INVESTMENT UPDATE

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Economic Snapshot April 2011

The U.S. economic recovery appeared to be gathering momentum in early 2011, as new hiring began to pick up. However, a surge in oil prices threatens to dampen the pace of growth in the near term. Higher food and energy prices are putting upward pressure on consumer price inflation, but such increases tend to be short-term in nature (the key is what happens to the trends in underlying inflation and inflation expectations). The Fed is expected to complete its $600 billion asset purchase program at the end of June (as scheduled), but short-term interest rates are unlikely to be raised until 2012.

Real GDP growth appears to have risen at a moderate pace in Q111. However, consumer spending growth slowed to some extent (from a strong Q410). Expectations of GDP growth in 2011 have decreased (from 3.5%-4.0% seen in February, to 2.5%-3.0% more recently).

Job losses continue to trend at a low level, except in state and local government. Small and medium-sized businesses have increased their hiring, but improved job growth has not done much to reduce the large amount of slack in the labor market.

Consumer spending ended 2010 on a strong note, but slowed in Q111. The impact of reduced payroll taxes has been offset by the expiration of the Making Work Pay tax credit (for low-income households) and by higher gasoline prices (for low- and middle-income households).

Corporate profit growth has remained strong, helping to fuel business fixed investment. However, factory shipment data were a bit soft in Q111. New orders and production have been uneven, but the trend is higher. Inventories are lean. Factory jobs are being added.

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Monthly Market Commentary

Morningstar Market Commentary for April

- Morningstar economists are optimistic on growth for the year
- Consumer spending and business investment remain the keys
- Possibility of rising inflation is a conern

The market has had its ups and downs in March, but the overall atmosphere has been optimistic in light of less negative news from Japan and the Middle East. On the not-so-optimistic side, however, bad news on the European debt crisis (Portugal in particular) may signal some dark clouds looming ahead.

Employment: After a year of almost no progress, employment statistics have finally begun to show some improvement. Current unemployment claims are in the 300,000–350,000 range, approximately half of the 674,000 we've seen in the early months of 2009. Since 20%–25% of the jobs lost during the recession were in the construction sector, significant improvement in unemployment numbers may not occur until both the homebuilding and construction industries recover. Still, in light of these recent positive numbers, next week's jobs report is an eagerly awaited piece of news.

Consumer spending: Other statistics to be released next week include personal income and spending data for the first quarter of 2011, which may provide insight into whether consumer confidence is back or still waning. Consumption numbers are crucial data points for quarterly GDP forecasts, which for now appear to be in the 2.0%–4.0% range. With higher inflation rates and volatile import numbers, Morningstar analysts estimate that first-quarter GDP growth may be on the lower side of this range. However, companies will start reporting corporate earnings next month, significantly impacting the market and economic forecasts.

Tech sector: Excellent news from the tech sector fueled the market in recent weeks, with some technology companies reporting revenue growth as high as 25% and raising their dividends. In the improving economic environment, businesses now have more money to invest in new technologies, such as cloud computing, which in turn may fuel future growth.

Housing market: Unfortunately, housing data still does not indicate any significant improvement. New and existing home sales in February were dismal; only 250,000 units were sold, a new record low dating back to the 1960s. This is in sharp contradiction with realtors' and builders' optimism about the spring selling season. Even when taking seasonal factors into account, such as bad weather and low temperatures, the outlook remains bleak.

Economic growth: The GDP number for the fourth quarter of 2010 has been revised for a third and final time, from 3.3% to 2.8% and now back to 3.1%. Increasing consumer confidence was reflected in strong spending on consumer durables, with modest growth in non-durable goods and consumer services displaying the smallest growth. The overall message is clear: consumers are back, increasingly confident and willing to spend.

The tale of two recoveries (rich versus not so rich): As worrisome as this news may be, it is by now clear that so far in the recovery higher earners have fared much better than their counterparts (especially those with less education). The latter continue to face double-digit unemployment and have difficulties confronting the higher food and energy costs. Further pain in the lower income brackets may create a ripple effect and stall overall economic growth.

Quarter-end insights: Although this year started on a bad note, Morningstar economists are optimistic and predict that real GDP growth of 3.5%–4.0% may still be possible if inflation doesn't get out of control. However, this is a big "if." Judging by the already-rising fuel and food prices, inflation may reach 3% in no time (the annualized increase in the Consumer Price Index over the last six months is an even more frightening 3.9%). Looking forward, consumer spending remains key, as well as business investing. These may well be the two most important determinants of the recovery for the rest of the year.

The Many Faces of Inflation

During the recent 2007–2009 recession, it seems all we've seen and heard about the economy was bad news: the housing market collapsing, 401(k)s suddenly being worth much less than before, a lifetime of savings almost disappearing in a few months, rising unemployment, and fluctuating prices. Now that the recession has officially ended in June 2009 and we're on the road to recovery, inflation may become a concern once again. In this uncertain economic climate, it may be helpful to learn about the different types of inflation and their immediate effects.

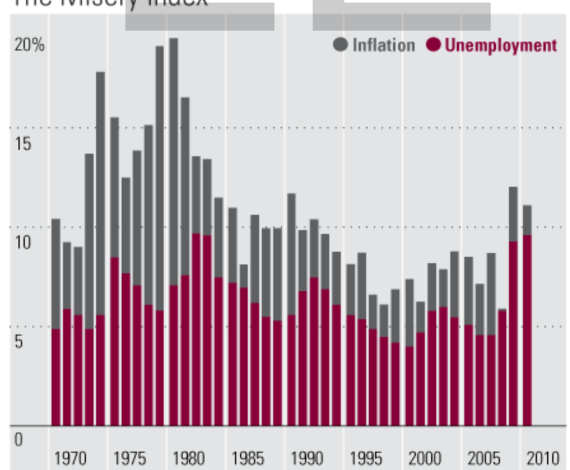
Inflation: Inflation is defined as a continuing rise in the general prices of goods and services. Simply put, if prices, on average, are going up in an economy, then you've got inflation. With a set amount of money in an inflationary environment, consumers are able to buy less and less over time. High rates of inflation can generate uncertainty, lower productivity and discourage investment. The leading measure of inflation in the United States is the Consumer Price Index (CPI). The government can change its monetary policy to control the money supply and keep inflation in check, although this is not the only variable affecting inflation. In November 2010, the Federal Reserve announced it would buy back long-term Treasuries in order to inject money into the economy, a policy called quantitative easing, which can trigger higher inflation.

Hyperinflation: Hyperinflation is extremely high, out of control inflation, caused by a steep increase in the money supply without a corresponding increase in the output of goods and services. Well-known examples include the German hyperinflation after World War I and the hyperinflation in Hungary after World War II. It appears that such an extreme phenomenon occurs mainly as a result of radical changes and prolonged economic instability.

Deflation: Deflation is the opposite case: a general decline in the prices of goods and services. In the U.S., deflation occurred as recently as 2008 and 2009: The change in CPI was negative in the third and fourth quarters of 2008 and in the fourth quarter of 2009, a clear indicator of deflation. The obvious positive effect here is lower prices—many argue that deflationary periods are good times to buy. The problem with deflation, though, is that consumers reduce spending and businesses stop growing, which is not good for the economy.

Stagflation: This is the worst-case scenario: high inflation and slow growth simultaneously. Normally, there is an inverse relationship between inflation and unemployment; if the economy is able to tolerate a higher rate of inflation, lower unemployment can be achieved, and vice versa. But during a stagflation period, both inflation and unemployment go up. An interesting measure for stagflation is the misery index, which, as illustrated in the image, combines the unemployment and inflation rates. The U.S. experienced severe stagflation in the 1970s, when unemployment and inflation reached a combined high of almost 20%. There has been talk of stagflation during the recent crisis as well, but the potentially encouraging news is that the misery index is not nearly as high now as it has been in the past.

The Misery Index



Source: Inflation is represented by the Consumer Price Index, and unemployment by the national unemployment rate, not seasonally adjusted, from the Bureau of Labor Statistics.

Equity Commentary

Despite unsettling civil and military developments in the Middle East, earthquakes, tsunamis, nuclear melt downs in Japan, and continuing fiscal problems in the U.S. (with a 2011 budget deficit projected at $1.5 trillion and a current federal debt of $14.2 trillion), and sharply higher oil prices, U.S. equity markets have continued to move erratically higher.

The prime drivers for U.S. equities continue to be: (1) improving corporate earnings, (2) strengthening corporate balance sheets through enhanced cash flows, favorable refinancing, and debt repayments, (3) continuing very low yields in money markets and bank CDs, and (4) relatively low P/E valuations on the S&P 500. Individual investors remain guarded in their equity investments while institutional investors, mutual funds, and ETFs have experience substantial gains due to the S&P resurgence of approximately 100% from the March 6 lows of 2009.

Capital market conditions have improved significantly over the last one and a half years and the ability to underwrite equity and debt offerings is now more broadly an option for most corporations. Credit availability has improved most for those individuals with solid credit ratings but much of the U.S. population does not have a credit score above 700, thus credit for them is more problematical and their annual costs will likely be greater. Commercial banks retain tighter credit standards, credit administration, and lending practices with availability of loans still very limited to the part of the U.S. population that can be described as unemployed, under-employed, or credit-challenged. With the housing market still depressed, a sharp increase in foreclosures in 2011 is expected to further expand the volume of unsold homes available in the marketplace.

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