TOTAL INTERNATIONAL EQUITY	36,632,324	0.66	4.11	4.11	11.22	10.52	5.41	0.40		Nov-06
JRF CUSTOM INTERNATIONAL EQUITY IND		0.52	4.30	4.30	11.02					
MSCI EAFE (NET)		0.82	5.13	5.13	12.04	11.25	5.00	-0.89	9.69	
MSCI EMERGING MARKETS (NET)		-1.72	-1.62	-1.62	3.87	1.96	3.27	1.09	17.05	
JRF TOTAL GLOBAL EQUITY	170,982,769	3.05	9.27	9.27	11.01	13.56	11.61	5.37	8.72	Oct-93
JRF CUSTOM GLOBAL EQUITY INDEX		3.14	9.46	9.46	11.08	13.56	11.26	4.92		

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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
DOMESTIC FIXED INCOME										
JRF DOMESTIC FIXED INCOME	59,579,164	0.18	0.58	0.58	1.15	5.60	6.70	6.65	6.97	Oct-93
JRF CUSTOM DOMESTIC FIXED INDEX		0.06	-0.10	-0.10	0.36	4.57	6.17	6.05	5.40	
Barclays Aggregate Bond		0.08	-0.12	-0.12	0.09	3.77	5.52	5.47	5.02	
JRF PRIVATE PLACEMENTS	3,043,953	-2.34	-1.50	-1.50	0.91	1.47	2.62	0.92	6.95	Oct-01
JRF CASH ACCOUNT	3,106,818	0.25	0.65	0.65	1.57	1.67	0.69	0.86		Sep-03
JRF TOTAL FIXED INCOME	65,729,935	0.07	0.46	0.46	1.10	5.10	6.09	5.78	7.00	Oct-93
ALTERNATIVE INVESTMENTS										
JRF REAL ESTATE	3,158,020	0.00	0.00	0.00	0.00	8.00	13.07	8.50		Oct-03
JRF SHORT TERM INVESTMENTS	5,998,685	0.03	0.09	0.09	0.24	0.54	0.47	1.16		Oct-03
JRF TOTAL ALTERNATIVES	9,156,705	0.02	0.07	0.07	0.38	3.08	4.60	3.16		Oct-03
JRF TOTAL F.I. PLUS ALTERNATIVES	74,886,640	0.06	0.44	0.44	1.04	4.87	6.02	5.51	6.72	Oct-93

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING March 31, 2013

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	245,869,409	2.11	6.36	6.36	7.70	10.75	9.73	5.60	7.90	Oct-93
JRF TOTAL PLAN POLICY		2.25	6.63	6.63	7.87	10.86	9.47	5.13		