



Sound of the Economy

NORRIS, PERNÉ & FRENCH LLP

Investment Counsel

Established 1933



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Introduction

It was a West Michigan winter we thought might never end. But the miracle of the seasons continues intact, and from our offices, we look out on Pearl Street and see signs of summer where there was only white just months ago.

It was this time last year that the combination of Greece's request for an IMF/EU bailout, the "Flash Crash", and a series of weaker than expected economic data served as the catalyst for the market to begin a growth scare that caused a 15 percent world stock market decline that lasted from April to August. Of course, the market bounced back and by April 2011 stock prices reached highs last seen in the summer of 2008.

Now a year later, after four season changes, has anything changed? Worries about Greece's debt have again dominated headlines and economic growth is weaker than expected. Last year there were concerns about the curtailing of the Fed's monetary easing, the first quantitative easing (QE1), and today there are concerns about economic growth post QE2. At times like these (actually we've never had such times as these, just as we've never had a future just like the past) it is fairly easy to talk oneself into an overly negative position.

Homer's Odyssey is the epic tale of the Greek hero Odysseus and his long struggle to return home after the Greeks' conquest of the Trojans. Odysseus endures many trials along the way home. One occurs when his ship passes by the Island of the Sirens. The Sirens send out cries that are so haunting that all who hear want to stay forever and are thus trapped. Odysseus' men have to lash him to the mast of his ship so they can pass safely by.

Over the last couple of weeks the Sirens' cries of the markets have obscured better than expected first quarter corporate earnings and improving (albeit) sluggish economic growth. While the market attempts to digest today's headlines, we remain focused on our core stock tenants and the individual businesses that we own for our clients.

We remain confident in the power of capitalism and the U.S. economy. We believe the economy will continue to gradually improve, transitioning from recovery to expansion. The second half of this year and next year should be one of growth for the economy and stocks, but it is hardly the beginning of a period of above-average growth and prosperity. We look to the fundamental strengths of the companies in which we invest to pull us through and keep us off the rocks by the Island of the Sirens.

First Quarter Real GDP

The U.S. economy grew at a slower than expected pace in the first quarter as the consumer limited purchases, home construction fell and government spending declined. Real GDP increased at an annual rate of 1.8 percent in the quarter (that is, from the fourth quarter to first quarter), according to the "second" estimate released by the Bureau of Economic Analysis. Economists had projected 2 percent growth for the first quarter. In the fourth quarter, real GDP increased 3.1 percent.

Higher gas and grocery prices prompted U.S. consumers to limit spending after they ramped up purchases in the last three months of 2010. Consumer spending, which accounts for more than two-thirds of U.S. economic activity, expanded at a much slower 2.2 percent rate, down from 4.0 percent in the fourth quarter 2010. The personal consumption expenditures index rose 3.8 percent in the first quarter as compared to 1.7 percent in the fourth quarter.

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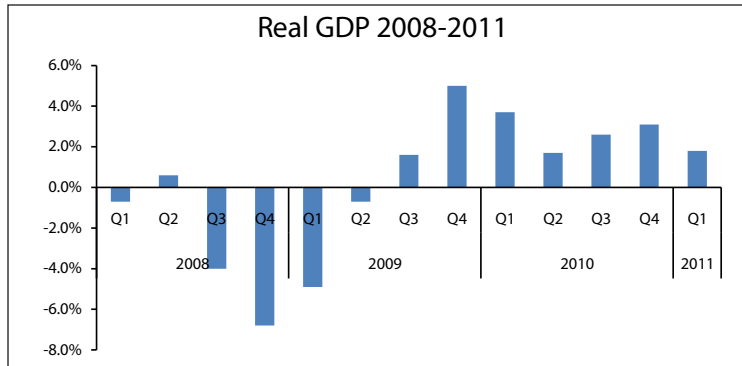
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Fourth Quarter Real GDP Cont.

The weak first quarter performance was a setback to an economy still struggling to shake off the worst recession in a generation. The recent economic data is showing the economic recovery is both sluggish and slowing, with unemployment stubbornly high. This is consistent with recoveries after a financial crisis like the 1973 oil shock, the late 80's S&L crisis and the bursting of the Japanese stock and property bubble.



Housing

U.S. single family home prices dropped in March, dipping below their 2009 low, as the housing market remained bogged down by inventory and weak demand. In the first quarter, the S&P/Case-Shiller composite index fell 4.2 percent, compared to a decline of 3.6 percent in the fourth quarter of 2010.

Nationally, home prices are back to their mid-2002 levels. The median price in March fell to \$159,600, down nearly 6 percent from a year earlier. Housing prices have now declined for 57 consecutive months. Zillow's chief economist believes prices won't hit bottom before next year and expects they will fall by another 7 to 9 percent.

Housing remains troubled and the existing market woes continue to ripple into the new home sector. Builders are having trouble competing with existing inventory, particularly rock bottom prices on distressed deals. During the month of March, existing home sales increased 3.7 percent, the highest in two years. Distressed sales accounted for 40 percent of all sales in March.

During periods of economic recovery, housing tends to take off boosting construction and many categories of spending that go with an improving housing market. But consumers are still deleveraging and concerned about jobs and are in no condition to spark a vigorous recovery. With the lack of bank lending and consumer spending, and housing so weak, there is not much to propel a recovery.

It takes a lot of confidence to buy a house. There needs to be an improvement in the job market to see an improvement in the housing market.

Unemployment

The unemployment rate increased to 9.1% in May as the U.S. gained only 54,000 jobs. Economists' consensus estimates were for 170,000 jobs and an unemployment rate of 8.9 percent.

Currently there are 13.9 million unemployed U.S. workers. The percentage of those who have been without work for longer than six months increased by 361,000 to 6.2 million or 45.1 percent. The opportunities for the long-term unemployed are limited as the longer these people remain out of work, the more difficult it will be for them to get jobs.

In addition to the unemployed, there are 8.5 million part-time workers and 2.2 million people not counted because they hadn't looked for a job in the prior four weeks. If laid-off workers who have given up looking for new jobs or have settled for part time work were included in the calculation, the unemployment rate ("underemployed rate") would jump to 15.8 percent.

The Wall Street Journal reported that a survey of 54 economists expect the economy to add about 2.2 million jobs over the next twelve months. This forecast is down from last month's forecast of 2.5 million jobs. Such a slow rate of job growth would bring the unemployment rate down very slowly. On average, economists forecast an unemployment rate of 8.2 percent in June 2012 and 7.9 percent in December 2012.

Current economic policies are not encouraging job growth. They are creating an environment of uncertainty and hampering job growth. Business owners are reluctant to hire when the message is more taxes, more regulation, and more intrusion in the free market system. There needs to be an environment where businesses can flourish and start hiring again, and that will be the start of robust economic growth for the country.

Although numerous federal stimulus programs have failed to create job growth, we are confident in the strength of the private sector to create jobs. Non-financial companies are in good shape and cash on corporate balance sheets are at all time highs. Corporations are finding it increasingly difficult to squeeze additional productivity out of their employees and will have to increase hiring to generate profitable growth.

Inflation

The price index for GDP purchases, which measures prices paid by U.S. residents, increased 3.8 percent in the first quarter and 2.1 percent in the fourth quarter. Excluding food and energy, the index for GDP purchases increased 2.2 percent in the first quarter, compared with an increase of 1.1 percent in the fourth quarter.

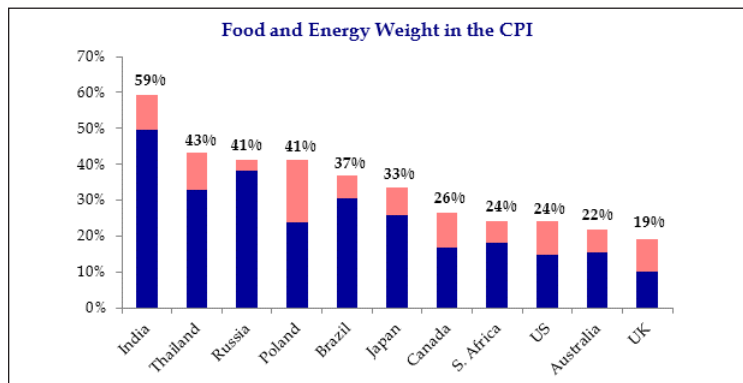
Michigan vacationers are seeing lower prices at the pump but will still pay more for gasoline than they did during last year's vacation. AAA Michigan reports that gasoline prices are down 16 cents per gallon over the past week to a statewide average of \$3.72. The statewide average is about \$0.92 per gallon higher than a year ago.

Although consumers have seen gasoline prices rise 40% in the last year and food prices increase at the grocery store, the Consumer Price Index (CPI) is showing an increase of only 3.6 percent year-over-year.

Part of the reason for the dichotomy between the prices consumers paid and the official measure of inflation is how the government calculates CPI. The housing component of CPI represents approximately 41% of the Index. A major portion of the housing component is "owner's equivalent rent", a calculation that estimates the rental cost alternative to actual home ownership. As one would expect, given the dismal housing market, the housing component of CPI has had a restraining effect on reported inflation.

The higher prices that consumers see at the pump and at the grocery store are a small portion of the CPI calculation. Gasoline is 5% and meats, poultry, fish, eggs, cereals and bakery products combined equal less than 3 percent of CPI.

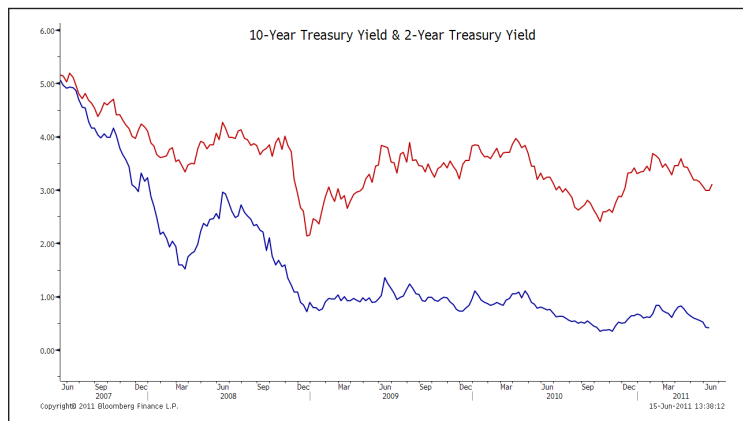
In developing countries, food is a large component of daily expenses for consumers. Rising commodity prices have more adversely affected developing countries than the developed economies.



We are cognizant of the risk of increased inflation expectations from massive government spending. Currently the deflationary forces exerted by relatively high unemployment and a weak housing market have overshadowed expectations for inflation. Regardless of the official CPI calculated rate of inflation, prices paid by consumers are rising in the US and globally.

Fixed Income

Bonds have performed better than many investors anticipated during the past few months as the economy has cooled off and commodity prices have started to fall. Investors have turned more cautious during the past two months causing the bond market to rally and the stock market to consolidate.



The Treasury yield curve came down across all maturities as the Greek debt debacle resurfaced and sluggish economic growth resulted in a flight to quality that drove Treasury yields lower. The 2-Year and 10-Year Treasury yields have declined to 0.45 percent and 3.11 percent, respectively, over the past three months.

The difference in yield between the 2-Year and 10-Year Treasury yield measures the steepness of the yield curve. A normal (positive) yield curve occurs when longer-term rates are higher than shorter term rates. The opposite holds for an inverted yield curve.

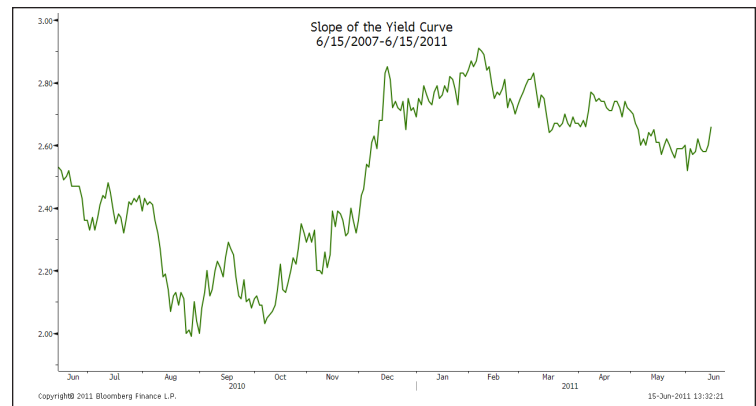
Currently, the yield curve has a positive slope and is at a historically steep level.

Last fall, the markets began to anticipate a better economy in 2011 and bonds prices sold off despite the Fed's decision to embark on another round of quantitative easing. The yield curve steepened from its flattest point of 195 bps in August to reach a steepness of 270 bps at year end 2010.

During the first few months of 2011, the yield curve experienced a lot of volatility only to settle almost where it started. The yield curve began March with a steepness of about 275 bps. In April, increased

risk aversion and weaker domestic economic reports renewed the flight to quality, sending rates lower and flattening the curve slightly. The yield curve remains steep at 266 bps.

Historically, yield curves have correctly forecasted the future direction of the economy. An inverted yield (negative) curve indicated difficult economic times or a recession lying ahead while a positive sloped yield curve indicated future economic growth and prosperity.



Rates will move up and down on medium and longer term bonds but we still expect the Fed to keep short term rates low in 2011. We would not be shocked to see the 10-Year Treasury rise toward the 4 percent range later this year.

On the Fed Funds side, the futures market is currently pricing in a high probability of a rate hike to 50 basis points before June of next year and a rate of 1 percent by September of next year.

In the municipal bond market things are looking better. Earlier this year, investors were attracted to the high yields in a historically safe sector moving prices higher relative to the investment grade taxable bond sector. The Barclay's 5-Year Municipal bond Index had a total return of 3.1 percent through May 31st as compared to a 2.6 percent return for the Barclay's Intermediate Government/Credit Bond Index.

There have been numerous articles and stories discussing the substantial fiscal issues facing states, counties, cities, etc. As is often the case, the "market" has tended to "throw the baby out with the bathwater". By analyzing and selecting high-quality credits with a focus on general obligation and essential service revenue bonds, there are opportunities to buy attractive tax-equivalent yields with a high degree of safety. As always, our focus begins and ends with credit quality.

Stocks

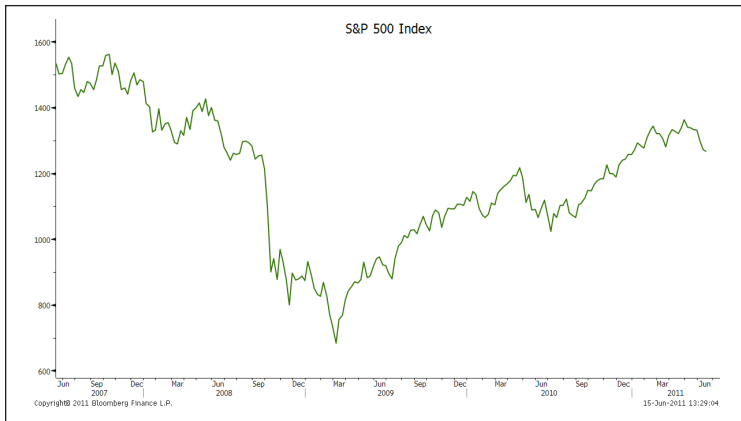
May was a tumultuous month for stocks and the volatility has continued into June. The lowering of stock prices since late April has taken a toll on investors' psychology. By some measures bearishness is at its highest level since late in the 2007-2009 bear market. Worries about a new bear market have induced a shift away from stocks and back toward the perceived safety of bonds.

Over the last two weeks, a technical analyst from Strategas described the technical data as oversold, but not yet capitulative. That's beginning to change as more and more indicators trade into ranges not observed since the depths of the financial crisis. The CBOE Equity Put/Call Ratio, for example, is now at its highest level since January 2009 (it hit 1.02 at the June 10 close). These sentiment measures are often regarded as contrarian indicators. That is, stocks

Stocks Cont.

generally decline when investors are most bullish and stocks rise when investors are most bearish. As legendary investor Warren Buffett is famous for saying “Be fearful when others are greedy, and be greedy when others are fearful”.

As discussed in our previous letter, we were expecting a decline in stock prices sometime this past quarter. This expectation became reality with a retrenchment of approximately 7% in mid-March only to be followed by renewed strength through the end of the month. May saw continued volatility, ending the month down a little more than 1% on the S&P 500. The market decline has continued into June with the S&P 500 down almost 4 percent thru June 15th.



Our colleagues at Fidelity have shared some enlightening research with us regarding the current stock market condition. The average

frequency of stock market corrections: 5% three times per year, 10% once per year and 20% once every 3.5 years. The market (S&P 500) is (only) 7 percent off its recent peak. Can we go down further? Yes, but big corrections (>12%) are normally associated with recessions or markets that are over valued.

Recent economic sluggishness aside, we expect economic growth to continue past the tepid 1.8 percent growth of the first quarter. There is no recession in the near term forecast. The domestic stock market remains anything but expensive and has an attractive valuation relative to the bond market. P/E ratios for the broad stock market are reasonable, earnings are growing, investor sentiment is signaling a bottom for prices and the VIX Index (stock volatility index) is relatively low as compared to last summer. Furthermore, domestic corporations have accumulated record amounts of cash (~\$1 trillion) which should continue to support mergers and acquisitions and higher dividends in the coming quarters.

Conclusion

We expect the “Fed induced” recovery to continue at a muddled pace through the second half of the year and into 2012. All in all, the domestic stock market remains anything but expensive and currently offers better relative value than the bond market. Things are looking better in the municipal bond market and we continue to find attractive opportunities for our bond portfolios.

As fishermen say to wish someone good luck, we offer you “tight lines” – good luck- for a wonderful, healthy and prosperous summer, one where you get to pursue your passions with family and friends. We will keep your lines off the rocks by the Island of the Sirens.

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