

## Commentary

So far investors seem undeterred by the upcoming expiration of QE2. As you may recall, the Federal Reserve's latest round of Treasury bond purchases (also known as quantitative easing) was enacted in November 2010 when the economy appeared to lose momentum and the threat of deflation and a double-dip recession was heightened. Since then, the stock market has soared (along with prices of other risk assets), unemployment has fallen, and inflation has picked up. The rise in commodity prices was significant enough to have some wondering if the Fed would cut short further stimulus. However, Fed Chairman Bernanke has indicated that the central bank will continue its \$600 billion bond-buying program as planned until completion in June due to the headwinds to the economy offsetting inflation risks (moribund housing market, high unemployment, and high gas prices).

For now, the central bank will also maintain its policy of ultra-low short-term interest rates. For many, the question of when the Fed might start to raise rates (assuming the economy continues to expand) is just as relevant, if not more so, than what happens when QE2 ends, especially since financial assets may have already priced in the scheduled expiration of the Fed's buying of U.S. Treasury bonds. Historically, in the early stages of Fed tightening cycles, lower quality high yield debt tends to outperform Treasuries and investment grade bonds. Stocks, not surprisingly, tend to be much more resilient to rate hikes than bonds, though corporate profit growth does eventually slow. Higher rates are also viewed as helpful to the U.S. dollar, while performance of gold is a mixed bag. Nevertheless, Mr. Bernanke has stated that, unless the inflation outlook worsens, he is not inclined to boost rates anytime soon, with most interpreting that to mean 2012 at the earliest.

## CONVERGENT TACTICAL POSITIONING

Given an intermediate-term risk in the ability of bonds to preserve purchasing power, we are underweight our strategic core fixed income target. This risk comes if rates stay at historically low levels or prices are hurt by a further rise in yields. The underweight accommodates a shift to opportunistic credit segments (such as multi-sector, emerging market currencies/debt, and mortgages) where we can collect a current yield while addressing inflation, currency, and U.S. interest rate risks. Within the real assets bucket, we remain underweight REITs in favor of gold, which serves as a paper currency hedge and safe-haven asset.

<b>EQUITY</b>	<b>neutral</b>	
U.S. Equity	overweight	
Developed Non-U.S.	underweight	
Emerging Markets	overweight	
Private Equity	neutral	
Directional Hedge	underweight	
<b>REAL ASSETS</b>	<b>neutral</b>	
Real Estate	underweight	
Commodities	overweight	
<b>ARBITRAGE/CREDIT</b>	<b>overweight</b>	
Multi-Strategy Hedge	neutral	
Opportunistic Credit	overweight	
<b>CORE FIXED INCOME</b>	<b>underweight</b>	
Core Fixed Income	underweight	
Cash Equivalents	neutral	

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Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

## THE EQUITY AND FIXED INCOME MARKETS

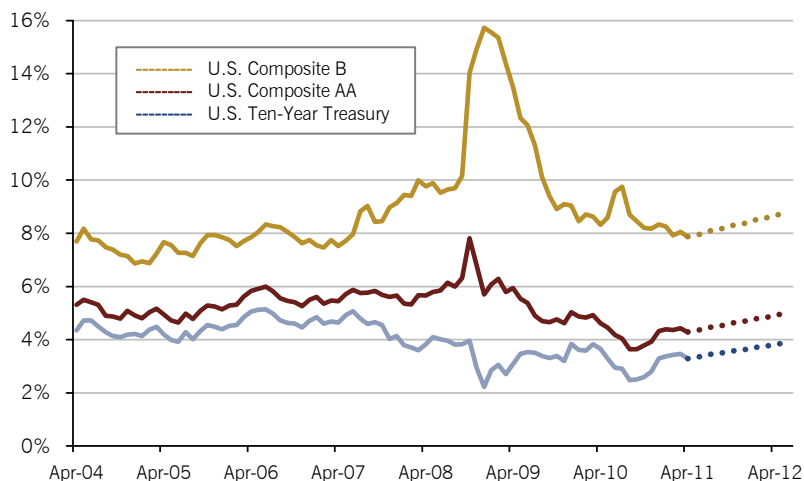
### S&P 500 PRICE

Stocks rose in April as the Fed pledged to keep short-term rates low for some time and strong corporate earnings confirmed the vigor in the industrial and manufacturing sectors. While the S&P 500 has doubled off its 2009 lows, it remains about 13% below its all-time high. Meanwhile, the Russell 2000 index of small cap stocks is at a record high and the Nasdaq is at its highest level since 2000.



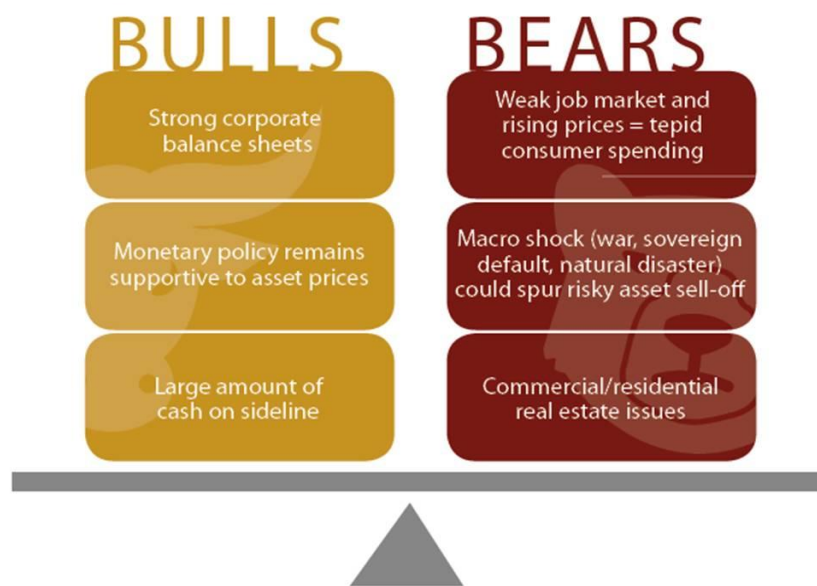
### CREDIT YIELDS

A lower-than-expected reading on first quarter GDP, assurances from the Fed that it is in no rush to scale back its support for the U.S. economy, and statements from Chairman Bernanke that he views inflationary pressures as transitory helped bond yields drift lower in April. The lower yields came despite a warning from Standard & Poor's on the huge federal budget deficit.



### SUMMARY OF CURRENT EQUITY MARKET LEANINGS

Overall, we are at a neutral weighting (in line with strategic target) with regard to our equity allocation. While there are still some headwinds, we believe the global economy will continue its recovery and several factors (valuations, fundamentals, and technicals) are supportive of stock markets. Within the equity bucket, we are overweight U.S. and emerging market equity while underweight developed international and long/short equity.

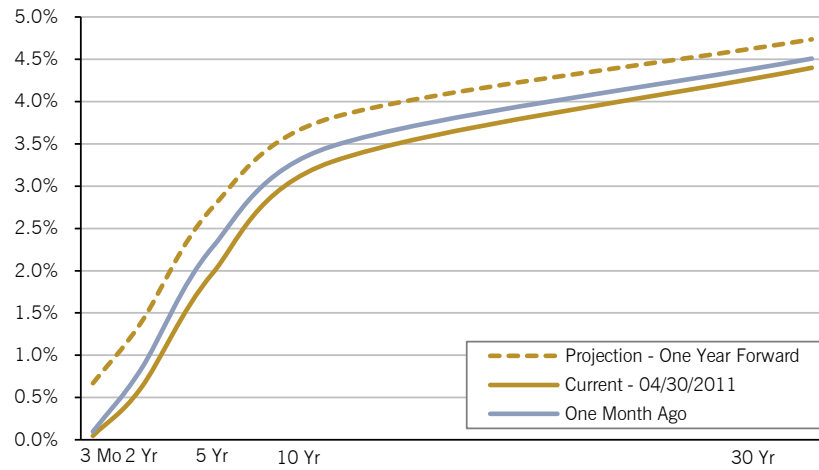


## THE EQUITY AND FIXED INCOME MARKETS

### U.S. TREASURY YIELD CURVE

Compared to the prior month, the Treasury yield curve shifted slightly lower in April, despite a downgrade in Standard & Poor's credit outlook for the United States. As short-term rates remain exceptionally low, the curve is near the steepest level on record. For many, this indicates investor expectations of a continued improving economy.

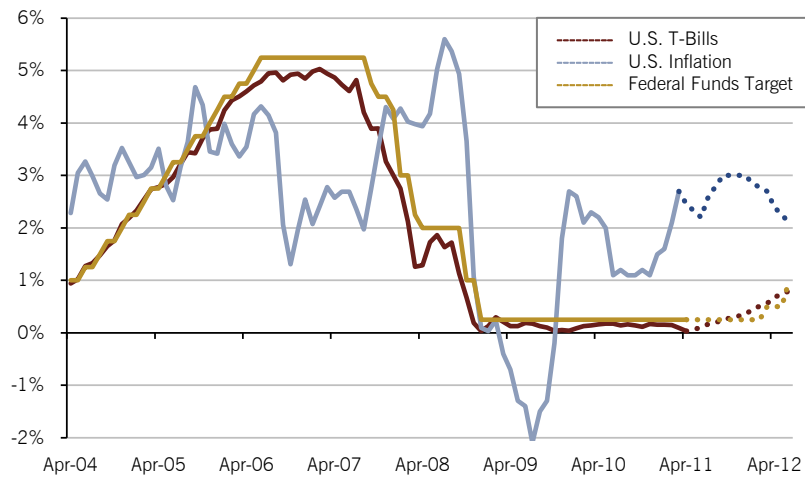
**Advantage: Neutral to Bullish**



### T-BILLS, FEDERAL FUNDS, AND INFLATION

Surging energy and food prices have contributed to a pickup in inflation in recent months. The Fed, however, believes that longer-term expectations are still subdued thanks to high unemployment, a soft real estate market, and low capacity utilization. As such, most do not see the Fed raising short-term rates for some time, even as QE2 is wrapping up in June.

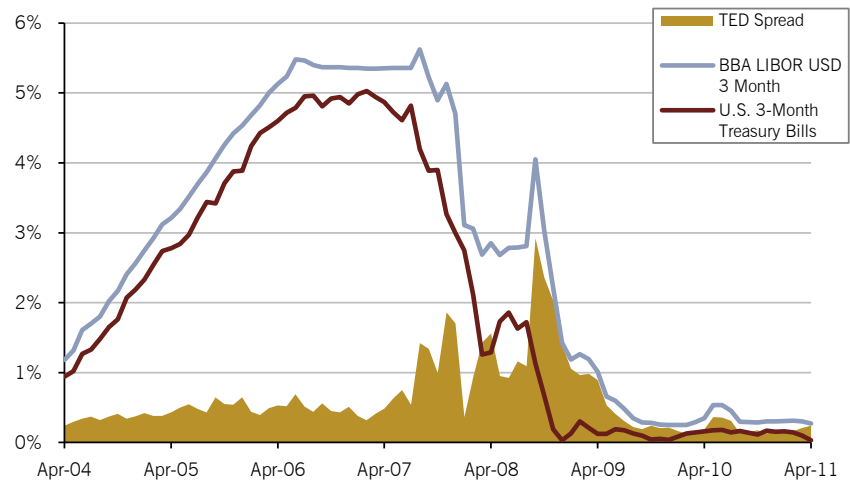
**Advantage: Neutral to Bullish**



### LIBOR/T-BILL RATES AND TED SPREAD

The TED spread is a measure of how tight the credit markets are, as illustrated by the difference between T-Bill yields (a risk-free loan) and LIBOR yields (the rate at which banks lend to one another). Current low spreads illustrate credit markets are operating with little anxiety.

**Advantage: Bulls**

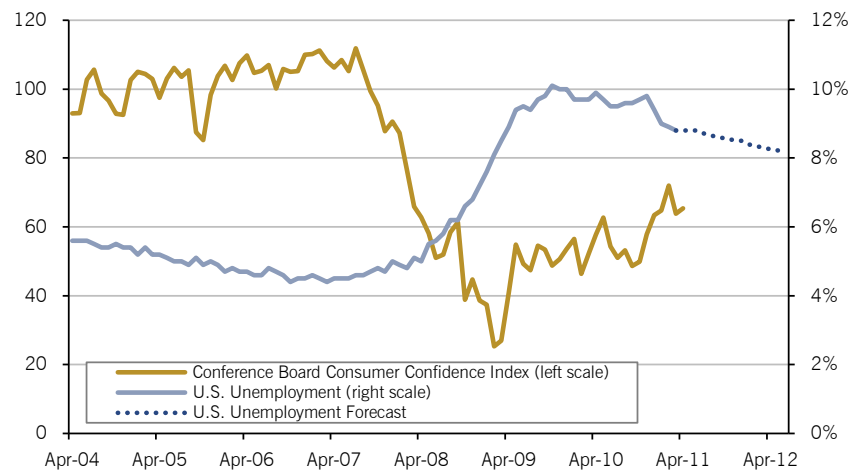


## THE ECONOMY AND THE CONSUMER

### CONSUMER CONFIDENCE AND UNEMPLOYMENT

The unemployment rate fell to a two-year low of 8.8% in March, and surveys indicate several of the nation's largest companies plan to step up hiring in the second half of this year. The improving labor market is helping consumer sentiment offset rising fuel costs. Still, many people who stopped looking for jobs during the recession have yet to start again.

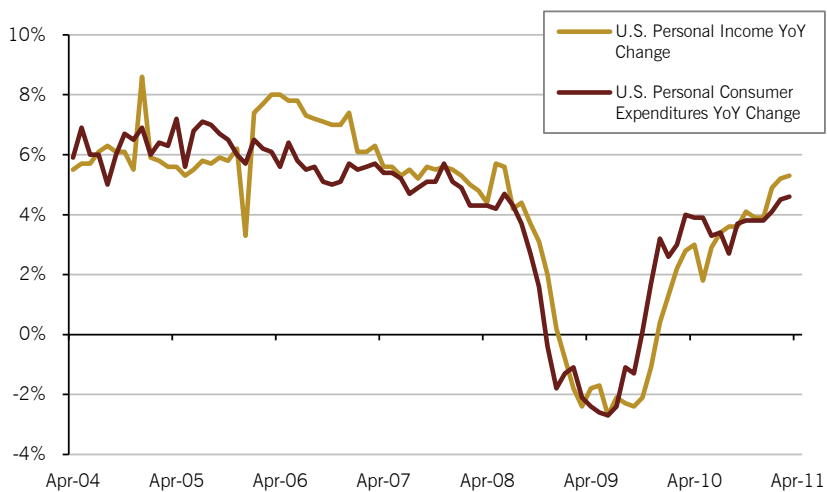
**Advantage: Neutral**



### U.S. CONSUMER INCOME AND SPENDING

Consumer spending rose in March, boosted by rising fuel and food prices. Incomes also rose, but much of the extra money went to pay for gasoline. Some economists fear consumers would have a more difficult time adapting to high commodity prices, leading to less growth in spending for discretionary items.

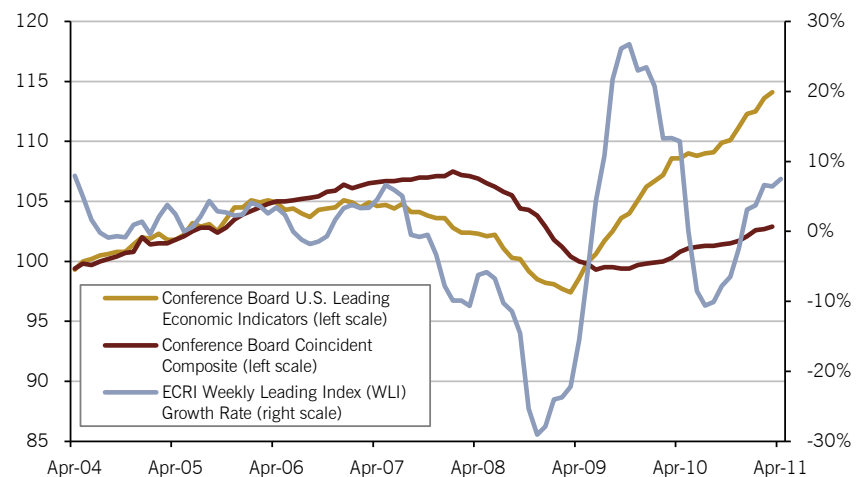
**Advantage: Neutral**



### LEI AND ECRI

The U.S. leading economic index (LEI) continues to trend upward, withstanding higher fuel costs and recording its ninth consecutive gain in March. Strength among the LEI components has been fairly widespread. Meanwhile, the index of coincident indicators (a measure of current economic activity) has been rising at a more measured pace.

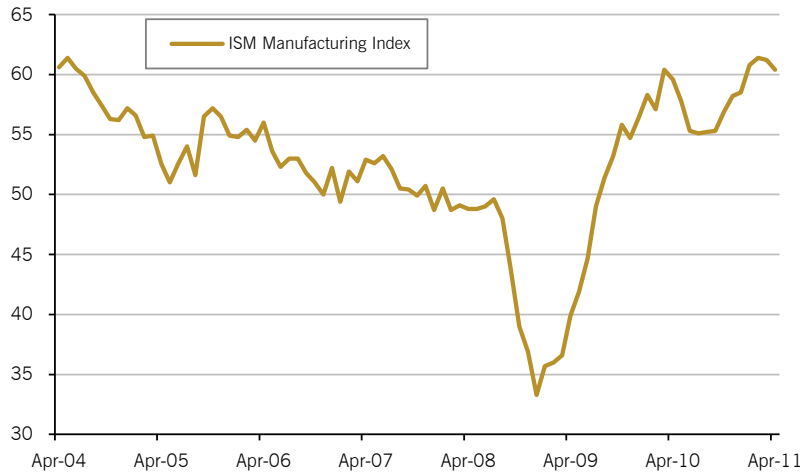
**Advantage: Neutral to Bullish**



**ISM MANUFACTURING INDEX**

The ISM report is a national survey of purchasing managers covering such indicators as new orders, production, employment, inventories, prices, and export/import orders. A reading over 50% indicates expansion relative to the prior month, while a reading under 50% indicates contraction. The latest reading was expansionary but a bit slower than March, as manufacturers are experiencing cost pressures from commodities and other inputs.

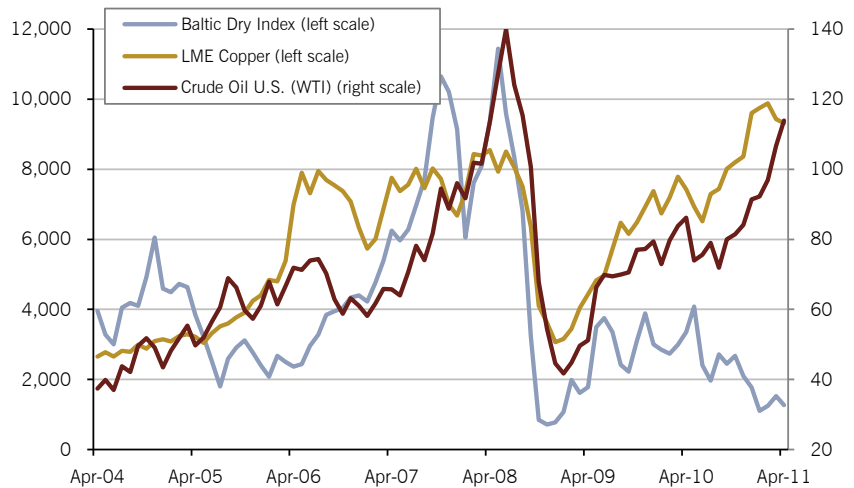
**Advantage: Bulls**



**BALTIC DRY INDEX & COMMODITIES**

The Baltic Dry Index (BDI) measures shipping costs for commodities and is used to evaluate world trade. Copper, a plentiful and heavily used metal in construction and manufacturing, can reflect trends in global economic growth. Recently there has been a huge divergence between the BDI and the price of commodities, and many feel the BDI says more about the oversupply of ships than the demand for cargo.

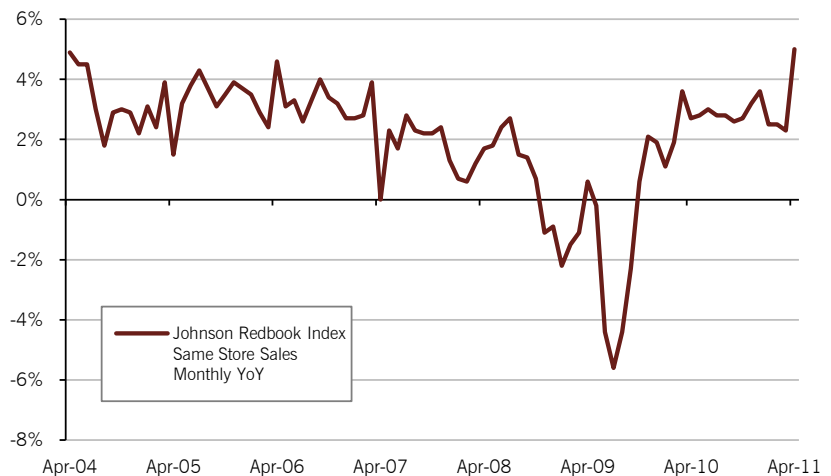
**Advantage: Neutral**



**RETAIL SALES**

Retail sales figures track the dollar value of merchandise sold to consumers and are an indicator of economic recovery. A late Easter as compared to last year contributed to higher spending this April, particularly for apparel. However, higher gas prices are pressuring other segments.

**Advantage: Neutral**

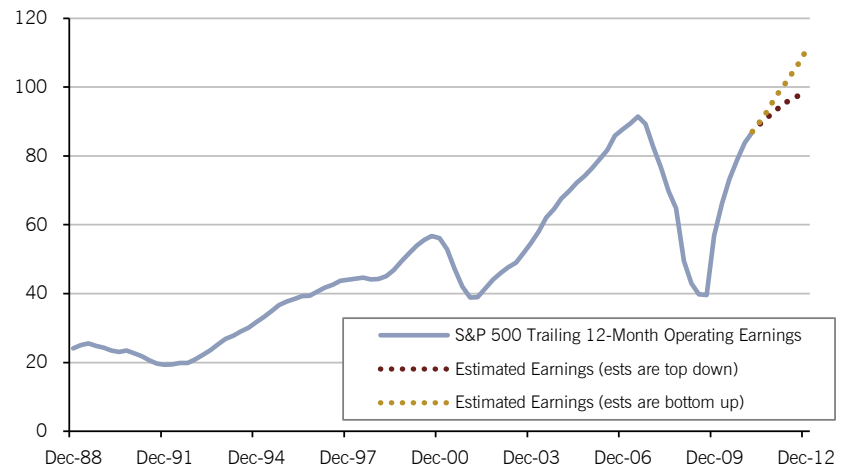


## U.S. CORPORATIONS

### CORPORATE EARNINGS

Earnings have recovered to pre-recessionary levels, benefitting from significant cost cutting over the past two years. While earnings are expected to reach record highs in the second half of 2011, the rate of growth might taper off as year-over-year comparisons to 2010 will become more difficult.

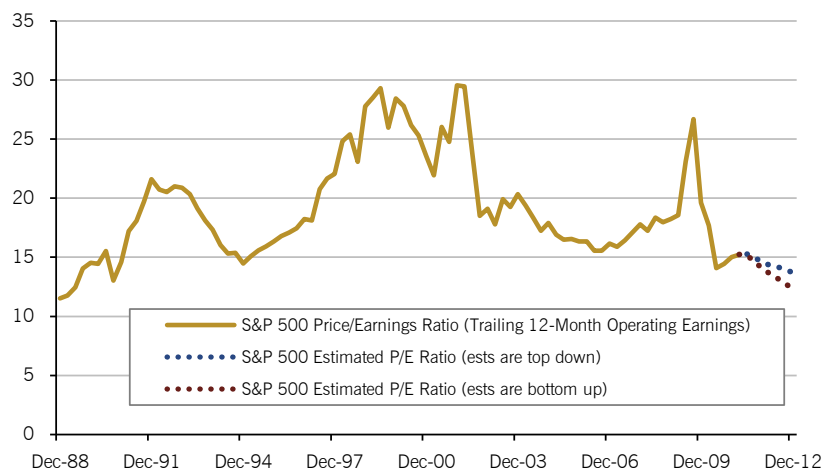
**Advantage: Neutral to Bullish**



### STOCK MARKET VALUATIONS

Earnings growth over the past year has helped trailing 12-month P/E valuations look reasonable (slightly below historical norms) despite a run-up in stock prices. However, longer-term methods of measuring valuations, such as the normalized P/E ratio developed by Yale economist Robert Shiller, remain a bit elevated (over 23).

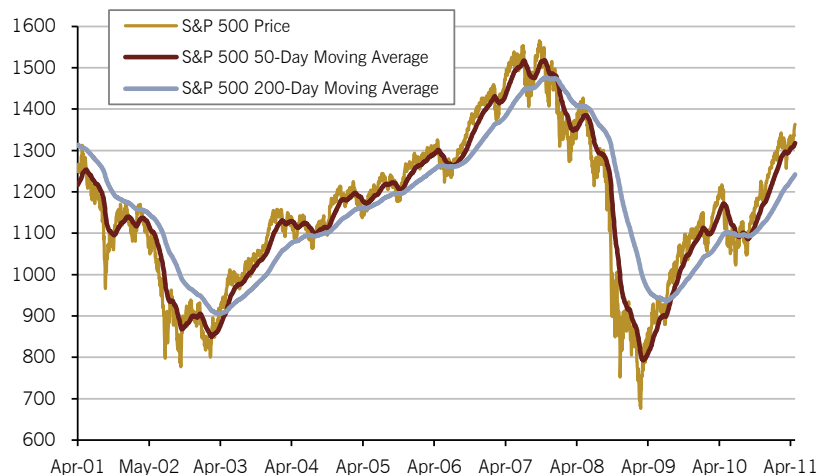
**Advantage: Neutral to Bullish**



### STOCK MARKET TECHNICALS

The S&P 500 50-Day moving average is higher than the 200-Day moving average, which is interpreted by many as a bullish signal.

**Advantage: Bulls**

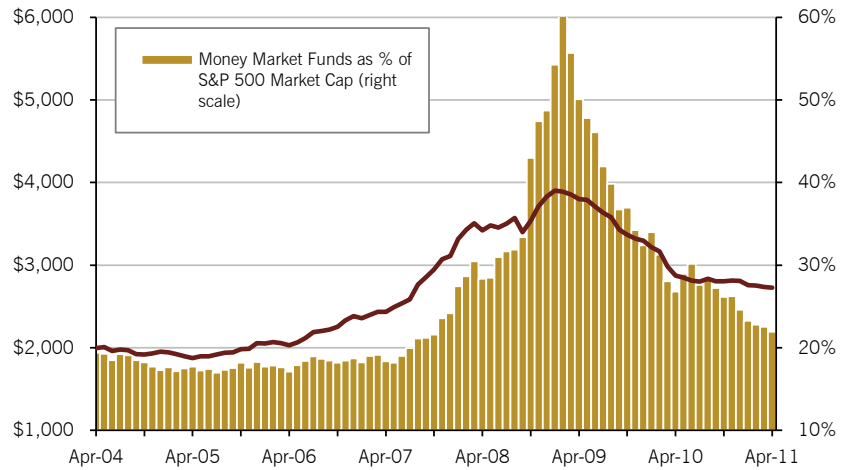


## INVESTOR FLOWS AND LIQUIDITY

### MONEY MARKET FUNDS ASSETS (\$ BILLIONS)

Money market fund assets continue to decline as dry powder on the sideline is slowly deployed, particularly as a percentage of rising stock market assets. Nevertheless, investors still have plenty of cash available to put to work.

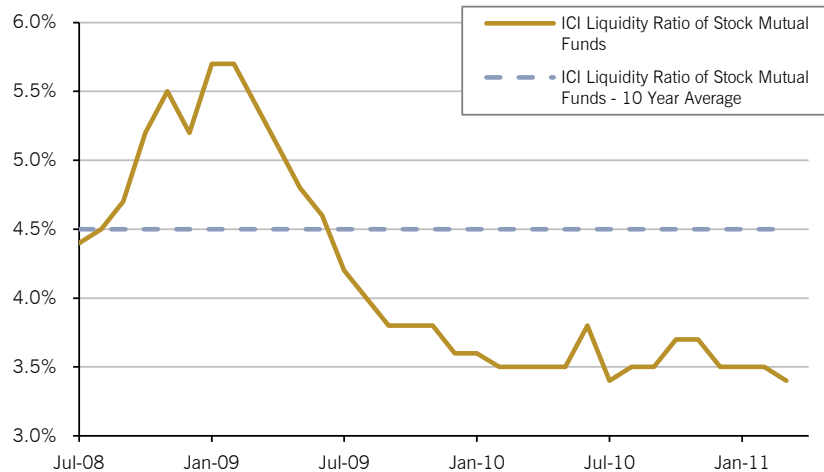
**Advantage: Bulls**



### MUTUAL FUND LIQUIDITY RATIO

The liquidity ratio compares the amount of cash relative to total assets held by stock mutual funds. As stocks tumbled in 2009, mutual fund managers were bearish and sitting on a large amount of cash. Since then, managers have put most of that cash to work and, unlike retail investors, have been holding low levels of cash for some time (meaning little in additional cash to invest).

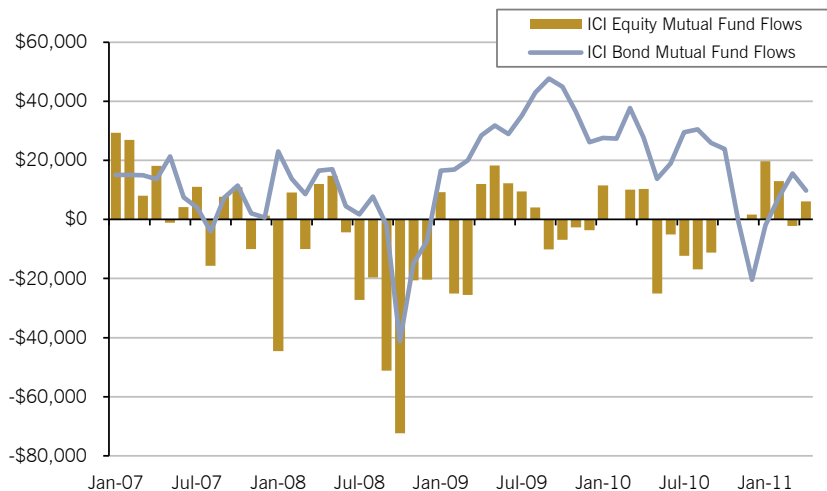
**Advantage: Bears**



### MUTUAL FUND CASH FLOWS (\$ MILLIONS)

Stock and bond funds saw modest yet positive inflows in April. However, municipal bond funds continued to experience net outflows for the sixth consecutive month.

**Advantage: Neutral**

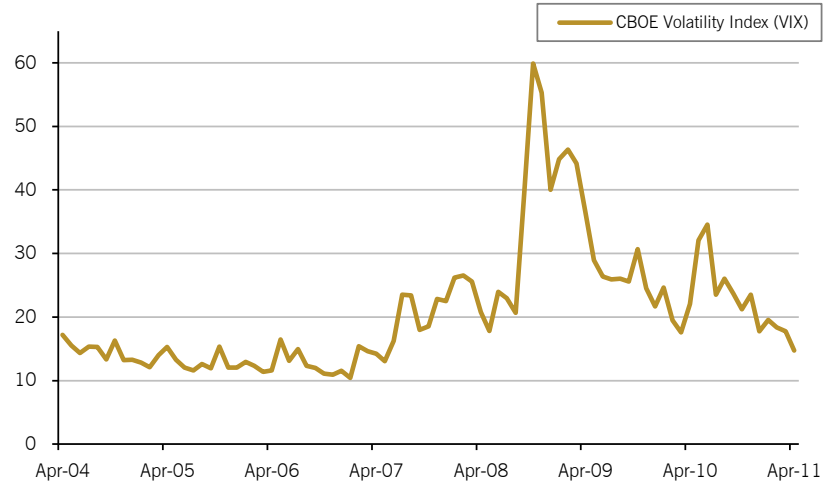


## FEAR MEASURES

### STOCK MARKET VOLATILITY

Volatility as measured by the Chicago Board Options Exchange Volatility Index (VIX) ended April at 14.8, the lowest level since before the credit crisis began. Readings in excess of 30 generally correspond with times of investor fear or uncertainty, while values below 20 are typically associated with less stressful (or even complacent) times in the markets.

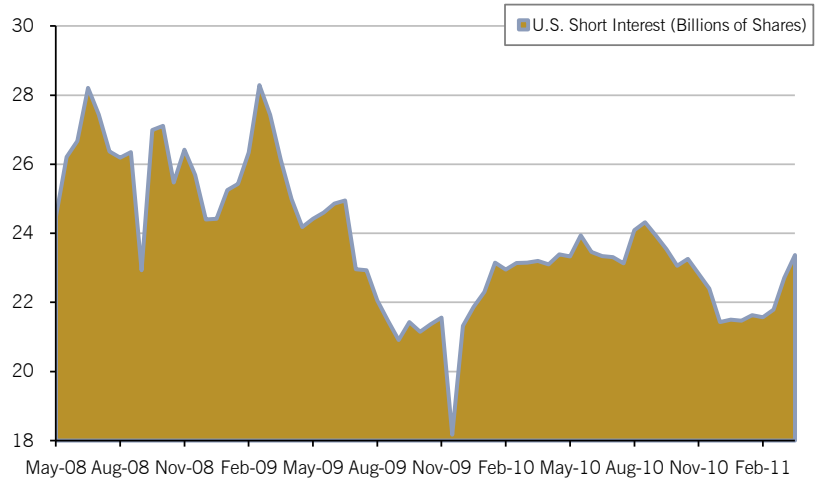
**Advantage: Neutral**



### U.S. SHORT INTEREST

Short interest can be a measure of investor sentiment, though it is often viewed as a contrary indicator since high levels of short positions are eventually covered, providing upward pressure on stock prices. Short interest rose in early April, but has stayed within a relatively narrow band over the past year.

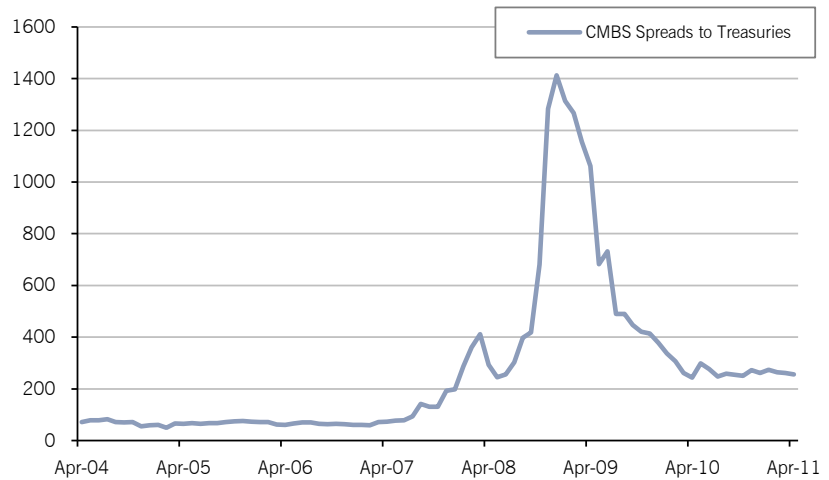
**Advantage: Neutral**



### CMBS SPREADS

Even as the delinquency rate for commercial mortgage-backed securities remains at high levels, CMBS spreads over swap rates and Treasuries have been in a stable range since last year.

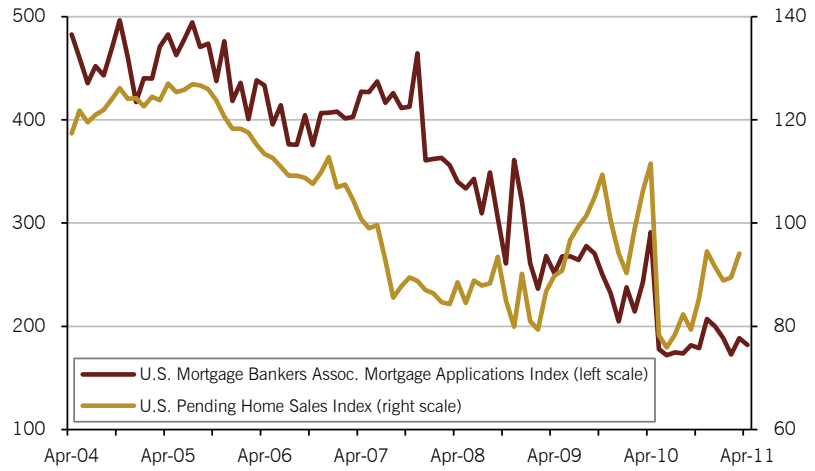
**Advantage: Neutral**



**MORTGAGE APPLICATIONS AND PENDING HOME SALES**

Pending home sales ticked up recently as investors looked to take advantage of low prices. However, lending standards remain tight and the housing market is still hindered by high unemployment and a glut of inventory.

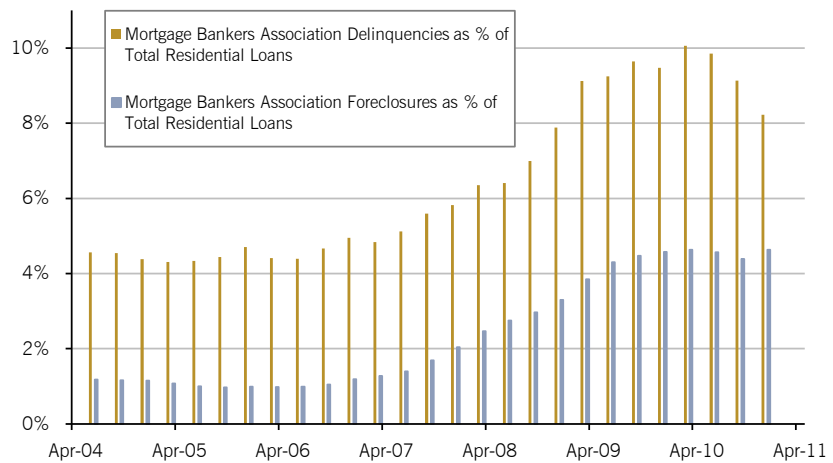
**Advantage: Bears**



**RESIDENTIAL DELINQUENCIES AND DEFAULTS**

Mortgage delinquencies and foreclosures appear to have reached a plateau as market conditions have improved. However, they could still get worse as a large amount of mortgages set to mature in the next few years might not get refinanced.

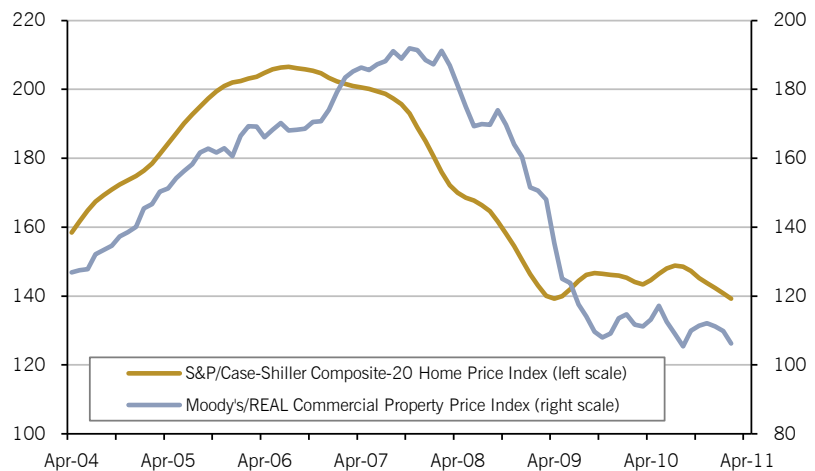
**Advantage: Bears**



**RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES**

Residential home values continue to weaken. The Case-Shiller 20-city index of home prices fell for the seventh straight month and is testing lows seen during the recent recession.

**Advantage: Bears**

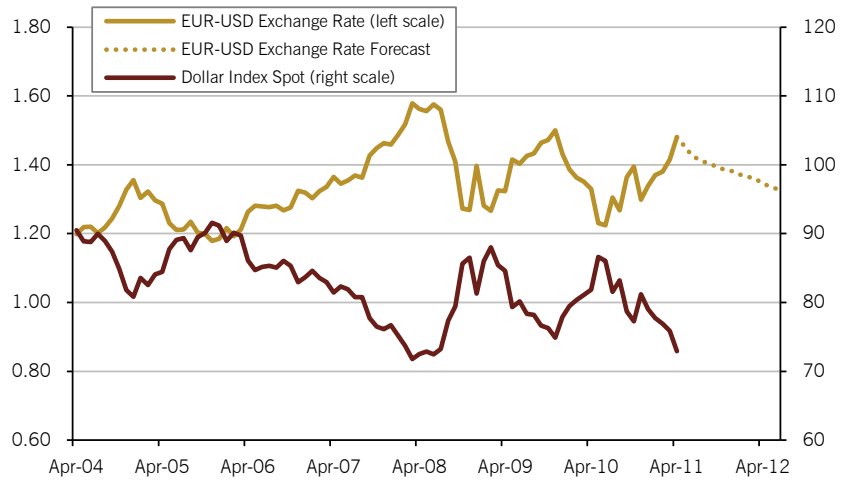


## CURRENCY

### U.S. DOLLAR

The U.S. dollar fell to its weakest level since mid-2008. Worries about the U.S. government debt burden and the Fed's low interest rate policy (especially as the European Central Bank has recently raised rates) continue to hinder the dollar, and some claim the Fed is contributing to the decline through its quantitative easing programs.

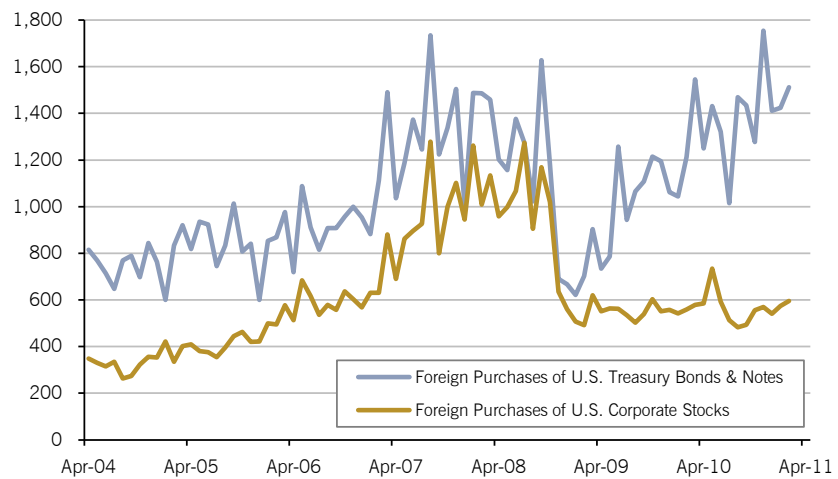
**Advantage: Neutral**



### FOREIGN PURCHASES OF U.S. SECURITIES (\$ BILLIONS)

While global demand for U.S. securities (bonds and equities) was slightly higher in April, an ongoing long-term worry is that high government debt levels could cause foreign buyers to either demand higher U.S. interest rates or stop buying Treasuries altogether.

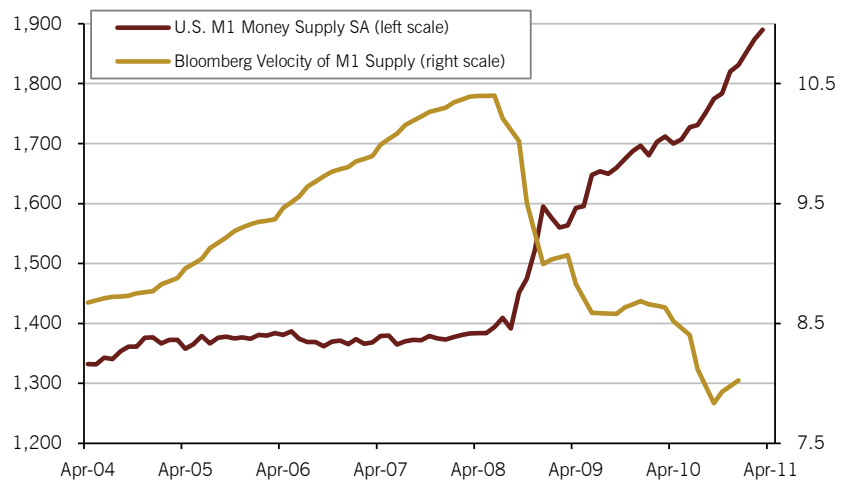
**Advantage: Neutral**



### U.S. M1 MONEY SUPPLY AND VELOCITY

M1 consists of the most liquid forms of money, namely currency and checkable deposits. With the recent stimulus, M1 has spiked to unprecedented levels, causing fears of eventual inflation and dollar weakness. Velocity of money (the rate at which money changes hands), however, remains low as consumers and businesses are not spending or borrowing at high levels. Any increase in velocity could provide insight into future inflation.

**Advantage: Neutral**

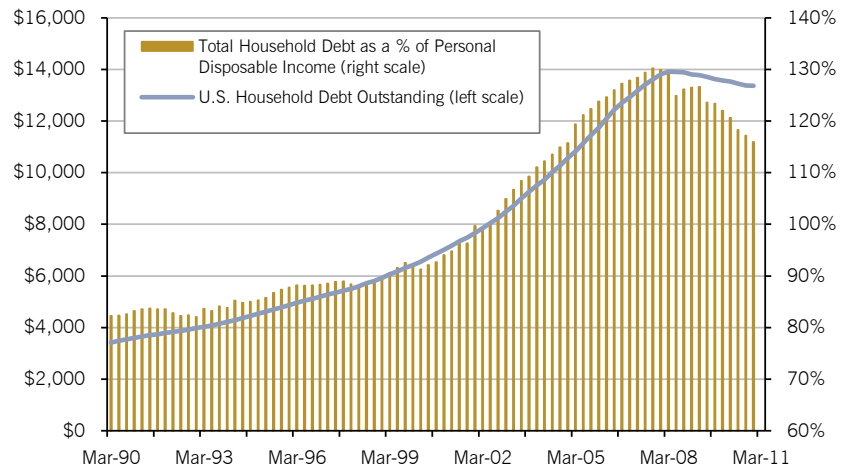


## BORROWING

### U.S. HOUSEHOLD DEBT AS A % OF DISPOSABLE INCOME

U.S. household debt (including mortgages and consumer credit), and the percentage it represents of disposable personal income, have increased dramatically since the early 1990s. Thus far in the current deleveraging cycle consumers have been decreasing debt slowly and still have a way to go.

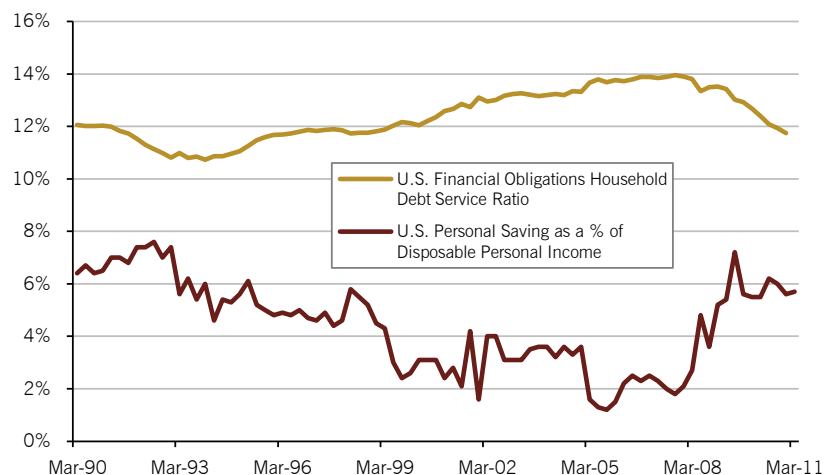
**Advantage:** Neutral to Bearish



### U.S. SAVINGS AND HOUSEHOLD DEBT SERVICE RATIO

The debt service ratio measures the amount households spend on debt payments as a percentage of their earnings. Despite the remarkable increase in total debt over the past few decades, the rise in service ratios has been more muted due to the decline in interest rates. However, if rates spike, so too would debt payments, which would be problematic.

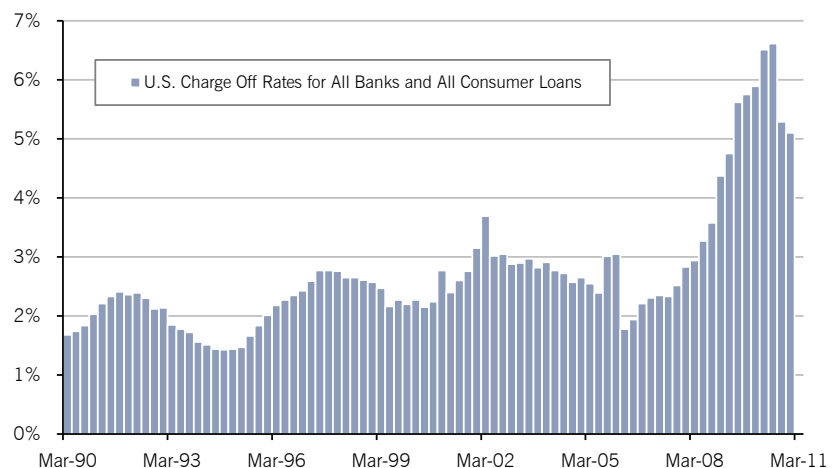
**Advantage:** Neutral to Bearish



### U.S. CONSUMER LOAN CHARGE-OFF RATES

Given improvements in the labor market, banks are optimistic that they will not have to write off as many bad loans this year. Still, consumer bank loans (including credit cards but excluding real estate) written off as unrecoverable remain near the highest levels on record.

**Advantage:** Neutral to Bearish



## DISCLOSURE

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