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The first quarter was, in many ways, a continuation of the trends that began in October 2011. The U.S. economy continued to firm, improving gradually from last summer's slowdown. Both manufacturing and service surveys showed solid growth in the first quarter, with particular strength in new orders. Even home sale data ticked up, although prices remained a source of concern. In addition, employment figures released each month exceeded investor expectations, as private firms added more jobs than economists forecast.

At the same time, fears over potential debt defaults in Europe continued to recede. European Central Bank actions initiated in 2011 provided support to sovereign bond prices, allowing troubled Southern European countries to refinance their debt. Confidence was reinforced by pledges from Germany and France to provide assistance to struggling Eurozone members, starting with Greece. In early March, Greek bondholders agreed to terms for a debt swap, accepting longer dated, lower yielding bonds in exchange for their holdings. Although technically deemed a default, the orderly process was well-received by financial markets.

Stocks rose steadily through the first quarter. The large cap S&P 500 gained 12.5% in its strongest first quarter since 1998. U.S. small and mid cap stocks also posted solid gains. After falling more than 20% in mid-2011, most emerging and developed markets also posted solid gains. The German stock market led all developed countries with a 19% gain in the first quarter, as confidence in the global recovery grew, and fears about the viability of the Eurozone were set aside.

Economically sensitive sectors posted strong gains, led by materials and technology. In contrast, defensive stocks, including 2011's strongest performer, the utilities group, lagged broader markets by a substantial margin.

The steady rise in stocks surprised traders, as both actual and expected volatility fell throughout most of the quarter. The Volatility Index, or VIX, which measures the price investors are willing to pay for options to provide insurance for their holdings, dropped steadily. Market timers hoping for a significant pullback were disappointed, as were stock market bears, who were forced to cover short positions, adding fuel to the rallly.

U.S. Treasury bonds generally lost ground in the first quarter, as confidence in the economy led investors to demand higher yields from fixed income. The rise in bond yields was tempered by the Federal Reserve's repeated pledges to keep rates low into 2014. Corporate bonds faired better, posting gains in the quarter, as yields on both investment grade and high yield debt fell, and spreads against comparable Treasuries narrowed.

In the absence of external shocks, such as last year's earthquake in Japan, recent improvement in economic indicators is likely to continue. The U.S. manufacturing sector should continue to expand, and will likely benefit from heightened export activity as European economies steady and begin to grow again. Steady gains in employment should boost consumer confidence, helping retail sales. Stocks should continue to rise in this environment, albeit at a slower rate than in the first quarter.

Corporate bonds should continue to provide steady returns, with yields well above Treasuries of comparable maturity. However, shorter to intermediate bonds may outperform longer maturities, which may be squeezed by further increases in interest rates. International fixed income may provide significant opportunities in 2012, as confidence in European economies grows.

There are definitely potential storm clouds which will give investors pause, and bear watching. The long term viability of the Euro has been called into question, and that issue has not yet been settled. Gasoline prices in the U.S. continue to rise, and could crimp consumer spending. And while there have been some small signs of improvement, the U.S. housing picture is still a significant concern.

These worries may keep investors from fully committing to equity markets, but when everyone is completely comfortable with stocks, it may be time to sell.

As always, I encourage you to contact me with any questions or concerns.

Sincerely,

Kenneth M. Bernard, CFA