



MARKET UPDATE

QE II Sails Away

Strong stock market gains in April were quickly forgotten in May as markets spent the majority of the month in a gradual decline. The S&P 500 fell 1.35% for the month of May, an abrupt shift from the previous climb over the past seven months. Commodities led the way down with oil falling below \$100 per barrel, gold below \$1,500 an ounce, and silver plunging 25%. Negative market action can be blamed on a variety of economic and global events.

Over the past 6 months, markets have been buoyed by a government program we have talked about several times in our newsletters, Quantitative Easing. While the intent of this program was to stimulate the economy, many economists have criticized it out of concern that it could be saddling government balance sheets with poor quality debt. The program is slated to stop at the end of June; now that it is near its end, many question whether the economy will be worse off without this monetary boost.

Amongst other concerns dragging the market down have been lowered GDP growth, continued weakness in housing, and the fact that the U.S. has hit its debt ceiling. Think of the debt ceiling like a line of credit from the bank. When one needs more money, one has to go to the bank, cross their fingers, and hope the bank thinks they are "credit worthy" enough for an increase. In the government's case, Congress gets to decide for itself whether or not to increase the limit. We've had 5 increases since the beginning of 2008, so we're not very good at saying no to ourselves. This time, a contentious debate has arisen between political parties, neither side wanting to budge. It has become a game of chicken, with the AAA rating of the U.S. debt potentially on the line. As Federal Bank Chairman Ben Bernanke stated, a compromise is needed to avoid severe market disruptions and damage to the role of the dollar; failure to get our fiscal house in order will hamper our long term economic vitality.



QE II sails away. Bon-Voyage!

Investment Outlook Summary

Asset Class	Outlook	Commentary
Cash / Stable Value	<ul style="list-style-type: none"> – In general, higher than normal levels of cash 	Even though money market rates are basically zero, having investments with high safety and liquidity provides access when opportunities arise, and stability when markets turn volatile.
Bonds / Fixed Income	<ul style="list-style-type: none"> – In general, slight underweight level of bond exposure – Cautious of Treasuries for the long-run – Positive on Treasury Inflation-Protected Securities (TIPS) – Slightly positive on floating rate bonds – Positive on emerging market bonds 	<p>Many bond mutual funds have enjoyed great gains, along with record inflows from investors during this latest "flight to safety." It may be time to look for fixed income investments outside of the traditional mutual fund.</p> <p>Primarily used for safety, but with yields at historic lows and the risks of future inflation present, treasury owners may not be paid adequately for the potential risk.</p> <p>Essentially, these are treasury notes with an interest rate tied to inflation. Used for safety, but the future interest paid will increase with inflation. <i>TIPs have performed well lately.</i></p> <p>A rising interest rate environment is positive for floating rate investments. <i>Floating rate investments have risen in value due to the expectation of higher rates.</i></p> <p>As this asset class develops and matures, there will be great potential for investors over the coming years. <i>Emerging Market Bonds held up well this past month despite a rising dollar.</i></p>
Stocks / Equities	<ul style="list-style-type: none"> – <i>In general, shifting to underweight level of stock exposure</i> – Neutral on preferred stocks – Positive on dividend paying stocks – Utilizing covered call strategies to hedge – Selective of international stocks – Positive on <i>Korea, Brazil, Canada and Australia. Cautious of China</i> – Avoid much of Europe, the U.K., and Japan 	<p><i>Right now, a level of caution should be heeded for the stock market.</i> Pullbacks should be seen as an opportunity to increase stock exposure to neutral levels, that is neither underweight nor overweight.</p> <p>Preferred share class stocks have performed well and seem to be more than fairly valued.</p> <p>Many of the traditional dividend paying companies are more attractively valued than the general stock market.</p> <p>Covered call options strategies can provide extra income to your portfolio while you own stocks.</p> <p>International diversification is still very important to your portfolio, however individual country selection will likely play an increasing role in international stock performance.</p> <p>While the long term opportunities remain with emerging market economies, resource rich countries like Canada and Australia provide the building blocks the world needs in order to grow.</p> <p>Current solutions appear to be a band-aid to a much larger problem inherent in a shared currency. <i>The Greece issues have escalated.</i></p>
Alternate Assets	<ul style="list-style-type: none"> – Positive on Gold and Silver – Negative on the Euro currency – Positive on energy trusts 	<p>Primarily used as an inflation and currency hedge. The risks of global currency dilution are present. <i>Gold continues its climb to new highs. Silver plunged 25% in May, yet is still up 16% for 2011.</i></p> <p><i>Fiscal problems in Europe are back in center stage.</i></p> <p>Many energy trusts provide a good dividend source with the potential for capital gains.</p>

Italics denote a change from last month

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Inflation or Deflation: Watching for Warning Signs

There's been much debate in investing circles over the last year about whether inflation or deflation represents a more likely threat to the future of the U.S. economy. With a recovery that's still tentative compared to previous recessions, measures designed to stimulate the economy or cut spending to rein in the budget deficit provoke warnings about their potential to create one or the other.

The case for inflation

As the economy has begun to recover, worries about the potential for future inflation have become widespread. The Fed has undertaken extraordinary measures to make sure there is plenty of money in circulation, but some experts worry that the

increased money supply will eventually cut the dollar's purchasing power, especially if interest rates are kept at historically low levels for too long. They cite the easy availability of money as contributing to the late-1990s tech bubble and the mid-2000s housing bubble, and fear that another could be on the way.



The Federal Reserve Board's monetary policy committee maintains that inflation currently is too weak to support normal economic growth, let alone launch an inflationary spiral. However, those who see inflation in our future watch for warning signs such as increased Treasury yields, particularly on longer-term bonds. Higher yields when bonds are auctioned suggest that investors are increasingly wary of tying up their money for long periods at a fixed interest rate if they feel that inflation is going to erode the buying power of those fixed payments over time. Wholesale prices also are watched closely; higher prices at the wholesale level can be a precursor of higher prices at retail (that is, if retailers are able to pass those costs along to buyers, which is not always the case).

The case for deflation

At first blush, the falling prices that characterize deflation don't sound like such a bad thing. Who wouldn't like to be able to buy things for less than they cost now, especially when times are tough? The problem is that those falling prices can harm the economy in several ways, as Americans were reminded during the recent recession. When prices are dropping, people tend to postpone purchases, hoping to pay less in the future (consider what's happened with real estate since 2007). Delayed spending puts pressure on corporate profit margins and companies tend to cut spending themselves, creating financial difficulties for companies that rely on business spending. Cutbacks begin to ripple through the economy.

Deflation typically affects not only prices but wages; scarce jobs can lead to pay cuts even for those who stay employed. And lower incomes can start a new round of cost-cutting by both consumers and business. If this process sounds familiar, it's because for much of 2009, the U.S. experienced negative annual inflation rates for the first time since 1955.

Though consumers have loosened their purse strings in recent months, deflationistas argue that if another financial crisis were to reduce credit availability, or if high ongoing unemployment once again begins to weigh on consumers' willingness and ability to spend, the threat of deflation could return. Those concerned about the possibility of a new round of deflation at some point keep an eye on consumer spending, the state of the credit and housing markets, and the stability of banks and other financial institutions.

Seeing shades of gray

Inflation and deflation aren't necessarily an either-or proposition. It's possible to have inflation in some areas and deflation in others; anyone who has watched food prices or health-care costs increase while their paycheck stayed the same and the value of their house declined can vouch for that.

From an investing standpoint, inflation isn't black-and-white, either. Some industries and asset classes benefit from inflationary forces, while companies that are highly dependent on both commodity prices and cheap labor can be more challenged by rising prices.

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SDW's TAKE

Economists and market strategists alike are split on their opinions regarding the potential outcome—a dangerous excessive inflationary environment or a potentially more dangerous deflationary environment. Noted economist Gary Shilling states that it is quite possible that we will experience a whipsaw effect—that is an excessive high inflationary period directly preceding a prolonged deflationary period.

As the article above states, investments that perform well in an inflationary environment can be quite different from those that perform well in a deflationary one. While we are also uncertain as to whether excessive inflation or deflation will take hold, we know the investment decisions that need to be made. It is more important to prepare for either scenario ahead of time and be flexible, rather than stubbornly staking ground on either side. The effects of being wrong can be highly detrimental.

Clients of SDW have the benefit of knowing that their portfolios are being managed with both potential outcomes in mind. Either inflation and deflation can arise with very little warning—or better put, the warnings won't be so obvious until after the fact.

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