

The first quarter of 2011 was, in one word, tumultuous. The major earthquake that struck Japan, political unrest in the Middle East, the European debt crisis and signs of weakness in the housing market contributed to volatility in the financial markets. This was reflected in Gallup's February Economic Confidence Index which noted a drop in optimism about the U.S. economy. In the midst of doom and gloom, financial markets seemed to have survived the constant pounding, and according to the March 15 press release from the Federal Reserve Open Market Committee (FOMC), "the economic recovery is on a firmer footing, and overall conditions in the labor market appear to be improving gradually".

Onward and Upward

Despite obvious turmoil, the markets recovered quickly and many U.S. benchmark indices posted gains at quarter close. The Dow Jones Industrial Average (DJIA) rose 6.4%, its best first quarter in percentage terms in 12 years. The following table summarizes the average annual returns for various indices:

Index	1st Qtr	1 Year	5 Year	10 Year
S&P 500 (Composite Total Return)	5.92%	15.65%	2.63%	3.29%
Russell 2000	7.94%	25.79%	3.35%	7.87%
MSCI EAFE (Net)	3.37%	10.42%	1.30%	5.39%
Barclays Aggregate Bond	0.27%	5.24%	6.05%	5.42%

The S&P 500 is a commonly used measure of common stock total return performance, the Russell 2000 is a commonly used measure of small capitalization stocks, the MSCI EAFE is a commonly used measure of common stock total return performance of international markets, and the Barclay's Aggregate Bond Index is a commonly used measure of the bond market.

All referenced indices are unmanaged and not available for direct investment.

Past performance is not a guarantee of future results.

NYSE Circuit-Breaker Levels

Trading curbs, known as "circuit-breakers", are designed to halt trading temporarily or, under extreme circumstances, close the markets before the normal close of the trading session. Circuit-breakers were instituted by the New York Stock Exchange (NYSE) in response to the stock market crash of 1987, known in the financial industry as Black Monday. The NYSE states that "by implementing a pause in trading, investors are given time to assimilate incoming information and the ability to make informed choices during periods of high market volatility". Circuit-breaker levels are set quarterly at 10, 20 and 30 percent of the DJIA average closing values for the previous month, rounded to the nearest 50 points. In March, the NYSE announced its second quarter 2011 circuit-breaker levels which, if reached, would halt trading for specific lengths depending on the time of day. The level 1 halt is set at a 1,200-point drop, level 2 is at a 2,400-point drop and level 3 is at a 3,600-point drop. In the event a level 3 halt is reached, the market would close for the remainder of the day.

Relying on Japan

Businesses worldwide were reminded of how much they rely on Japan in the wake of the destructive combination of earthquake, tsunami and nuclear accident. With the horror still unfolding, it seems insensitive to talk about the impact of the disaster on the global economy; however, the aftershocks are being felt across the world, and will continue for many months to come. Japan makes up 8.7% of the world's gross output, and is mainly known for being one of the largest suppliers of electronic components. According to the Wall Street Journal, the small island nation manufactures 60% of the world's silicon wafers, 20% of computer chips, and 90% of BT resin for circuit boards. Needless to say, electronics companies will face disruptions in their supply chain. Japan also manufactures many components utilized by auto makers, leaving many scrambling to find alternative parts or suppliers. Shortages and setbacks in the supply chain will likely impact the auto industry's bottom line. Furthermore, many of Japan's automobile manufacturing plants were damaged in the disaster, which could have a significant impact on their position in the global auto industry. Honda, Toyota, Mazda and Nissan plants all announced temporary suspensions in production immediately after the earthquake struck, but have slowly resumed production nearing the end of March. A recent World Bank report estimates damages could reach \$235 billion and that rebuilding efforts could take five years.

GDP Highlights

Real GDP grew at an annual rate of 3.1% in the fourth quarter of 2010, and 2.9% in 2010 overall. According to the U.S. Bureau of Economic Analysis (BEA), this upturn is due to increased exports, nonresidential fixed investment (e.g.: equipment and software), consumer spending and inventory investment. The chart below shows quarter-to-quarter growth in real GDP for the past 4 years, based on data from the BEA (second and third estimates provided for Q4, 2010):



Personal consumption expenditures rose 4.1% in the fourth quarter, its largest increase since the first quarter of 2006. However, after years of discounted prices, a noticeable increase in prices of goods and services in the U.S. is causing concern. Energy and food prices picked up significantly in the fourth quarter of 2010, with overall prices rising 2.1%. Rising prices in raw materials, manufacturing, freight and labor largely contributed to this situation. With further price increases looming, economists are questioning whether consumer spending will be derailed or if it can keep a solid pace.

Labor Market Momentum

The national unemployment rate experienced a gradual decrease in the first quarter of 2011, closing the month of March at 8.8%, its lowest mark in two and a half years. January and February employment numbers were disappointing, but March capped off the quarter with a better-than-expected jobs report. According to the Bureau of Labor Statistics, nonfarm payroll employment rose by 216,000 and private sector employment rose by 230,000 in March, with job growth occurring in professional and business services, health care, leisure and hospitality, and mining. The four-week moving average for unemployment insurance benefits claims through the end of March was below 400,000 per week. Financial analysts keep track of this metric because it provides insight into the direction of the economy. Lower initial claims typically correlate with a strengthening

economy and larger job gains could have a beneficial impact on consumer spending.

Quantitative Easing

In a speech delivered at the Institute for Monetary and Economic Studies International Conference in May 2010, Federal Reserve chairman Ben Bernanke describes quantitative easing as “[a method] in which the central bank provides additional support for the economy and the financial system by expanding the monetary base, for example, through the purchase of long-term securities”. Quantitative easing is non-standard monetary policy and has the potential to cause some unwanted effects if not well managed. In early November 2010, just as the Federal Reserve was about to announce its plan to continue expanding its holdings of longer-term Treasury securities, former Federal Reserve Chairman Paul Volcker raised concern about the potential inflation risks of quantitative easing. Volcker was quoted as saying “it does worry people that we’re going to create so much money that down the road we’ll create inflation.” With the quantitative easing set to expire at the end of Q2, 2011, Americans will look with interest to what the Federal Reserve has in store in terms of monetary policy.

Conclusion

Of late, “slow and steady” seems to be the *modus operandi* in the U.S.’ undertaking toward economic recovery. Although the pace is slower than most analysts would like, there are several indications that the economy is on firmer footing. Increased exports and business spending, stronger-than-expected job growth in March, and the resilience of the stock markets amidst a bumpy first quarter are all positive signs. In the next few months, investors should keep a watchful eye on changes in monetary policy, which could heavily impact the economic outlook for the remainder of 2011.

JAMIESON FINANCIAL SERVICES

1 Northfield Plaza, Suite 430
Northfield, IL 60093
Main: 847.441.4200
Toll Free: 855.441.4200

www.JamiesonFS.com

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