

Invest well. Manage well. Live well.™

MAY 2011

## Commentary

There is little question that the U.S. economy has hit at least a temporary bump in the road. Disappointing economic data of late have included soft jobs growth, weak consumer spending, a slowdown in manufacturing, and the seemingly perpetual decline in the housing market. Some have even speculated as to whether there might be another round of stimulus if things get worse. However, most anticipate the slowdown to be temporary and chances of the Federal Reserve engaging in additional quantitative easing measures to be low.

Despite the less-than-ideal environment, we do not see outsized near-term risks that would spur us to reduce our neutral equity positioning. As you may recall, we do not try to time stock market corrections but we attempt to mitigate exposure during significant economic downturns, which often coincide with painful bear markets. That being said, while neutral overall, within the equity bucket we remain overweight to U.S. large cap equities where we see continued benefits from strong corporate balance sheets, accommodative monetary policy, and increasing participation in the emerging market growth story. And despite the prospect for increased volatility in emerging stock markets, we are overweight to that segment as well. We believe it is a long-term opportunity for which investors will ultimately be rewarded for riding out unpredictable ups and downs.

What would cause us to reconsider our equity weighting? Among other things, we will continue to watch the U.S. budget deficit, the European debt situation, and the Fed's actions in dealing with potential inflationary pressures. Additionally, we will watch for further deterioration in a variety of economic indicators, any decline in the health of corporate balance sheets, increasing valuations, or a shift in yield spreads.

## 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 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

## OVERVIEW OF THE EQUITY AND FIXED INCOME MARKETS

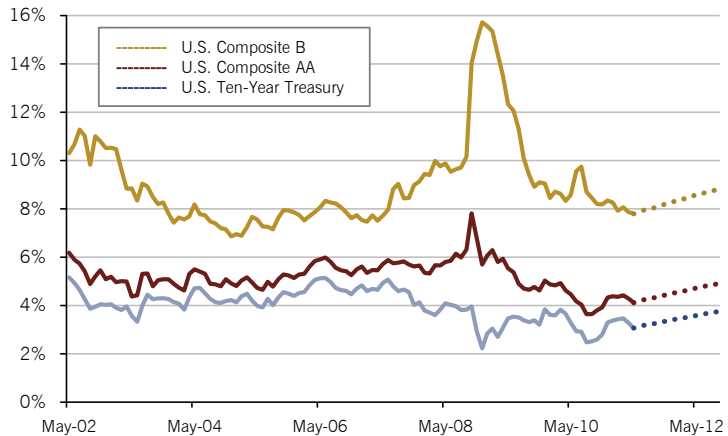
### S&P 500 PRICE

Stocks fell in May, with the S&P 500 posting its first monthly loss of the year (on a total return basis) and worst monthly return since August 2010. Concerns about high gasoline prices, disappointing economic data, and a resurfacing of the European debt crisis all contributed to investors taking some risk off the table. Commodities and international equities were among the hardest hit asset classes.



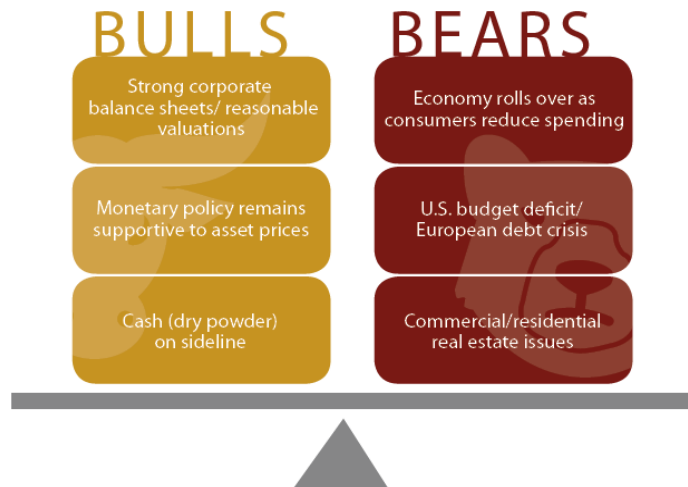
### CREDIT YIELDS

The yield on the ten-year Treasury note fell to near 3% at month's end, close to its lowest levels of the year. Indications of a slowdown in the U.S. economy (as evidenced by falling home prices, declining confidence, and weaker manufacturing data) have bolstered government bond prices, even in the face of staggering budget deficits. A potential default in Greece also contributed to a flight to safety.



### SUMMARY OF CURRENT EQUITY MARKET LEANINGS

- Our equity allocation is at a neutral weighting
- While there are still headwinds, we do not believe a double dip recession is imminent. Certain key factors (monetary policy, valuations, and corporate balance sheets) are supportive of stock markets.
- Within the equity bucket, we are overweight U.S. and emerging market equity while underweight long/short equity.



## MARKET PULSE SUMMARY

### SUMMARY OF ECONOMIC AND MARKET STATISTICS

We feel continued supportive Fed policy, strong corporate balance sheets, and reasonable valuations support a positive view of the markets over the intermediate term. However, the U.S. economy appears to have hit at least a temporary soft patch, which could lead to increased short-term volatility. We are keeping an eye on the slowdown in the pace of hiring, unexpected weakness in the manufacturing sector, the renewed downturn in the already dismal housing market, the worrisome U.S. budget deficit, and the European debt crisis. Despite these numerous headwinds, we believe the risk of recession remains contained and economic growth will continue (though perhaps slow and uneven).

<p><b>CREDIT MARKETS</b> U.S. Treasury Yield Curve T-Bills, Federal Funds, and Inflation LIBOR/T-Bill Rates and TED Spread</p>		<p><b>Bullish</b> Neutral to Bullish Neutral to Bullish Bullish</p>	<p>curve remains steep indicating recession is not anticipated supportive Fed despite end of QE2; inflation looks contained low spread = little anxiety</p>
<p><b>THE ECONOMY AND THE CONSUMER</b> Consumer Confidence and Unemployment U.S. Consumer Income and Spending LEI and ECRI</p>	↓	<p><b>Mixed</b> Neutral to Bearish Neutral Neutral to Bullish</p>	<p>employment stalled in May; confidence has faltered incomes and spending rising, but going towards gasoline leading indicators slipped, but still up strong over past year</p>
<p><b>THE ECONOMY AND SUPPLIERS</b> ISM Manufacturing Index Baltic Dry Index and Commodities Retail Sales</p>	↓	<p><b>Neutral to Bullish</b> Neutral to Bullish Neutral Neutral</p>	<p>still expansionary, but the pace slowed dramatically in May commodity use is high, but shipping costs are stagnant high gasoline prices eating into discretionary spending</p>
<p><b>U.S. CORPORATIONS</b> Corporate Earnings Stock Market Valuations Stock Market Technicals</p>		<p><b>Bullish</b> Neutral to Bullish Neutral to Bullish Bullish</p>	<p>S&amp;P 500 earnings expected to reach record levels trailing 12-month P/E near historical norms S&amp;P 500 50-day average &gt; 200-day average</p>
<p><b>INVESTOR FLOWS AND LIQUIDITY</b> Money Market Funds Assets Mutual Fund Liquidity Ratio Mutual Fund Cash Flows</p>	↓	<p><b>Mixed</b> Neutral to Bullish Bearish Neutral</p>	<p>investors have plenty of dry powder, but raised cash in May mutual fund managers holding low levels of cash positive cash inflows in April for stocks and bonds</p>
<p><b>FEAR MEASURES</b> Stock Market Volatility U.S. Short Interest CMBS Spreads</p>	↑	<p><b>Neutral to Bullish</b> Neutral to Bullish Neutral Neutral</p>	<p>VIX at 15.5 -- low levels indicate little investor stress has been in a narrow band for some time in a stable, though elevated, range since last year</p>
<p><b>REAL ESTATE</b> Mortgage Applications and Pending Sales Residential Delinquencies and Defaults Residential/Commercial Property Price Indices</p>		<p><b>Bearish</b> Bearish Bearish Bearish</p>	<p>hindered by high unemployment and large inventory have hit a plateau at high levels at 2003 levels; foreclosures providing downward pressure</p>
<p><b>CURRENCY</b> U.S. Dollar Foreign Purchases of U.S. Securities U.S. M1 Money Supply and Velocity</p>		<p><b>Neutral</b> Neutral Neutral Neutral</p>	<p>budget deficit is weighing on the U.S. dollar strong demand for bonds... but shifting to shorter-term M1 at unprecedented levels but velocity is low</p>
<p><b>BORROWING</b> U.S. Household Debt U.S. Savings and Debt Service Ratio U.S. Consumer Loan Charge-Off Rates</p>		<p><b>Neutral to Bearish</b> Neutral to Bearish Neutral to Bearish Neutral to Bearish</p>	<p>debt level has increased dramatically in past 20 years a spike in rates could increase debt servicing costs remain near the highest levels on record</p>

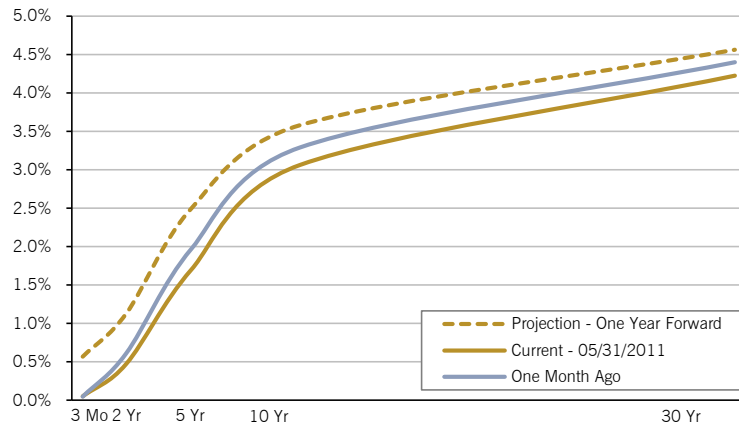
Note: the arrows indicate the directional change from the prior month's reading (i.e., a shift from "Bullish" to "Neutral to Bullish" is viewed as a negative change).

## THE CREDIT MARKETS

### U.S. TREASURY YIELD CURVE

Compared to the prior month, the Treasury yield curve shifted lower in May on signs of economic weakness. Even though longer-term yields declined more than already exceptionally low short-term rates, the curve remains at an extremely steep slope. For many, this indicates investor expectations of a recession are remote even though growth may remain slow.

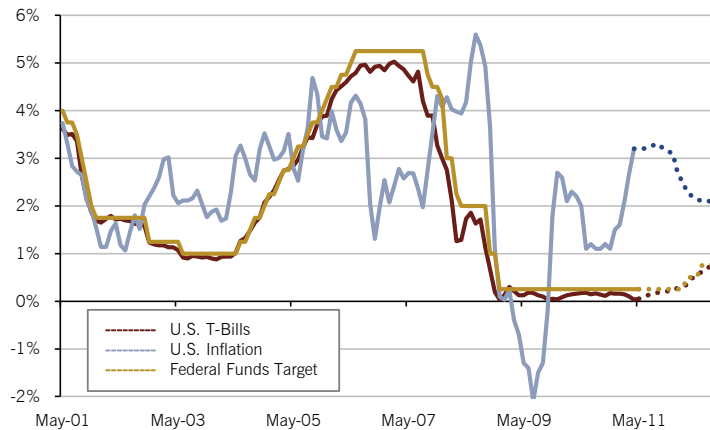
**Advantage: Neutral to Bullish**



### 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 until later in 2012.

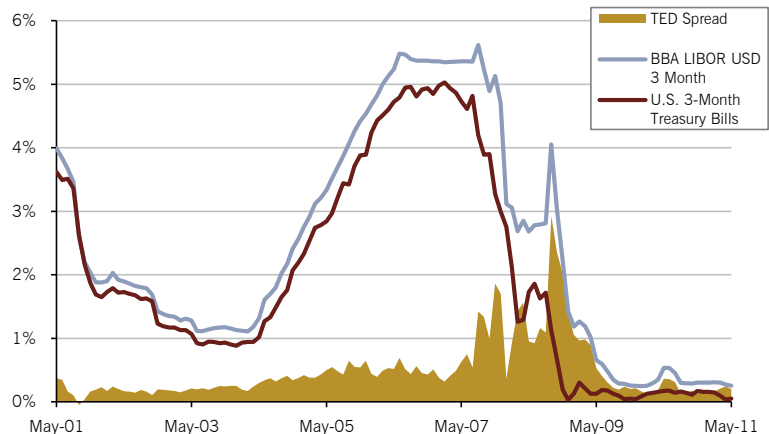
**Advantage: Neutral to Bullish**



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

The TED spread is a measure of the tightness of the credit markets, 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.

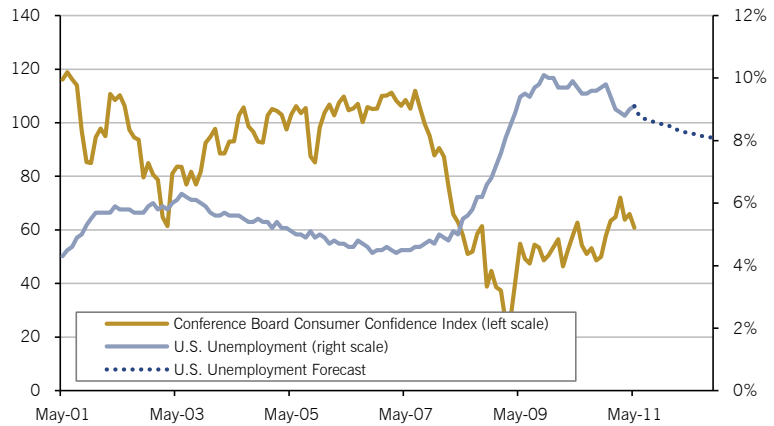
**Advantage: Bullish**



**CONSUMER CONFIDENCE AND UNEMPLOYMENT**

Hiring stalled in May and the unemployment rate rose to 9.1%. According to the Labor Department, employers hired only 54,000 workers in May, the fewest in eight months. Meanwhile, consumer confidence fell to a six-month low amid employment issues, high gas prices, and a possible double dip in the housing market.

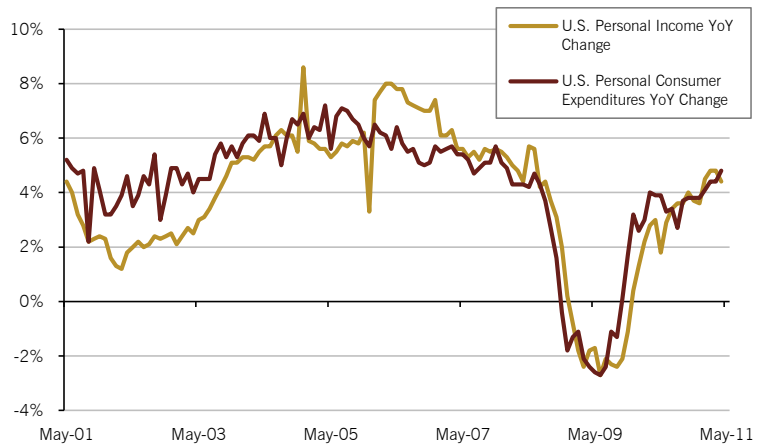
**Advantage: Neutral to Bearish**



**U.S. CONSUMER INCOME AND SPENDING**

Consumer spending rose in April, but much of the increase was accounted for by higher energy and food costs. Incomes also rose, though they were flat after being adjusted for inflation. If prices keep rising, a worry is that consumers will reduce spending for discretionary items, dampening economic growth.

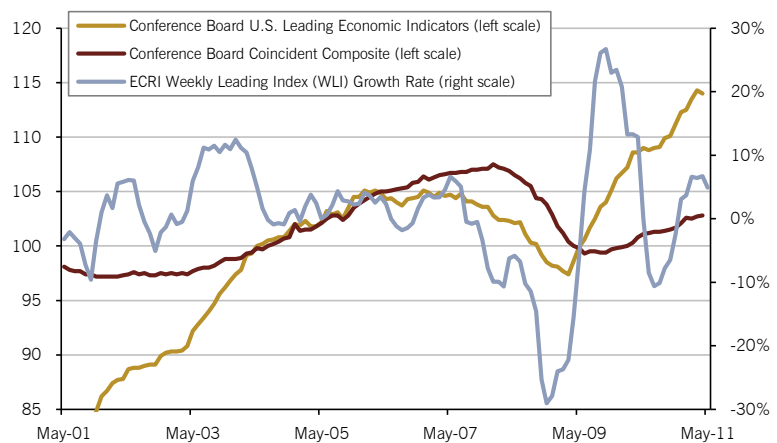
**Advantage: Neutral**



**LEI AND ECRI**

Led by a pick-up in jobless claims, the U.S. index of leading economic indicators (LEI) slipped in April after nine months of strong gains. Many economists expect the recent slowdown to be temporary and that growth will continue throughout the summer, though it may be slow and choppy.

**Advantage: Neutral to Bullish**



**ISM MANUFACTURING INDEX**

The ISM report is a national survey of purchasing managers covering numerous metrics. A reading over 50 indicates expansion relative to the prior month, while a reading under 50 indicates contraction. While the latest reading was still expansionary, the pace of growth slowed dramatically to the lowest level since September 2009 as costs have climbed.

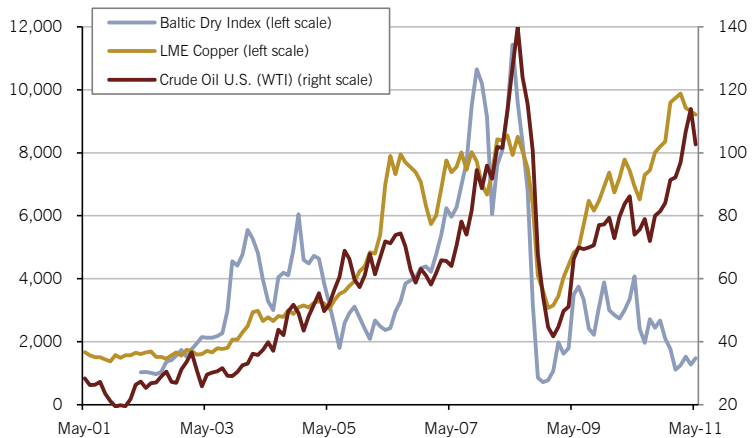
**Advantage: Neutral to Bullish**



**BALTIC DRY INDEX & COMMODITIES**

The Baltic Dry Index (BDI) measures shipping costs for commodities and is used to evaluate world trade. Copper, which is used in construction and manufacturing, can reflect trends in global economic growth. During the recovery there has been a huge divergence between the BDI and the price of commodities. The question is whether it reflects a simple oversupply of ships or a troublesome combination of a slow economy and market speculation.

**Advantage: Neutral**



**RETAIL SALES**

Retail sales figures are an indicator of economic recovery. Higher gas prices cut into sales at U.S. retailers in May, as consumers became a bit cautious and put off some purchases.

**Advantage: Neutral**

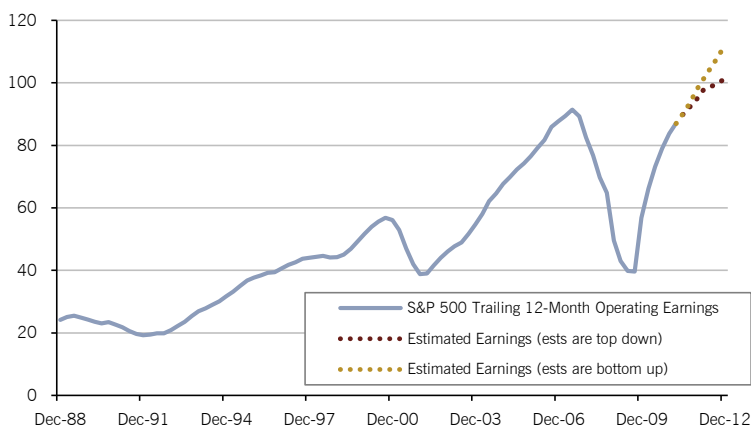


## U.S. CORPORATIONS

### 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 may taper off as year-over-year comparisons to 2010 become more difficult.

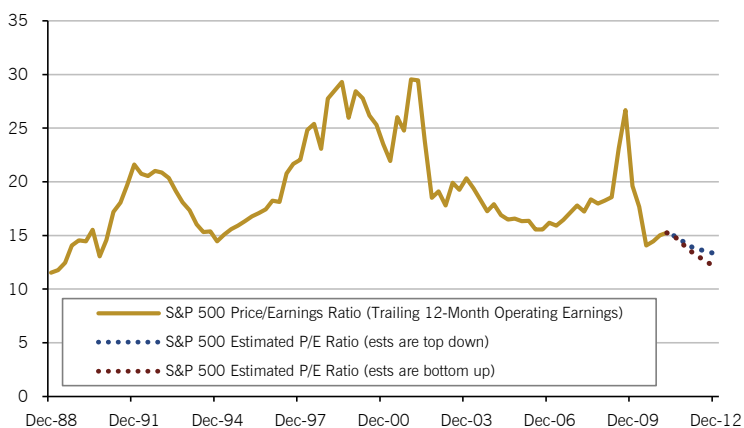
**Advantage: Neutral to Bullish**



### STOCK MARKET VALUATIONS

Earnings growth over the past year has helped trailing 12-month P/E valuations look reasonable (slightly below historical norms). 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).

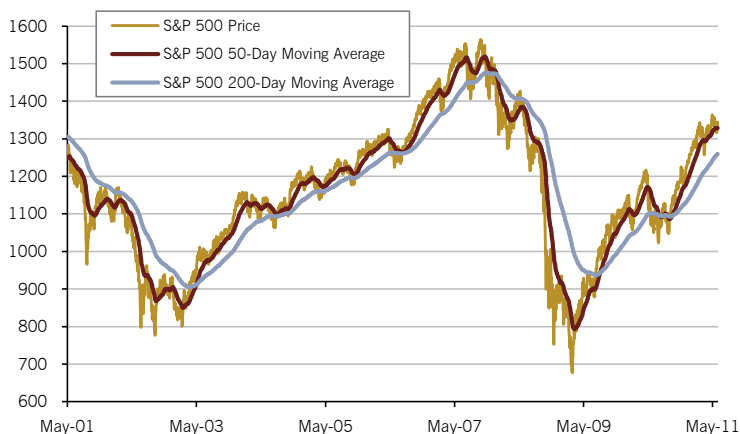
**Advantage: Neutral to Bullish**



### 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: Bullish**

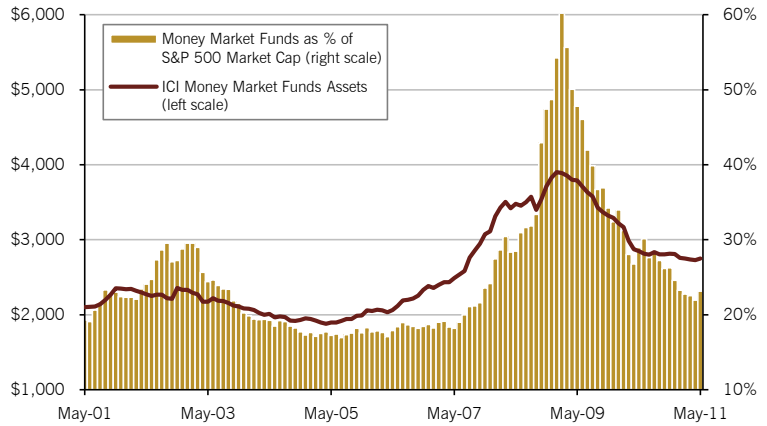


## INVESTOR FLOWS AND LIQUIDITY

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

Money market fund assets crept higher for the first time in six months as the S&P 500 posted its only negative month so far this year. Still, investors have plenty of dry powder on the sideline, particularly as a percentage of stock market assets.

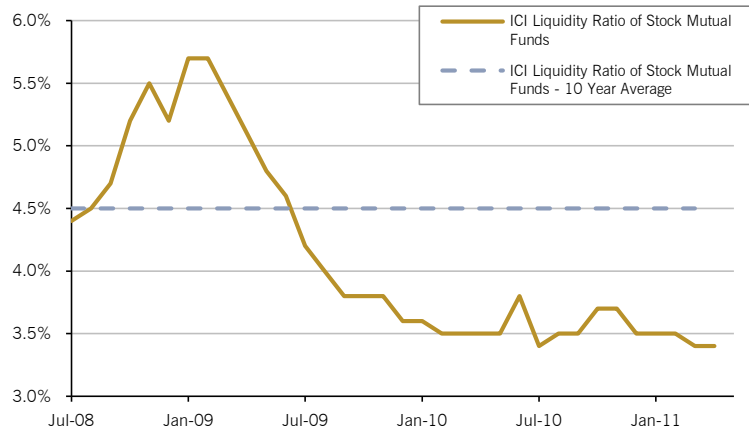
**Advantage: Neutral to Bullish**



### 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 significant 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).

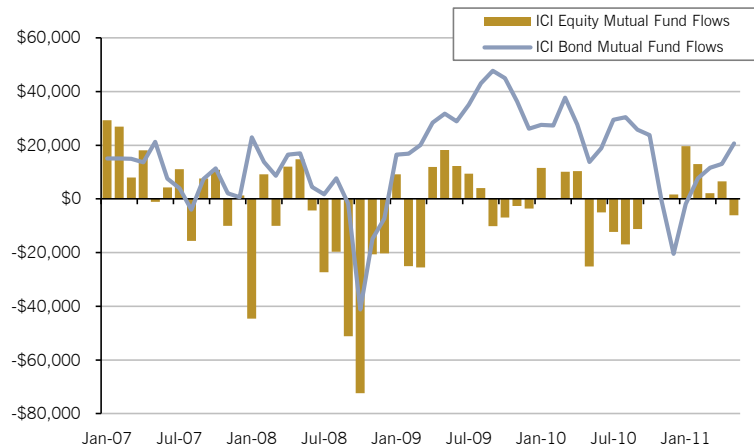
**Advantage: Bearish**



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

After expressing interest in stocks at the beginning of the year, investors have been turning away from equities in favor of bonds. For the fourth consecutive month, bond funds saw positive inflows in May while stock funds experienced net outflows for the first time in six months.

**Advantage: Neutral**

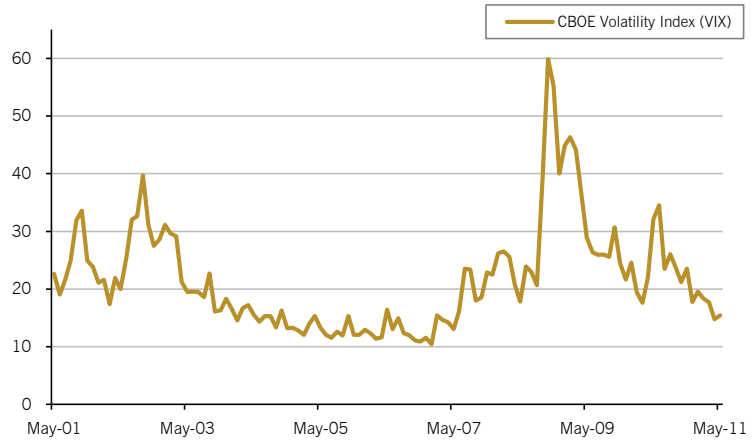


## FEAR MEASURES

### STOCK MARKET VOLATILITY

Despite falling equity markets, volatility as measured by the Chicago Board Options Exchange Volatility Index (VIX) ended May only slightly higher than April at 15.5, still near the lowest levels 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 times in the markets.

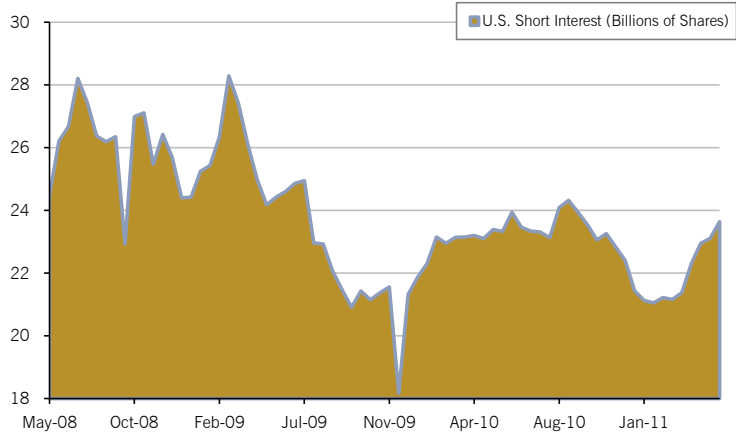
**Advantage: Neutral to Bullish**



### 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 May, but has stayed within a relatively narrow band over the past year.

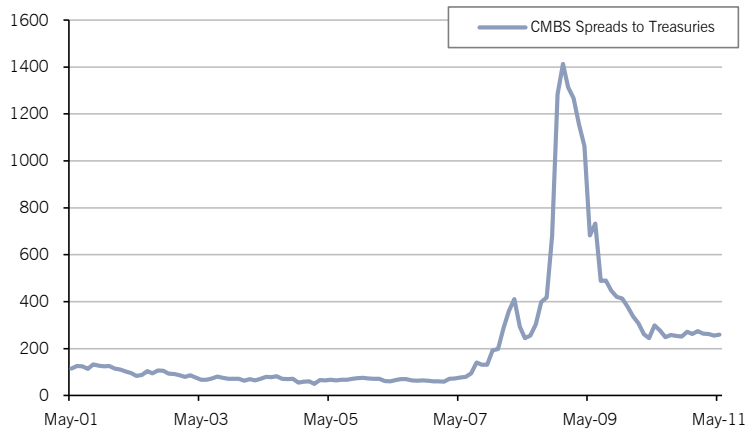
**Advantage: Neutral**



### 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.

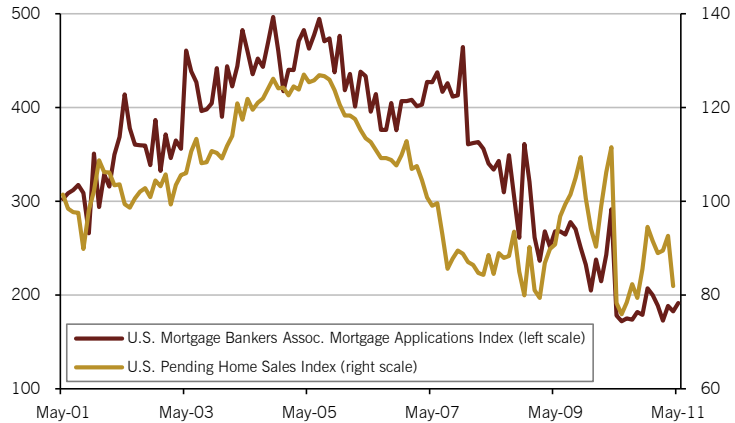
**Advantage: Neutral**



**MORTGAGE APPLICATIONS AND PENDING HOME SALES**

Pending home sales plunged to a seven-month low in April, a blow to the housing market recovery caused in part by continued high unemployment and rising gasoline prices. Making matters worse, lending standards remain tight and the housing market is still hindered a glut of inventory.

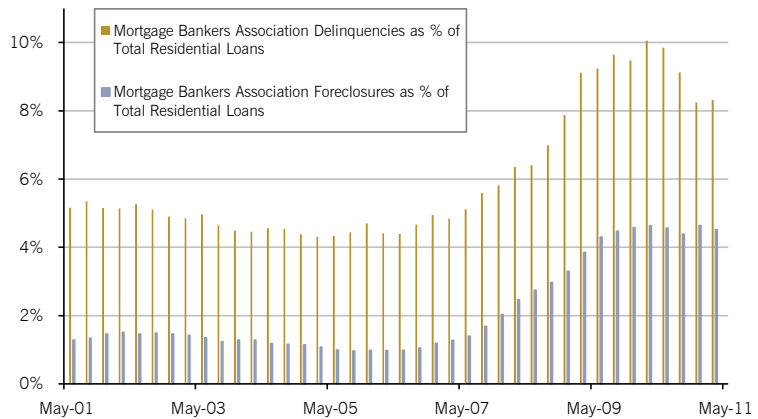
**Advantage: Bearish**



**RESIDENTIAL DELINQUENCIES AND DEFAULTS**

Mortgage delinquencies and foreclosures appear to have reached a plateau at relatively high levels. Unfortunately they could get worse as a large amount of mortgages set to mature in the next few years might not get refinanced.

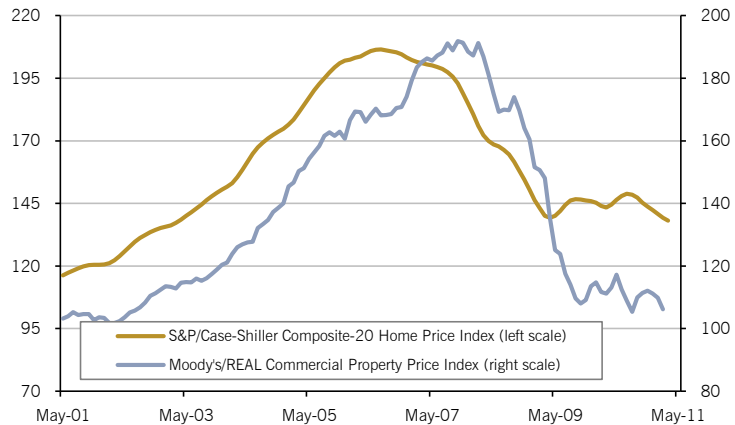
**Advantage: Bearish**



**RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES**

Residential home values have dropped to the lowest level since 2003, according to the Case-Shiller 20-city index of home prices. Tight lending conditions, high unemployment, and a backlog of foreclosures continues to provide downward pressure on prices.

**Advantage: Bearish**

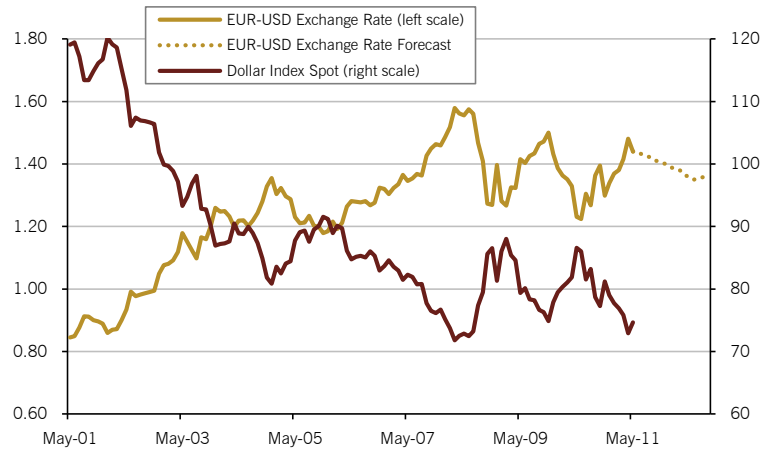


## CURRENCY

### U.S. DOLLAR

The U.S. dollar rose modestly in May amid concerns about a possible debt default in Greece. Still, worries about slower U.S. economic growth and the debt burden are expected to hinder the dollar going forward.

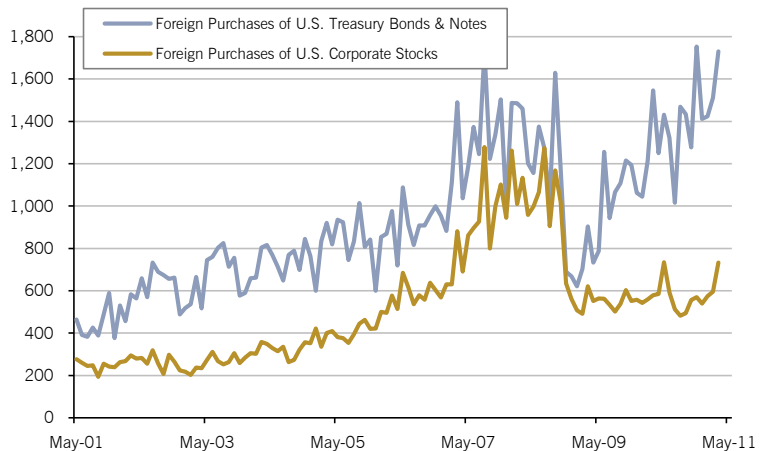
**Advantage: Neutral**



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

While global demand for U.S. securities was higher in March, there was a shift from long-term securities to shorter-dated assets as purchasers want less interest rate risk. A longer-term worry is that high government debt levels could cause foreign buyers such as China to either demand higher U.S. interest rates or stop buying Treasuries altogether.

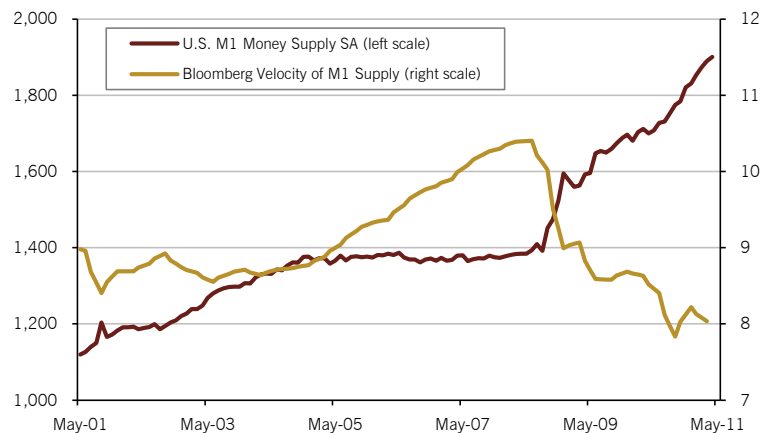
**Advantage: Neutral**



### 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 inflation and U.S. 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**

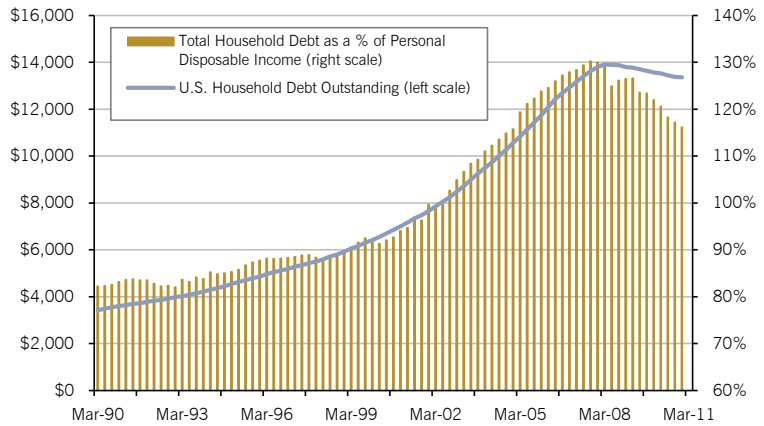


## BORROWING

### 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.

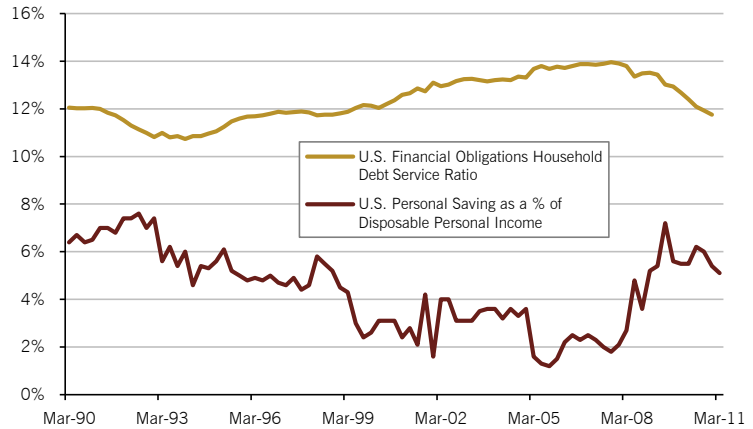
**Advantage: Neutral to Bearish**



### 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.

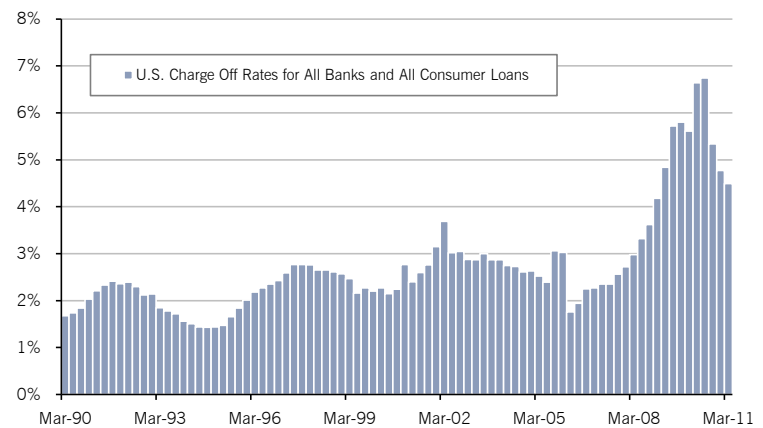
**Advantage: Neutral to Bearish**



### 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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