Dear Client: May 31, 2012

Spring 2012 Update

With Memorial Day now behind us, I am sure you are all looking forward to a fun-filled summer enjoying friends and family. Unfortunately this letter arrives to you in the midst of an equity market correction, coupled with continued problems in Europe, specifically Greece. This uncertainty abroad has lead investors to a flight for safety, resulting in a robust Treasury market rally where the yield on the 10-year was driven below 1.7%. While the possibility of a Euro Crisis is placing downward pressure on the European and American economies, there is still much to be optimistic about in the U.S. economy. Therefore our recommendation, as it was in our last communication, is to "proceed with caution, but proceed."

Concern over Europe is nothing new this decade. However, there are recent developments we would like to address.

Increased discussion on the possibility of a Greek exit from the Euro prompted *The Economist* in its May 19th issue to outline the direct consequences of such an exit:

1) Leaving Greece without notes or coins
2) Amassing of debt to the EU of over €290 billion
3) Devaluation of the Greek Drachma resulting in hyperinflation

The surrounding chaos would paralyze the Greek economy for years to come. And the most serious risk of all would be the contagion effect on the remaining marginal countries (Portugal, Italy, Ireland, and Spain). Adding to the complexity of the problem, recent elections in France saw a new socialist government elected, creating even more uncertainty. What we can be certain of (and what was also evident in 1992 to the founders of the Maastricht treaty) is that the Euro Zone must be more politically integrated or succumb to the risk of falling apart!

If the Euro Zone does indeed fracture, this will cause significant problems not only in Europe, but also at home. Direct effects on the U.S. of a Euro Crisis (as outlined by Mark Zandi, Chief Economist at Moody's Analytics) will include but are not limited to:

1) Sharp equity market decline.
2) Tightening of the global credit market, making it more difficult for U.S. companies to borrow; causing even slower growth of the U.S. economy.

3) Decline in imports to Europe combined with a slump in European tourism and investment to the U.S.

It is hard to see how the global economy could escape the Euro Crisis without much pain.

In spite of problems in Europe, economic conditions in the U.S. are improving. Liz Ann Sonders (Chief Investment Strategist at Charles Schwab) described the recent market pullback as a "garden variety" equity market correction and not overly concerning. If Greece and Germany can solve their problems (as Mr. Zandi believes they will) there is good reason to be optimistic. This has been a consistent theme at a number of economic symposiums that we have attended in recent weeks, hosted by well-respected market economists and strategists. We would like to share with you a synopsis of the encouraging themes from these discussions:

- The U.S. economy continues to recover and show signs of resilience to the aforementioned stress.
- While not a "V" shaped recovery, GDP will likely continue to grow at 2-3%.
- EU exports represent only 2% of GDP and 20% of total exports.
- A Manufacturing renaissance is currently taking place in the US.
  - Manufacturing hours are at historic highs.
  - Manufacturing represents 15% of GDP – well above average.
  - The cost of outsourced manufacturing abroad is rising as labor and transportation costs increase. This increases the attractiveness of producing goods within the US.
- We are in our 12th consecutive quarter of positive GDP growth.
- Housing and Labor are improving albeit never fast enough.
  - Over 2 million jobs were created last year in the U.S.
  - Housing prices are now rising
    - Personal consumption (a major driver of the U.S. economy) will strongly benefit from improvements in housing and employment.

Even with these optimistic headlines, there are still lingering concerns at home that may cause turmoil in the markets:

- U.S. debt level – currently greater than of 90% of GDP
- Increasing government spending
- Looming inflation
- Entitlement reform
- Obamacare
- November elections

While the U.S. economic outlook appears positive, there are still clear risks that could cause trouble for the world economy. We are certain our disciplined approach to diversification and rebalancing of portfolios will continue to serve us well throughout this uncertain time.

Please do not hesitate to contact us should you have any questions or require any additional information.

Best Personal Regards,

Locust Capital Management, LLC