VERITY Asset Management

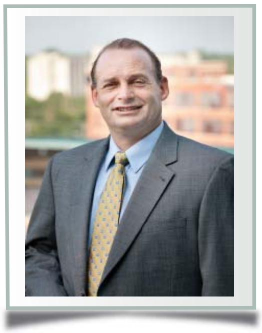
Market Commentary and Outlook

MAR. 31, 2012

CORE ALLOCATION

INDEPENDENT ADVICE ACTIVE MANAGEMENT

More of the Same or Something Different



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In some respects it seems we've come full circle. Little more than three years past the depths of the financial crisis, a glance at the charts of any of the broad stock market indices shows nothing other than upturns solidly in place.

A seemingly overwhelming consensus of financial "talking heads" continually trumpets the view that the U.S. stock market should be the hands down global market of choice for investors seeking value and potential growth. Many of the same experts also espouse the view that the U.S. dollar will be the logically strong currency of the developed world. Apparently, it is a fine time to be a participant in U.S. markets, unless of course your participation consists of attempting to find a job or sell a house.

Target Allocation by Asset Class / Strategy

57.0%	Equities - Domestic & Foreign
19.5%	Gold, Energy & Commodity Related
5.0%	Merger Arbitrage
7.5%	Equities - Short (Leveraged 200%)
6.0%	Bonds - Foreign
5.0%	Cash

So, given this backdrop, what was especially notable in the 1st quarter of 2012?

- Retail investors seem to believe none of the above. Outflows from mutual funds invested in stocks continued, with money moving to the "safety" of bonds. This may actually be quite supportive for the continuation of the bull market as it has been demonstrated that average investors frequently enter and exit the market at the wrong time. However, the continuing decline of overall volume in daily stock trading is quite significant and seems to suggest that many former market participants have moved permanently to the sidelines. The likely result -- although the 1st quarter has seen a dramatic decline in volatility -- is that we probably have a relatively short wait until volatility spikes again.

- The U.S. dollar, the new darling of many, actually failed to increase in value in the 1st quarter compared to any major currency with the exception of the Japanese yen. Declines for the greenback ranged from about 3% vs. the Euro and the British pound to over 4% vs. the Swiss franc and as much as a whopping 9% vs. the Mexican peso. So the very impressive 1st quarter stock market rally was consistent with most other strong periods over recent years - it coincided with a generally declining dollar, economic recovery slogging along at best, and incredibly accommodative central bank policy continuing to "grease the skids" with liquidity. In fact, in addition to the Federal Reserve's "operation twist" and artificially low short term interest rate policy, the European Central Bank pumped about $1 trillion into the global financial system, just as the Bank of Japan decided to also have a liquidity party of its own.

That brings us to the ***most*** notable global economic and market event of the 1st quarter:

- Call it what you will, the unavoidable fact is that a developed nation, Greece, essentially defaulted on its sovereign debt. And all indications are that the crisis in no way ended with Greece's disaster. While debate continues over the relative severity of the debt problems of numerous developed nations, there is little argument that any significant upward movement in interest rates will immediately make the debt woes afflicting Japan, England, the U.S. and even the stronger eurozone nations much more severe.

Of course the troubles in Greece were so structurally severe and apparent (literally decades in the making), one would assume that the markets gave great forewarning. Well -- not exactly -- and here's where things begin to get a bit uncomfortable.

- In January 2007, Greek 10 year notes were yielding 4.2%. More than two years later, September 2009, they were still yielding only 4.5%. However, by May 2010, they were yielding over 12% on the way to a high yield last month of 37%.

- In January 2007, Portuguese 10 year notes were yielding 4%. Three years later, in January 2010, they were still yielding just 4.2%. By July 2011, they were up to over 13%.

- In January 2006, Irish 10 year notes were yielding 4%. More than 4 years later, March 2010, they were still yielding just 4.5%. By July 2011 -- 14%.

In each case, the markets virtually ignored the severity of the massive debt burdens that had been building for years -- until they didn't. Once the markets began to pay attention, the rapidity of the adjustment and the severity of the repudiation of each country's fiscal soundness was breathtaking.

So, taking another look, what was perhaps really most notable in the domestic markets in the 1st quarter?

- U.S. 10 year Treasury yields went from 1.87% to a high of 2.39%, before closing the quarter at 2.22%. No matter the absolute rate, that's quite a move, especially when the Fed was actively buying longer dated Treasuries and the dollar was moving lower, and all of that money from retail investors was still moving into bonds -- all factors that would normally suggest lower yields. The rate rise could simply be a response to a whiff of inflation, but ...

The ultimate takeaway is obvious and unnerving: The U.S., among others, has an undeniable structural debt problem. Rising interest rates, whether triggered by higher inflation (which our Fed appears to be trying to create) or merely by a more rapidly expanding economy, would make the problem significantly worse. Alternatively, an intensified focus on concerns with the debt problem could cause market forces to drive interest rates higher, yielding the same negative effect. And if rates don't continue to move higher just yet, might we simply be experiencing what occurred in Greece, Portugal and Ireland from 2007 to mid 2010 -- which at some later date, maybe sooner than we expect, could be followed by a dramatic and potentially devastating interest rate spike?

At present, we continue to diversify very selectively while placing our focus on longer term investments in areas that have attractive risk/reward characteristics, taking into primary consideration that in this environment the most significant risks are those for which the consequences may only be fully apparent mere moments before they explode onto the investment landscape.

We have outlined in previous Market Commentaries the primary investment themes we are currently pursuing. We encourage you to review recent editions, particularly the June 20, 2011 edition, which may be found on our website at http://verityinvest.com/investment_management/commentary. Please feel free to contact us for more detailed information and insight into our process and our current thinking about market risks and opportunities.