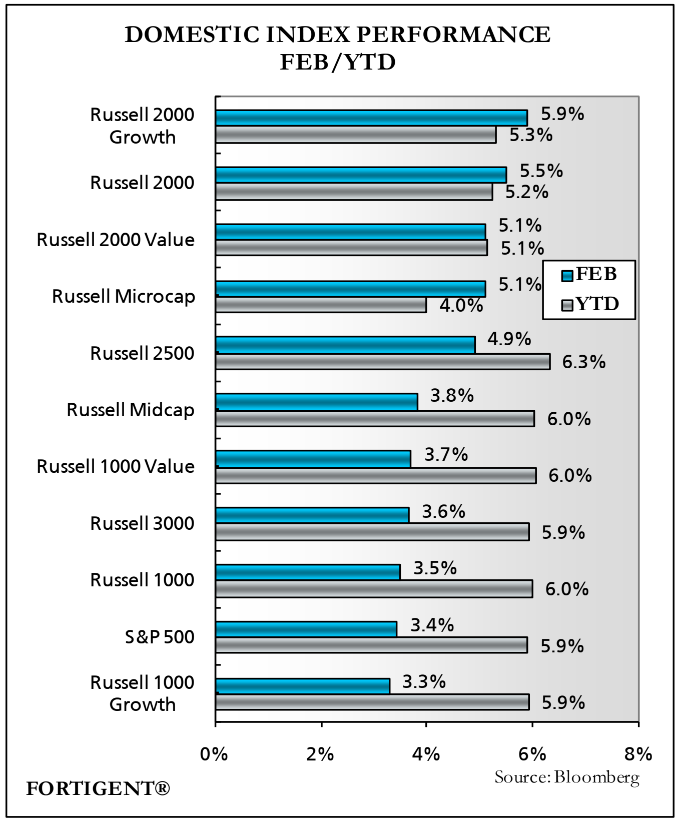
EVERMAY

# FEBRUARY FLASH REPORT – MARCH 4, 2011
(MONTH ENDING FEBRUARY 28, 2011)

## DOMESTIC EQUITIES: SLICK OIL

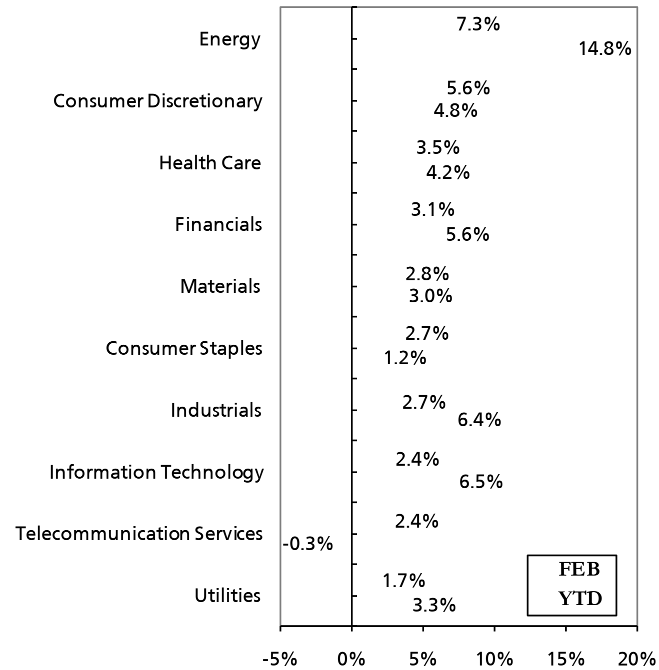
In equities, it was another headline-heavy month, which began with the end of Egyptian President Mubarak's 3-decade reign. After a tumultuous January, the move induced a short period of perceived calm in the region and equity market volatility declined. Domestic equities rallied on the news, supported by robust earnings, continued M&A activity [Sanofi bought Genzyme for over $20 billion; NYSE bought by Duetsche Boerse for $10.5 billion] and lower unemployment data. On the periphery, inflation fears mounted; resulting in several interest rate hikes abroad (China hiked rates then increased reserve requirements in less than a two week span). As turmoil in Libya came to the forefront, oil broke the $100/barrel mark, compounding inflation worries. The VIX jumped 40% (its highest percentage rise in almost a year), while equities tumbled, giving up almost all of their MTD gains. Ultimately, several positive economic releases toward the end of the month helped US markets recover – e.g., consumer confidence hit 3-year high; huge rebound in auto-sales. Most headline indices finished in the black, with the S&P 500 up 3.4% and NASDAQ up 3.0%.




Beyond the headlines, corporate earnings continued to come in strong. In aggregate, reporting companies of the Russell 1000 outpaced EPS expectations by 7%, or $15.6 billion, compared to 5% and $9.1 billion at the start of last year. Interestingly, the top 1% of firms from an earnings surprise standpoint, accounted for 50% of that surprise (Exxon surprised by $1 billion!), showing how top heavy aggregate market metrics can be. Materials were the strongest sector, outpacing expectations by more than 20.3%. Next in line was telecom, which surprised by 18.4%. If one dug a little deeper however, there was actual weakness in telecom, which is maybe why the sector has lagged so far this year. There are 18 telecom stocks in the Russell 1000 index. Of those, only six outpaced analyst EPS expectations. In fact, when Clearwire's $724 million beat is excluded (analysts expected EPS of -$0.55 and got +$0.16), the sector actually surprised to the downside. A review of utilities (there are 54 utility stocks in the Russell 1000) tells a similar story; EPS did come in ahead of expectations, but revenues actually fell $7.8 billion short.

Looking forward, analysts are showing signs of expectation moderation. According to Bespoke (as of Feb 25) "over the last four weeks, analysts have raised earnings estimates for 655 companies and lowered estimates for 538. This works out to a net of 117 or 7.8% of the index. While still positive, the current reading is the lowest level since early December (12/10)." The report goes on to mention that only two sectors have not experienced revision ratio declines since the start of the earnings season, materials and industrials. In a vacuum, this short-term trend does not indicate changes in market direction. Still, earnings revisions historically are a leading indicator. If EPS revisions begin to net out, the result may be headwinds for equity markets.

**RUSSELL 3000 (GICS SECTOR) PERFORMANCE FEB/YTD**




FORTIGENT® Source: Bloomberg

Fund flows over the past two months were quite strong, showing that despite growing macroeconomic uneasiness, investors are tired of sitting on the sidelines. January mutual fund flows showed over $15 billion moving into US equity funds, the highest number since February 2006. February ETF flow data confirmed the trend, with another $3.4 billion moving into US equities. An interesting side note, of the more than $1 trillion invested in ETFs in the US, 46% is in US Equities, 26% International Equities, 13% US Fixed Income, and 10% in commodities (the other 5% is spread amongst international fixed income, levered and inverse ETFs).

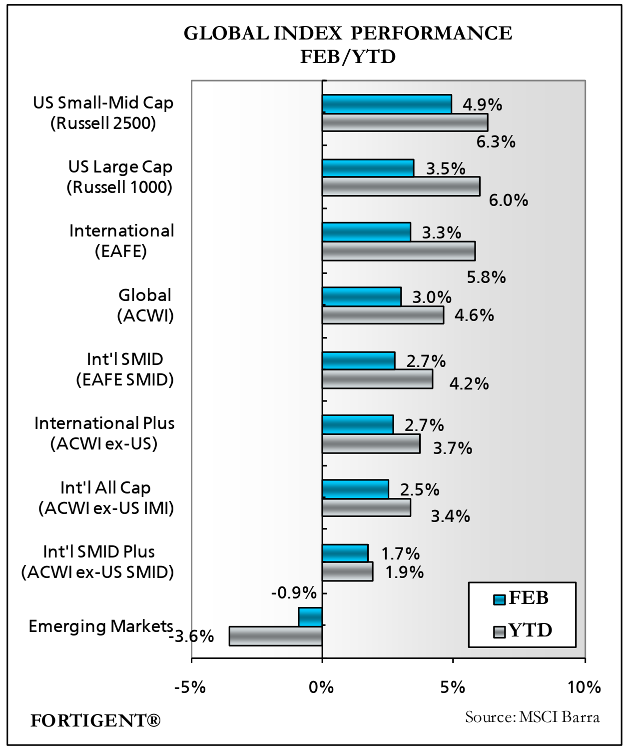
Of the $3.4 billion that flowed into equity ETFs, almost half went into XLE (Energy Select ETF), as concerns over oil production in Libya (producer of 3% of the world's oil) pushed many investors toward energy securities. The demand did not stop at equities, as the underlying commodity (oil futures) caught a strong bid during the month. The result was a rally in the front end of the futures curve, pushing Brent into backwardation (front month contract more expensive than a contract further along the curve). Oil was not the only beneficiary. Commodity ETFs in aggregate saw $2.3 billion in flows, with much of the flow concentrated on agricultural commodities. Many market pundits expect food shortages abroad and higher input costs due to rising oil prices will result in a further rise in food prices.

A trend that lost some steam but continued to chug along in February was M&A activity. According to the Wall Street Journal, global activity slowed by 7% during the month relative to January. On the other hand, YTD global M&A volumes are 9% ahead of the pace set last year, with the biggest jumps coming from US and Asia, where deal volume is up more than 30%.

From a capitalization standpoint, small caps are now in-line with large cap stocks YTD – recovering from a negative January. Mid cap stocks also performed well, in-step with their adjacent markets. Style performance fell along the capitalization line. Small cap growth and value beat their large cap counterparts, while growth beat value across the capitalization spectrum. Supporting growth stocks were the indices' relative underweights to utilities (0% vs. 12% in large cap, and 1% vs. 7% in small cap) which were a relative laggard, and overweights to consumer discretionary (17% vs. 9% in large cap, and 20% vs. 10% in small cap).

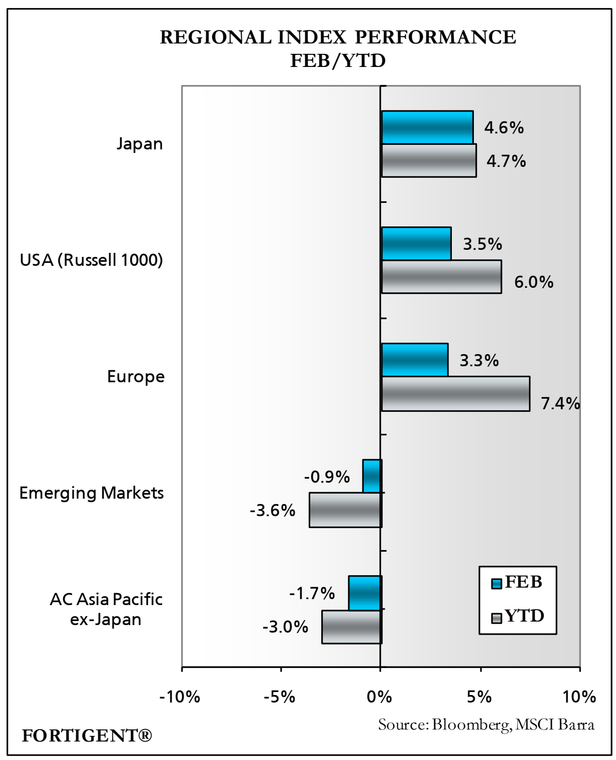
**Sources: Bespoke; Bloomberg, S&P, FactSet, Russell, Dealogic, WSJ**

## INTERNATIONAL EQUITIES: ENERGY STOCKS DRIVE GLOBAL RETURNS



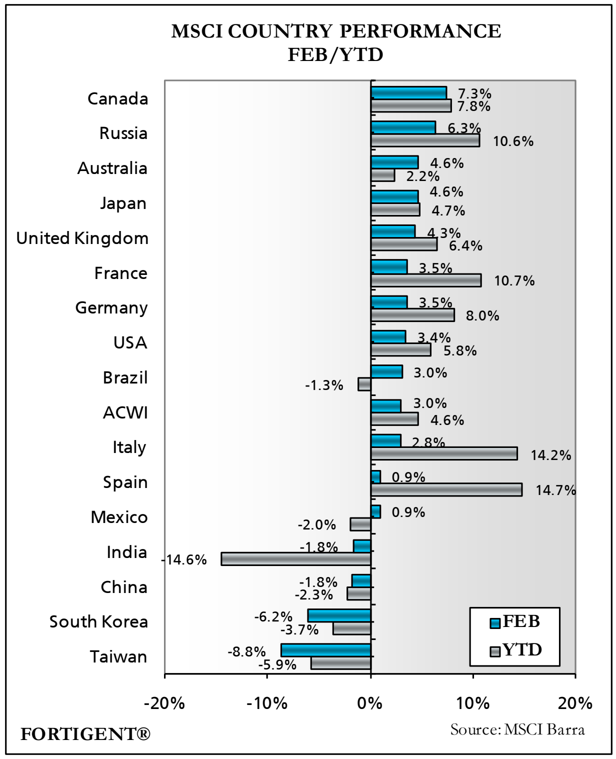

Despite political turmoil in the Middle East and its impact on oil prices, international equities managed to post a 2.7% gain in February. This performance lagged US stocks, as the broad index (MSCI ACWI ex-US) was weighed down by its 22% allocation to underperforming emerging markets. Developed international equities exhibited stronger performance, with the MSCI EAFE posting a US-like return of 3.3%. Interestingly, the US Dollar weakened against most global currencies in February, despite heightened market volatility and uncertainty. Prospects of tighter monetary policy in non-US countries and the threat of a government shutdown in the US were apparently enough to offset flight to safety demand.

Sector performance was fairly disparate in February, driving divergent country returns in both emerging and developed economies. Higher oil prices boosted energy stocks, as the sector rose 5.9% over the month. Countries with high energy exposure like Canada (28% energy weight), Russia (59% energy weight), Norway (48% energy weight), and Thailand (40% energy weight) were big beneficiaries. In contrast, technology stocks retreated during the month, posting a (-1.2%) return in the broad international index. The effect was more pronounced in emerging markets (falling over 6%) and skewing down the returns of several tech-heavy EM countries.

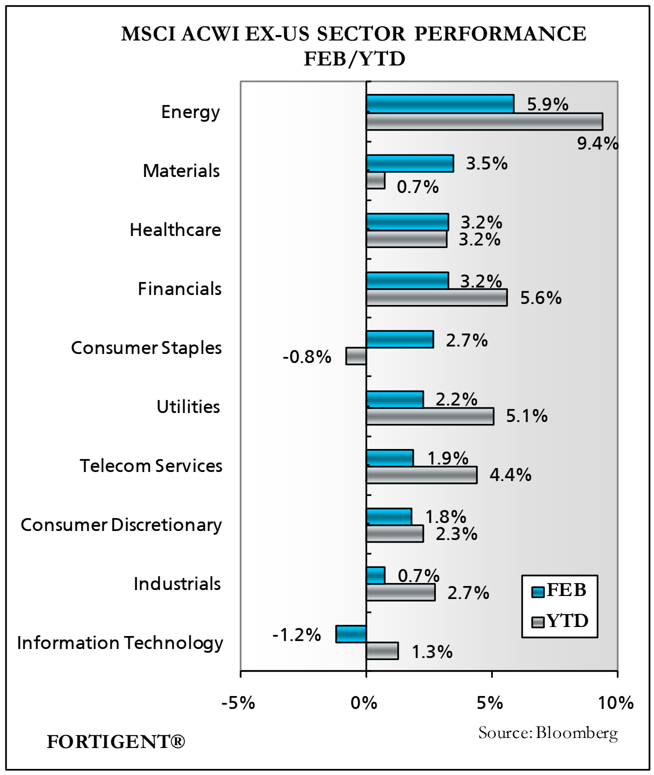



Despite minimal energy exposure within its index, Japan was the top performer among the major global equity regions during the month. Returns were positive across sectors, particularly in more domestically oriented industries like financials and telecommunications. Unlike last year in which the yen experienced significant revaluations against the dollar, currency effects were neutral in February and are marginal YTD.

Most European countries continued their January rebound, rising 3.3% in aggregate for the month. Equity returns were buoyed by the strengthening euro and Swiss franc, as the index rose a more modest 2.2% in local terms. Europe is now up 7.4% for the year in US dollar terms, outpacing all other major global regions. A rebounding financials sector has driven that performance – now up 15% through the first two months of 2011. This follows a near 10% decline (and over 20% decline in EU member countries) in 2010. Despite the positive performance of so far in 2011, bond yields and CDS spreads remain severely elevated for the region's fiscally troubled countries. A looming EU meeting in late March may bring some clarity to these countries' fiscal positions – the event is widely regarded as the deadline for comprehensive reform. Resolution may not necessarily be positive for global markets, however, (at least in the short term) as any burdensome measures could provoke defaults or debt restructurings.




While general de-risking led to most PIIGS countries posting modest or negative returns during the month, Ireland's equity index returned a healthy 6.7%. The country's stock market surged in the final two trading days of the month (rising nearly 4%) following the ouster of incumbent Prime Minister Brian Cowen and his ruling party Fianna Fail. Many Irish citizens have expressed consternation over the tough terms of the IMF/EU bailout package in December, which Prime Minister-elect Enda Kenny has promised to renegotiate with EU leaders.




Asia ex-Japan was the biggest laggard among the global regions in February, falling 1.7%. Underlying country returns were largely negative, with only a handful of commodity-driven countries in positive territory. South Korea and Taiwan were the worst performers, as those countries' high concentration in technology stocks proved to be a severe headwind. Among the larger index countries, resource-rich Australia (+5.8%) rose alongside other major commodity exporters, while China (-1.8%) and India (-1.8%) posted lackluster returns. The latter countries exhibited broad weakness across sectors, and continue to weigh on Asian and emerging market equity indices. Following India's sharp selloff in January, the MSCI country index is now down more than 14% YTD.

Emerging Markets posted a slightly better return than Asia ex-Japan in February, propelled by its energy and materials heavy EMEA segment (+4.8%). EMEA countries South Africa (+6.4%) and Russia (+6.3%) led all emerging markets in February, and Russia is now up more than 10% YTD. Latin American stocks were mixed, with Brazil rising 3% and small countries Chile (-2.7%) and Colombia (-2.4%) falling. Investors remain wary of emerging markets broadly, as negative headlines surrounding EM inflation and political unrest in the Middle East persist. Data compiled by Barclays Capital reveals significant mutual fund outflows thus far this year, with nearly $14bn exiting dedicated and non-dedicated EM funds through March 2nd. ICI data reveals similar trends for dedicated emerging markets ETFs, as assets in those products declined by nearly $8bn in January.

**Sources: MSCI Barra, Bloomberg, The Economist, Reuters, JP Morgan, Barclays Capital, ICI**

## FIXED INCOME: RISK LEADS THE WAY

**Econ:** Despite growing concern about higher commodity prices and geopolitical risks from the Middle East, domestic economic data showed further improvement during the month, indicating that the recovery is churning along at a slow, but steady, pace.

Following a disappointing employment report for January that was negatively impacted by snowstorms across the country, February was bound to show robust job growth. The February nonfarm payrolls report did not disappoint, showing that the economy added 192,000 over the course of the month, while the unemployment ticked down 0.1% to 8.9%. Private payrolls experienced a 222,000 increase to offset the 30,000 jobs lost in the government sector. Those figures were all more or less in line with economists' expectations, but served to confirm that although employment growth is slow, it is ever so gradually on the mend.

Manufacturing remains an extremely strong sector. The Institute for Supply Management (ISM) reported that its Purchasing Managers Index (PMI) posted additional gains in February, rising from 60.8% to 61.4%. Readings above 50% represent expansion in the manufacturing sector. With the New Orders Index well into expansionary territory at 68.0%, further momentum in the manufacturing sector is likely. Commodity prices are a sticking point, however, and manufacturers report no commodities as being down in price, but indicate that 29 distinct commodities are up in price. In total, 68% of manufacturers reported paying higher prices and 2% reported paying lower prices.

To start the year, consumer spending is showing signs of a slowdown. After a robust fourth quarter, consumer spending was up 0.2% in January, but most of that gain was driven by growth in auto and gasoline sales. The slowdown in spending resulted in the savings rate moving slightly higher to 5.8%, in line with levels from 2009 and 2010. In order for the recovery to become sustainable, consumer spending will need to reaccelerate in the months ahead. One month of poor growth is not cause for concern, especially considering the levels of growth in the fourth quarter of 2010, but continued weak consumer spending would raise the likelihood of a slowdown in overall economic growth.

**Federal Reserve:** Activity from the Federal Reserve was minimal as the FOMC did not meet during the month (the next meeting is scheduled for March 15th). Several officials from the Fed did provide commentary and insight into the current thinking at the Fed, including Fed Chairman Ben Bernanke. Bernanke testified before the House Budget Committee, describing the economic recovery as "self-sustaining" while also admitting that "until we see a sustained period of stronger job creation, we cannot consider the recovery to be truly established."

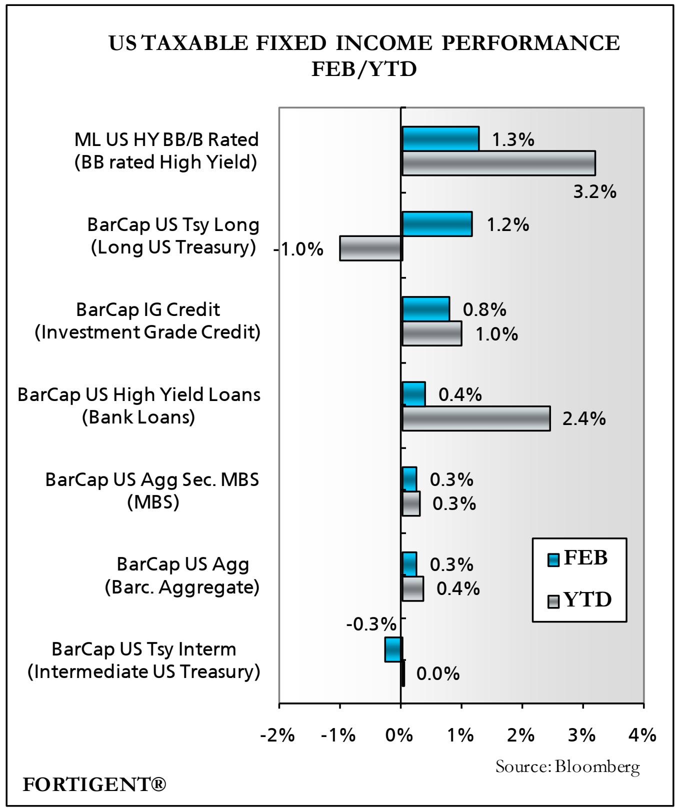
**US Treasury Yields**

| Security | 12/31/2010 | 1/31/2011 | 2/28/2011 | YTD Change |
|---|---|---|---|---|
| 90 Day | 0.12 | 0.14 | 0.13 | 0.01 |
| 2 Year | 0.59 | 0.56 | 0.68 | 0.09 |
| 5 Year | 2.01 | 1.94 | 2.14 | 0.13 |
| 10 Year | 3.29 | 3.37 | 3.43 | 0.13 |
| 30 Year | 4.33 | 4.57 | 4.50 | 0.17 |

SOURCE: BLOOMBERG

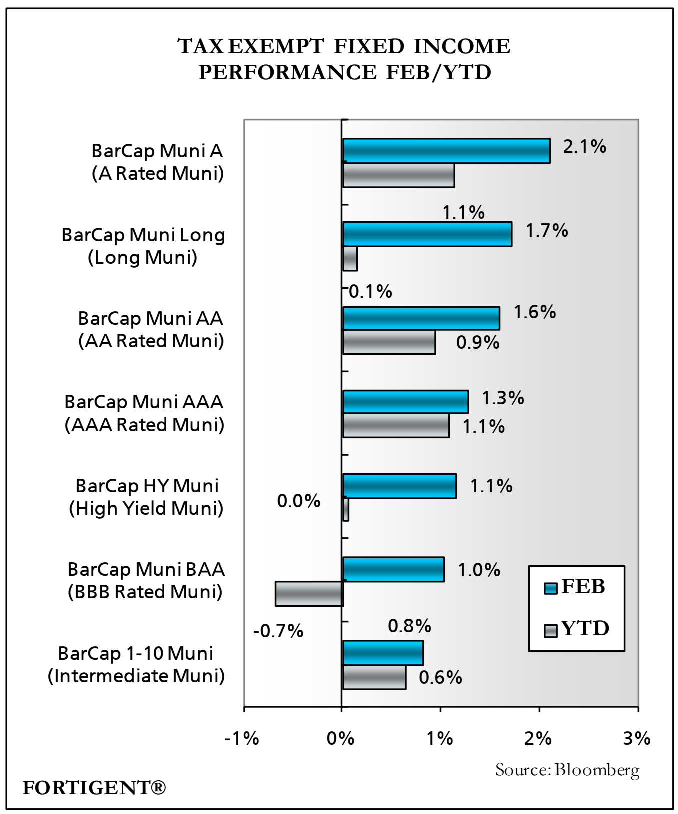
The Federal Reserve Beige Book, a snapshot of economic activity throughout the various Federal Reserve Districts, echoed a similar sentiment near month end. The Fed noted that "economic activity continued to expand at a modest to moderate pace in January and early February." Labor markets were described as improving, but concern was quite apparent about inflationary pressure building in certain markets. In particular, the Fed cited "strong agricultural commodity prices" and manufacturers increased ability to pass through higher costs as a growing point of concern. Wage growth is still benign, however.

**US Taxable Markets:** The broad based increase in interest rates continued at the start of February with US Treasury rates peaking early in the month. Turmoil in North Africa and the Middle East led to a retrenchment in the later part of the month. 10-year US Treasury yields started and ended the month near 3.4%, but reached 3.7% mid month as volatility rose. Behind the scenes, the Fed continued its quantitative easing campaign purchasing approximately $100 billion of nominal Treasuries and TIPs, while the US Treasury continued to issue new bonds. A total of $480 billion in new bonds are expected to be issued in the first quarter of 2010. The curve itself remains very steep with significant incremental yield offered for investors who venture further along the term structure.




Performance for US Treasuries was mixed. As measured by Barclays, long term assets gained 1.2% as long term yields fell for the month. Intermediate yields continued to increase, and for the month this area of the curve generated a loss of 30 basis points.

In review of TIPs performance, the Barclay's index posted a positive 90 basis points as long term TIPs rallied in sympathy with long term Nominal Treasuries. Breakeven rates for long term TIPs held steady at 2.4% and 2.5% for 10- and 30- year TIPs.




Corporate credit markets continue to perform well as investor demand for yield drove valuations higher. Case in point, flows into High Yield funds topped $7.2 billion in the first two months of the year. Spreads compressed further in February with Investment Grade bonds falling 10 basis points to 140 bps over comparable Treasuries. High Yield bonds fell 25 basis points to 460 bps. Corporate treasurers remained well attuned to the market and new issuance was hefty. This was particularly true in the High Yield market as $21 billion of new High Yield bonds were placed in February, the largest volume on record for the month.

In terms of performance, investment grade corporate bonds gained a solid 80 basis points while high yield corporate bonds posted a hefty 1.3%, as measured by Barclays. Convertible bonds were the clear winners, up 2.6% for the month as investors enjoyed the benefit of solid equity performance – true to form, converts captured 70% of the upside return of the mid cap index.

In review of Leveraged Loans it was a highly active market. The supply demand dynamic was extremely interesting. On the demand side of the equation, retail flows into Leveraged Loan funds topped $8.9 billion for 2011, matching half of 2010's total flow. In addition, JPMorgan speculates institutional investors added another $1 billion of investment in each month. Add this flow to the fact that repayments of loans since the start of 2010 averaged about $12 billion per month, and the demand side of the equation looks strong. This demand led to higher valuations for Leveraged Loans – case in point the S&P Leveraged Loan 100 index loan improved in the month from $93 to $96.

In review of supply, corporate treasurers, investment bankers and CLO creators have not missed the flows into the sector. New loan issuance spiked to $46 billion and 69 new loans were placed in the market. This was the highest new issue volume since June 2007. Because of the hefty flow into the market, new loans are getting placed with rather favorable terms to borrowers. This activity is allowing companies to reduce short term liabilities, further reducing the debt wall we, and many others, have commented on over the last two years. In terms of performance, Leveraged Loans were up 40 basis points in the month as measured by Barclays, extending its run of positive months to 8.

***Municipal Market:*** The late January positive turn in the municipal bond market carried through to February. Intermediate Munis as measured by the Barclay's 1-10 year index posted a positive 1% for the month. Looking at bit deeper into the curve, any investor positioned further along the curve did better - yields fell approximately 10 basis point for 5-year Munis and 13 basis point for 10- and 30-year bonds. Likewise long term Munis generated a 1.7% return in the month. High Yield Munis rebounded generating a positive 1.15% in the month.

**AAA Municipal Yields**

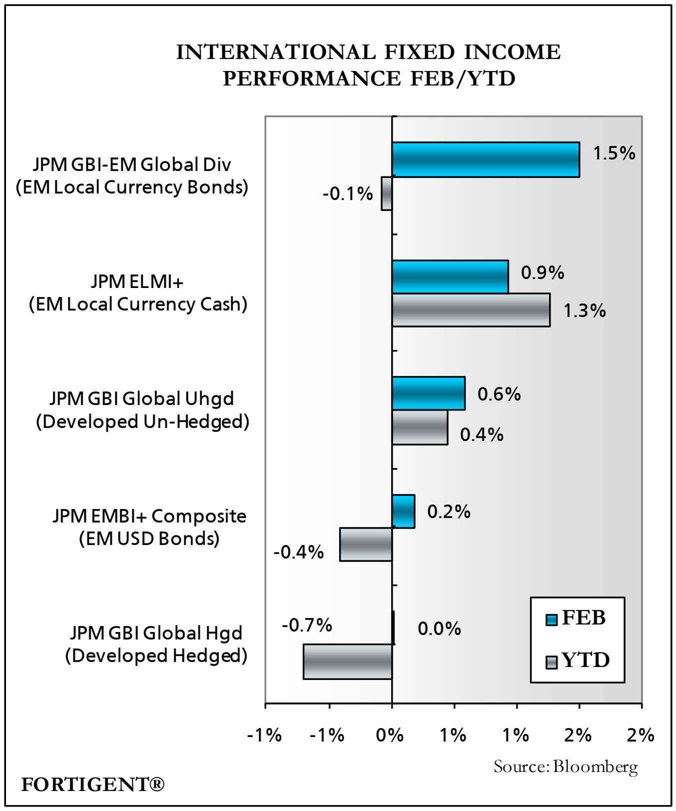
| Security | 12/31/2010 | 1/31/2011 | 2/28/2011 | YTD Change |
|---|---|---|---|---|
| **2 Year** | **0.75** | **0.90** | **0.81** | **0.06** |
| **5 Year** | **1.68** | **1.91** | **1.83** | **0.15** |
| **10 Year** | **3.16** | **3.41** | **3.28** | **0.12** |
| **30 Year** | **4.89** | **5.10** | **4.97** | **0.08** |

SOURCE: BLOOMBERG

The price stability and positive return mostly reflects supply demand dynamics. Primary issuance was extremely constrained as investment bankers and issuers elected to wait out recent market volatility. February issuance totaled $16.1 billion according to Municipal Market Advisors. For the last three months issuance totaled $50 billion, the lowest 3 month total since February 2001. While not reflected in terms of fund flows, which experienced $4.6 billion in outflows in the first three weeks according to ICI, demand appeared healthy as anecdotal evidence suggests institutional investors stepped into the market.

Budgetary problems remain, and will probably remain the big headlines for 2011. With labor 'protests' in the upper mid west prompting national concern, it's clear many states have the resolve to confront the issues around public pensions. While certainly not a pleasant situation, investors should take comfort in municipalities' willingness to confront their costs. The end result should be an improved financial situation and enhanced financial flexibility – both positives for bond investors.

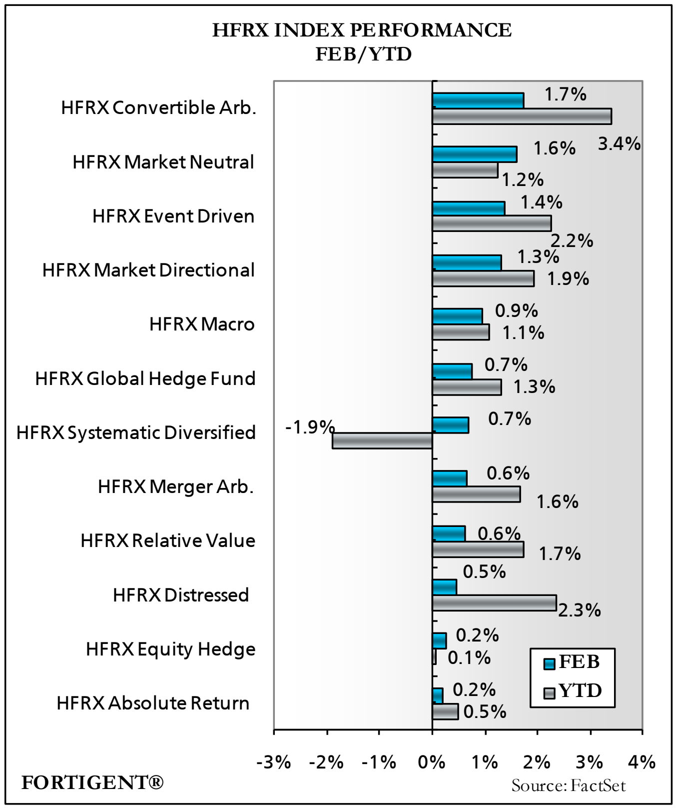
***International Markets***: For the first two months of the year, concern regarding inflation in emerging market economies has dominated the headlines. In February, central bankers in most regions of the world recognized the pressure and hiked their base rates by 25 basis points or more. In Asia, China and Indonesia chose to hike rates, piggybacking on January rate hikes by India and Thailand. In the Americas, Chile and Peru raised rates, following Brazil's mid January hike. Despite the short term rate hikes, yields for longer term emerging market bonds were mostly unchanged. Yields for the JPM GBI-EM Global Diversified index remained steady at 7%. Drilling a bit deeper into regions, yields rose slightly in Latin America, up 14 bps for the sub index, but fell 11 basis points in Asia. The net result was a slightly positive performance – up 40 basis points in local currency terms. When accounting for US dollar depreciation relative to EM currencies, the index was up 1.5%.




**Sources: Barclay's Capital, Bloomberg LP, JPMorgan, Municipal Market Advisors**

## ALTERNATIVES: HEDGE FUNDS IN THE BLACK ACROSS THE BOARD

All hedge fund strategies were in positive territory for the month of February, a month that was marked by broad gains in risk assets with the occasional hiccup due to macroeconomic concerns from the Middle East.




Convertible arbitrage continues to be a top performing strategy as the HFRX Convertible Arbitrage Index rose 1.7% in Febraury, for a gain of 3.4% on the year. Not surprisingly, convertible arb managers are lagging the long-only convertible indices which are up nearly 4.9% for the year, only slightly behind the gains for the S&P 500 Index. Spreads on convertible bonds tightened during the month, with non-investment grade convertibles tightening 45 basis points to a spread of 439 basis points.

Within the fixed income space, distressed investments are leading the charge, up 2.3% for the year, following a 0.5% increase in February. Many of the more popular trades, such as Ford, American International Group (AIG), CIT and Ally Financial, are faring especially well. On balance, the value of those positions was up between 0.2% and 1.3%. Of the top 50 issuers in the Barclays High Yield Index, only 4 lost money in February and 0 are in negative territory for the year. As liquidity and economic conditions improve, recovery rates are dually benefitting. After reaching a trough near 20 cents for every dollar, holders of defaulted debt in subordinated bonds are now receiving 40 cents per every dollar invested. Interestingly, recovery values in senior secured and senior unsecured bonds are falling in the past several months, while recovery values for subordinated bonds trend higher.

Managed futures/CTA managers recovered ground in February, rising by 0.7%. It has been a difficult environment for systematic managers since the beginning of the year due to sharp price reversals of numerous instruments with which they trade. As an example, gold lost more than 6% to start the year, before concerns about the Middle East led to a rally towards the end of January and throughout February. Energy, which was a bearish position for many funds throughout last year, gradually became a long holding for managers based on improving price momentum and fundamentals. The price for a barrel of Brent Crude jumped 11.5% in February after gains of 6.3% in January. In addition to an improving fundamental story, crude oil prices soared on news that Egypt and Libya were undergoing political stress. Libya produces less than 2% of the world crude supply, but produces a form of crude that is easier to refine than other sources.

Based on the HFRX data, hedged equity managers are struggling after the first two months of 2011. The HFRX Equity Hedge Index is up 0.1% through February, significantly behind the near 6.0% gain for the S&P 500 Index. Data from the HFRX Equity Hedge Index is not entirely consistent with return data from the HFRI Equtiy Hedge Index, however, which posted a much more sizeable gain in January (performance for Febraury is not yet availabile).

**Sources: HFRX, Bloomberg, FactSet, Barclay's**

## Disclosure Information

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