



First Quarter 2011

Market Insight

Table of Contents

2	Introduction	5	Commodities
3-4	The Stock Markets	6	Fixed Income-Taxable
5	The Economy	6	Fixed Income-Tax-Free



News & Views

from LPL Financial Research

Market Insight is a quarterly publication intended to inform and empower your investment decision making.

The first quarter of 2011 continued on the path of solid gains, but it was certainly not a smooth ride. Stocks and bonds had to steer clear of geopolitical risk, natural disasters, budget concerns, and European debt problems, among other roadblocks, to generate positive returns for investors.

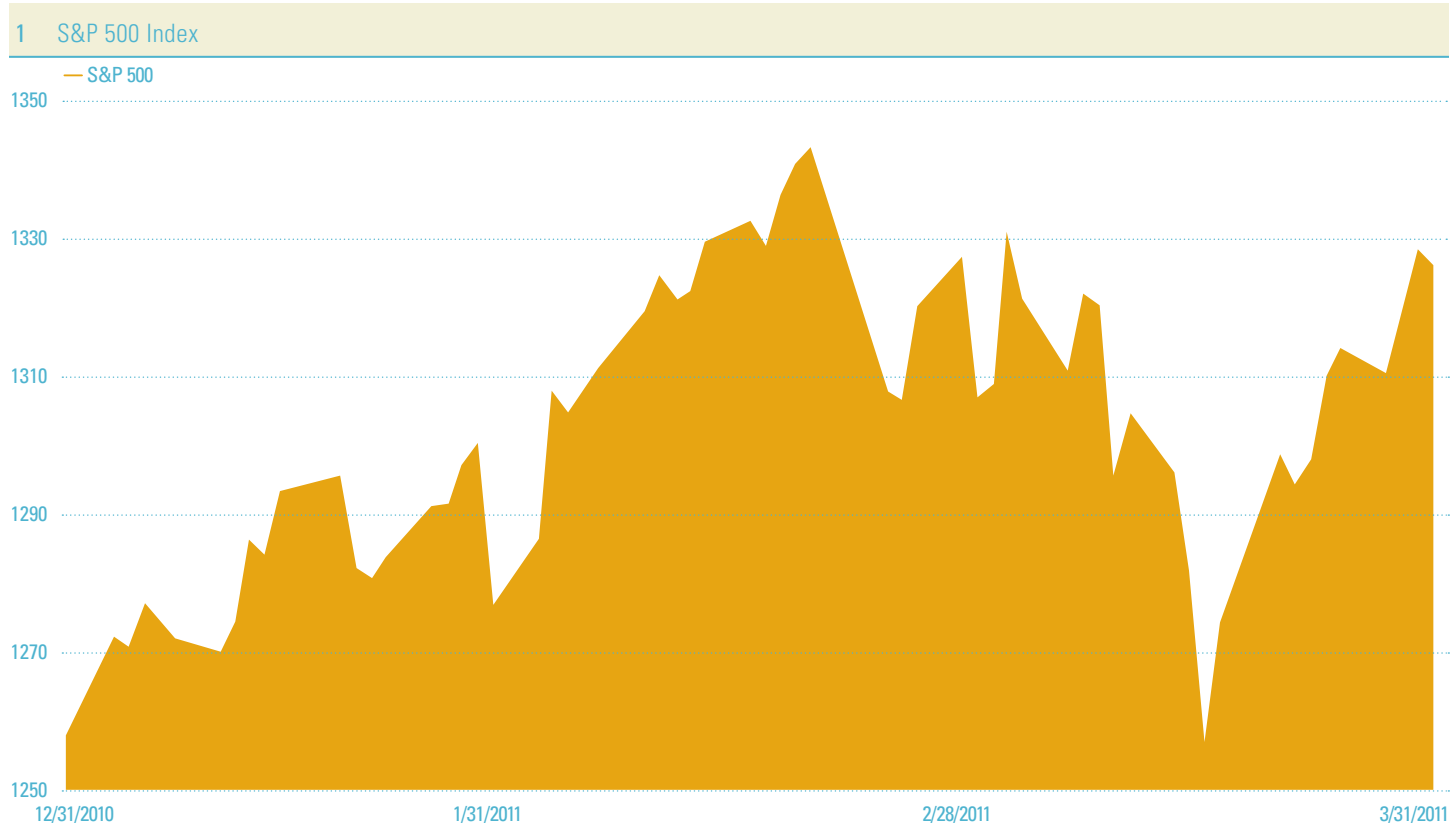
While stocks enjoyed their best first quarter in nearly 15 years, the strong performance may leave less fuel for gains between now and the end of the year. Bonds hit some speed bumps in the first quarter, but a middle-of-the road return in the low-to-mid single digits by year-end still seems likely. We expect volatility to remain a constant, however, that will continue to provide market opportunities to embrace and potholes to be avoided.

The Stock Markets

Following a strong end to 2010, the U.S. stock market, as measured by the S&P 500 Index, continued its march higher to begin 2011 with a gain of 5.9% in the first quarter. The Index's first quarter gain was its best first quarter since 1998 and the third best first quarter of the past 20 years. It was a relatively smooth ride, higher in the first six weeks of the year through mid-February when the Index peaked at 1344, a gain of nearly 7%. From there, stocks pulled back into early March and moved sharply lower following the devastating earthquake, tsunami, and radioactive fallout in Japan. The month-long contraction erased all of the quarter's gains as the Index closed at 1257 on March 16, exactly where it began the year. Stocks rebounded, however, and moved higher in eight of the quarter's final 11 trading sessions to finish at 1326 [chart 1]. Notably, the first quarter marked the two-year anniversary of the bull market that began in March 2009. From the S&P 500 Index closing low of 677 on March 9, 2009, the market is up approximately 100% on a total return basis.

The Index's first quarter gain was its best first quarter since 1998 and the third best first quarter of the past 20 years.

The stock market rally occurred despite a number of hurdles, including but certainly not limited to crippling snowstorms that covered most of the country in January, a potential U.S. government shutdown, ongoing state and municipal budget battles, renewed European debt concerns, rising energy prices, violence and political uncertainty in the Middle East, and the aforementioned devastation in Japan. Yet, another better-than-expected earnings season and generally robust economic data helped push the stock market higher. More than 72% of S&P 500 companies reported better-than-expected fourth quarter 2010 earnings, and more than 62% of companies exceeded revenue forecasts.



Source: LPL Financial, Bloomberg

The S&P 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

The Stock Markets (continued)

2 Q1 S&P 500 Sector Performance

Sector	% Return
Energy	16.8
Industrials	8.8
HealthCare	5.6
Telecommunications	4.9
Consumer Discretionary	4.7
Materials	4.5
Information Technology	3.5
Financials	3.0
Utilities	2.7
Consumer Staples	2.5

Source: LPL Financial, FactSet 3/31/11

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Focusing specifically on U.S. equity markets, there was not much distinction in returns based on market capitalization or style, as the Russell Indexes gained between 6.2% and 9.2%. However, it was a different story from a sector perspective, as economically sensitive cyclical sectors generally outperformed defensive sectors of the market. Given the strong performance of commodities, it was not surprising to see the Energy and Industrials sectors lead the way higher with returns of 16.8% and 8.8%, respectively [table 2]. The Materials and Technology sectors were somewhat surprising laggards among the cyclicals as both underperformed the broad S&P 500 Index during the quarter. The Materials sector was hampered by weak performance from the Metals and Mining industry, as concerns over slowing growth in China and lofty valuations were two key factors in the underperformance. It was the Communications Equipment industry that weighed on the Technology sector, due in large part to poor revenue guidance from an industry bellwether. The worst performing sectors in the market were two of the defensive sectors—Consumer Staples and Utilities—as neither gained more than 2.7% in the quarter, though both finished with positive returns.

Returns were not as strong among international equity markets as compared to domestic markets. Both developed foreign and emerging market stocks underperformed U.S. stocks in dollar terms. The MSCI EAFE Index, a proxy for developed foreign markets, trailed with a return of 3.5%. Japan weighed heavily on the EAFE Index with a decline of 5.1% in the quarter, though the Nikkei Index rebounded nicely off its mid-March low and rallied more than 13% in the final two weeks of trading. The MSCI Emerging Markets Free Index gained 2.1% in the first three months of the year. Concerns over rising inflation and central bank interest rate hikes hampered performance. China has been raising interest rates since October 2010 in an attempt to engineer a soft landing for its economy and contain inflation as food prices have skyrocketed. As markets became comfortable with the timing and extent of the rate hikes in China, Chinese equities rallied later in the quarter and posted returns of 1.7%, but India and Brazil, two countries also struggling to contain inflation, lost 5.3% and 1.0%, respectively, in dollar terms.

The Economy

From an economic perspective, growth continued at a moderate pace with a booming manufacturing sector offsetting weakness elsewhere. Consumer and business spending remained solid in the first quarter.

The U.S. government employment reports showed a total of 478,000 non-farm jobs were added to the economy in the first quarter, and the four-week average for weekly jobless claims fell to nearly a three-year low. The U.S. economy lost 8.75 million jobs during the downturn and has only gained 1.5 million jobs since then. But March's nonfarm payrolls gain of 216,000 jobs was the biggest number yet for this recovery when adjusted for the census hiring that bloated the numbers in the first half of 2010. The unemployment rate fell another 0.1% to 8.8% in March, and is now below the Fed's forecast (8.9%) for the end of the year. With gross domestic product, consumer spending, and the stock market at or near all-time highs, job growth has lagged thus far in the recovery. The recent job reports might finally reflect an emerging trend toward a more rapid pace of job growth.

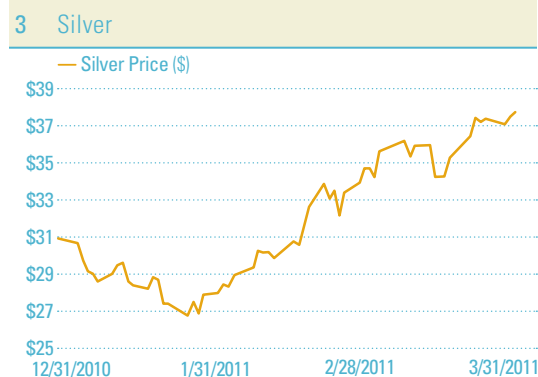
While the job market might have found traction in the first quarter, the same could not be said of the housing market, which continued to bounce along the bottom. New home sales marked an all-time low in February, down 28% year-over-year. Housing prices, as measured by the S&P/Case-Shiller Home Price Index, declined 3% year-over-year in the most recent period, with just two cities in the 20-city Index recording positive changes from a year ago. One potential positive for housing was an uptick in home purchase applications. Despite the rise in mortgage rates from the trough in early October 2010, applications were up 4% in the past six months. Despite the ongoing malaise in the housing market, however, REITs gained 7.5% in the quarter, as measured by the NAREIT Equity Index.

Commodities

Continuing the trend witnessed in recent quarters, commodity prices again moved higher in the first quarter, as the Commodity Research Bureau Index rose approximately 8%. Given renewed inflation concerns and a weakening dollar (the US dollar fell 2% in the first quarter), precious metals were standouts in the quarter. Gold closed the quarter at an all-time high (\$1,440) and silver jumped more than 20% in three months [chart 3].

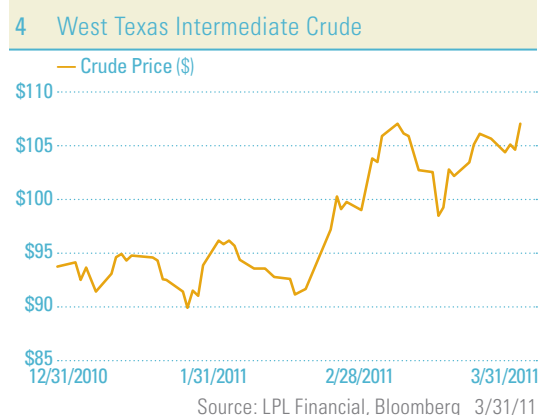
Political uncertainty and violence in the Middle East contributed to a sharp move higher in energy prices, particularly oil. West Texas Intermediate crude oil climbed from \$93 in January to \$107 at the end of March [chart 4].

As we detailed in our *2011 Outlook*, we expected commodities to be one of the winners from the Fed's quantitative easing program, known as QE2. We also highlighted the potential for volatility in oil-industry investments, as they are often driven by geopolitical events like those that remain ongoing in the Middle East.



Source: LPL Financial, Bloomberg 3/31/11

Precious metal investing is subject to substantial fluctuation and potential for loss.



Source: LPL Financial, Bloomberg 3/31/11

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

5 10-Year U.S. Treasury Yield



A good defense against rising rates proved to be the best offense as non-Treasury, or “spread”, fixed-income sectors again outperformed in the first quarter.

Bank Loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

Preferred Stock investing involves risk which may include loss of principal.

High-Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

The issuance of Build America Bonds (BABs) began in April of 2009. They were authorized by the ARRA economic stimulus of 2009 and can be issued for qualifying infrastructure projects. They are taxable municipal bonds and are considered a category of bonds.

Fixed Income–Taxable

After one of the worst quarters in recent memory for high-quality bonds, the Barclays Capital Aggregate Bond Index got off to another slow start in 2011. The Index spent a good part of the quarter in negative territory before finishing with a modest return of 0.4%. A second consecutive down quarter would have marked the first back-to-back negative quarters since the depths of the Great Recession in the second and third quarters of 2008.

Looking back to the fourth quarter for context, the 10-year Treasury yield rose steadily, from a low of 2.4% in early October 2010 to 3.5% in mid-December before settling into a range between 3.3% and 3.5%. That range held until early February 2011 when the yield shot 30 basis points higher in one week to 3.7% before gradually falling into a new range between 3.4% and 3.6% for most of February; stronger economic data was the catalyst for higher yields as bonds re-priced for better economic growth prospects. Yields rallied sharply, however, to 3.2% in mid-March on safe-haven buying in response to the Japanese crisis. The 10-year yield ended the first quarter at 3.5% [chart 5].

Despite higher commodity prices in the first quarter, recent readings on inflation remain benign. In addition, inflation expectations remain well contained, and market-based inflation expectations remain muted.

Following a 7.9% decline in the fourth quarter, long-term government bonds, as measured by the Barclays Capital U.S. Long Treasury Index, underperformed again, declining by 0.8% in the first quarter. A good defense against rising rates proved to be the best offense as non-Treasury, or “spread”, fixed-income sectors again outperformed in the first quarter. The Barclays Capital High-Yield Bond Index gained 3.9%, while preferred stocks (3.2%) and bank loans (2.8%) also outperformed. In another positive sign for high-yield, Moody’s reported that its 12-month trailing default rate finished February unchanged at 2.8%. According to Moody’s, only two companies defaulted in the first two months of 2011, compared to ten defaults over the same period in 2010. In response, Moody’s lowered its year-end 2011 default forecast to 1.4%.

Fixed Income–Tax-Free

Like taxable high-quality bonds, municipal bonds also started the year slowly. The sector was hit hard in the fourth quarter of 2010 as new supply overwhelmed the market with the year-end expiration of the Build America Bonds program. The trend continued in early January 2011 as massive mutual fund redemptions added to the supply-demand imbalance. Recognizing that the selling might have been overdone, some non-traditional buyers (i.e., institutional investors who do not enjoy the tax benefit of municipal bonds) stepped into the market to take advantage of the opportunity. Standard and Poor’s ratings agency reported in March that municipal defaults over the first two months of 2011 were 50% lower than 2010, based upon the number of issuers. Based upon the total dollar amount of bonds involved, defaults were lower by 33%. The report was another piece of evidence that contradicted news stories forecasting a massive wave of new defaults. By the end of the quarter, the Barclays Capital Muni Bond Index showed a return of 0.5%.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Stock investing may involve risk including loss of principal.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Precious metal investing is subject to substantial fluctuation and potential for loss.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Technology Software & Services Sector: Companies include those that primarily develop software in various fields such as the internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Health Care Sector: Companies are in two main industry groups—Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Telecommunications Services Sector: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

Consumer Staples Sector: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Russell 1000® Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

MSCI EAFE is made up of approximately 1,045 equity securities issued by companies located in 19 countries and listed on the stock exchanges of Europe, Australia, and the Far East. All values are expressed in US dollars. All values are expressed in US dollars. Past performance is no guarantee of future results.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of May 2005 the MSCI Emerging Markets Index consisted of the following 26 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The CRB Commodities Index is a measure of price movements of 22 sensitive basic commodities whose markets are presumed to be among the first to be influenced by changes in economic conditions. As such, it serves as one early indication of impending changes in business activity.

This Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Barclays Capital Long U.S. Treasury Index includes all publicly issued U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have \$250 million or more of outstanding face value. In addition, the securities must be denominated in US dollars and must be fixed rate and non-convertible.

The Barclays Capital High Yield Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment-grade or high-yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds must also have at least one year to maturity, have at least \$150 million in par value outstanding, and must be US dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

The Barclays Capital High Yield Municipal Bond Index is an unmanaged index made up of bonds that are non-investment grade, unrated, or rated below Ba1 by Moody's Investors Service with a remaining maturity of at least one year.

The NAREIT Equity REIT Index is an unmanaged index consisting of certain companies that own and operate income-producing real estate and have 75% or more of their respective gross invested assets in the equity or mortgage debt, respectively, of commercial properties.

The Nikkei Index is short for Japan's Nikkei 225 Stock Average, the leading and most-respected index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S. In fact, it was called the Nikkei Dow Jones Stock Average from 1975 to 1985.

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