

AN ECONOMIC AND MARKET COMMENTARY

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"A man in the prime of his life is lying on an operating table, bleeding from open wounds. A team of surgeons is busily clipping his toenails." Surprisingly, this paragraph was not written within the last few months or weeks as a commentary to our politicians' squabbling over the budget deficit, coincident with their inability to increase the debt ceiling comfortably ahead of the August 2nd deadline. This quote comes from *Bankruptcy 1995: The Coming Collapse of America and How to Stop It*, a fascinating book written in 1992 by Harry E. Figgie, Jr. and Gerald J. Swanson, Ph.D. Even more to the point, Harry Figgie identified one specific problem as the biggest threat to the future of the United States: *"The problem, which is of our own making, will precipitate an economic nightmare that will dwarf the Great Depression and turn the story of America into one of history's closed chapters. This problem has a name. It is "government debt."*

My colleague Joe Oricoli found the book recently in his extensive library and, after rereading it in a few hours, slipped it onto my desk. Despite the book spending more than nine months on the *New York Times Bestseller List* after its release, many of the contemporary reviewers thought of it as being too catastrophic and pessimistic in its evaluation of politicians' willingness to make the necessary decisions that would limit growth, and ultimately eliminate government debt. The predictions are dire, catastrophic, and frightening, and unfortunately apply directly to our present economic situation and political discussions. This book should be a required reading for all elected politicians. One would hope that after reading this book, they might stop playing their high stakes game of political chicken and get back to working for their constituents.

The second quarter of 2011 was another quarter of endless political squabbling in the U.S., and a number of global events continuing to negatively affect equity markets. Despite these challenges, global economic growth remained largely on track, supporting solid earnings results and cautiously positive expectations from the majority of publicly-

traded companies. After a strong April, equity markets declined in May and June, finishing the quarter in a positive territory only after an incredible four-day run-up at the end of June.

The S&P Index increased 2.96% in April, declined 1.13% in May, and after declining 5.84% by June 15th, recovered to end the month at -1.67%, finishing the quarter with a gain of 0.10%. The Russell 1000 Growth mirrored the S&P 500 Index pattern, increasing 3.35% in April, then declining 1.09% in May, and declining 1.43% in June, ending the quarter with a 0.76% gain. The Russell Top 200 Growth Index ended the quarter with a 0.42% gain, after a 3.24% gain in April, 1.39% decline in May, and 1.36% drop in June.

Only half of the S&P 500 sectors had positive returns during the quarter. The best performing sectors were those considered to be defensive sectors: Health Care (7.87%), followed by Utilities (6.14%) and Consumer Staples (5.25%). The worst performing sectors were Financials (-5.92%), Energy (-4.63%) and Information Technology (-1.37%).

The FEAM50 Large-Cap Growth Equity investment strategy is focused on the selection of 50 stocks without regard to sector or industry weights, so exposure to particular sectors is driven entirely by the individual stock selection. Because of my belief that the selected stocks have a similar probability of price appreciation in the future, the FEAM50 portfolios are initially equally weighted and periodically rebalanced. There were significant changes among the portfolio holdings during the quarter. As a result of these changes, Information Technology maintained its highest weighting at the end of the quarter (followed by Health Care, Industrials and Consumer Discretionary, with no stocks present in the Consumer Staples, Energy or Utilities sectors). In addition, the FEAM50 strategy continued its zero exposure to U.S. financial companies, adding non-U.S. banks and personal credit related companies. Both Visa and MasterCard were added to the equity portfolios, but both companies are classified under GICS (Global Industry Classification Standard) as belonging to the Information Technology sector.

First Empire Asset Management's FEAM50 Large-Cap Growth Equity strategy finished the quarter with a 1.74% return (gross of fees; 1.50% net of fees). The primary driver of FEAM50's performance during this period of time was sector exposure, and was

hurt by lack of exposure to the volatile Energy Sector that was by far the best-performing sector during the quarter.

The three largest sectors represented at the end of the quarter were Information Technology (38.64%), Industrials (19.53%), and Healthcare (15.48%). The best-performing sectors during the quarter were Telecommunication Services (10.2%), Consumer Discretionary (4.61%), and Healthcare (2.28%). Information Technology (1.83%), Materials (0.65%), and Financials (-1.40%) posted the weakest returns. For more information about performance and attribution analysis of the DIGS, APAs, LEAPS and other investment strategies, please contact First Empire Asset Management directly.

The unexpected and drastic slowdown in economic activity caught pretty much everybody by surprise. It will take some time to really understand what exactly happened to the U.S. and overall global economy. So far the best guess is that the interaction of several simultaneous events had an unexpectedly large effect on overall economic activity.

The earthquake and tsunami, combined with power supply issues in Japan, affected all areas of manufacturing on a scale previously unimagined. While shutdowns and slowdown in manufacturing of car components affected global car manufacturing operations, the significant shortages of a large variety of electronic components caused shortages, and a drastic increase in prices for components ranging from flash memory, DRAM, a variety of micro-controllers and transistors, to LCD panels and parts used for manufacturing LCD panels.

Unrest in the Middle East significantly affected oil prices. Many economists and financial media spent a significant amount of time arguing about the precise threshold beyond which U.S. consumers' start using less gasoline and curtail driving. In the meantime, consumers were affected not only by high gasoline prices, but also rapidly increasing food prices. The Consumer Price Index for April increased (from a year earlier) by 3.2% in April and 3.6% in May, the

For more information...

about our investment advisory services, please contact Jennifer Vernier at 631-630-2500, email jvernier@1empiream.com or write to First Empire Asset Management, 100 Motor Parkway, 2nd Floor, Hauppauge, New York, 11788.

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largest 12-month period increases since October 2008 (See Figure 1). Despite some increases in core inflation, nobody expected the Federal Reserve to take any action. The Federal Open Market Committee (FOMC) raised their forecast of inflation for the year, but expected the inflationary pressures caused by increases in energy and commodities prices to be “transitory,” and continued to keep short-term interest rates near zero.

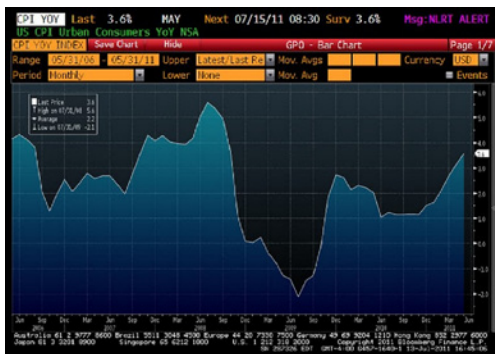


Figure 1 - U.S. CPI Urban Consumers YoY.
Source: Bureau of Labor Statistics, Bloomberg.

A weak U.S. dollar and continuing increase in demand from fast-growing Asian and South American economies kept pushing commodity prices higher, negatively affecting consumer and business sentiment around the world.

With disruptions in global supply chains, combined with spiking energy and commodities prices, another wave of sovereign downgrades, and politicized negotiations about the philosophy and structure of European bailouts, all played a pivotal role in bringing the global markets to its knees. Despite continuing signs of global demand, a lack of any major earnings announcement enabled financial media, together with many investors and economists, to fill the information void with fear of global contagion.

The violent market reaction was likely quite effective in pressuring the Euro zone governments to find a quick, even if a very temporary, solution to saving Greece from a seemingly unavoidable default. The quickly-rising spreads on PIIGS countries’ debt, and rising credit default swap prices, have been forcing European politicians to make tough budgetary decisions. This pressure will likely continue until a more permanent solution is agreed upon. Unlike their European counterparts, U.S. politicians are not

(yet) facing any increases in rates that the Treasury has to pay investors to attract them to the U.S. debt (the flight to quality is still driving investors away from European sovereign debt and towards U.S. Treasuries, despite our politicians’ inability to come to an agreement). The increasingly acrimonious negotiations seem to underscore our politicians’ obsession with scoring political wins, and positioning for next year’s elections, rather than responsible governing. FRB Chairman Ben Bernanke tried to enhance the politicians’ limited understanding of debt limit as balancing a checkbook by comparing their inability to increase the debt limit, to overspending on credit cards and refusing to pay the debt, but the message is taking a very long time to sink in, and forced several of the credit rating agencies to make noises about downgrading U.S. debt ratings.

In this context of global slowdown and political morass, the weaker-than-expected economic indicators affected the markets, especially during May and the first half of June. The expansion of private non-farm payrolls slowed markedly below the pace during the earlier part of the year. Initial claims for unemployment rose, the labor participation rate declined, the average wage stagnated, and the unemployment rate increased during the quarter.

Those who have read some of my prior quarterly commentaries are well aware of my healthy obsession with early economic indicators. During 2008, I have identified a number of indicators that I believed tap into the earliest stages of economic activity. Since then, they had been an excellent tool supporting my investment decision making. Such early economic indicators are particularly useful when there is a change in the pace of economic activity, whether slowdown or acceleration. When most commentators and many investors are focused on coincidental, or even lagging, economic indicators, I believe that equity markets investing should be much more focused on the future. The last time I presented my matrix of early economic indicators was in the third quarter of 2010. At that time, one could easily see the slowdown of the first half of 2010 and subsequent signs of reacceleration (for details see Third Quarter 2010 Review available on our website www.1empiream.com).

During the first half of this year, there was a point where the overall economic indicator pattern began to resemble last year’s second quarter decline. Many economists assumed that we were going to experience a slowdown of a similar magnitude to

2010, with some of the usual extreme permabear suspects once again declaring a double-dip into another recession. Contrary to those pessimistic expectations and weak numbers from many of the lagging indicators (especially those related to employment), the indicators tapping the very early stages of economic activity suggested a moderate and temporary slowdown.

It is quite clear that real estate (whether commercial or residential) is still in the doldrums for the time being (the best estimates of the bottom of residential real estate valuations extend into early 2012). The indicators addressing construction activity unfortunately support this conclusion. The Architecture Billings Index (ABI) is an indicator of commercial construction activity, capturing the nine-to-twelve months lag between architecture billings and actual construction spending. After a relatively consistent increase from its early 2009 bottom, the ABI peaked above the 50 breakeven points at the end of 2010, and declined to its most recent reading of 47.2, indicating once again a decline in demand for design services (See Figure 2).



Figure 2 - The Architecture Billings Index (ABI).
Source: American Institute of Architects, Bloomberg.

The Buildings Permit Index (Figure 3) tracks issuance of building permits in nearly 95% of U.S. localities. After an anemic recovery from its 2009 lows, the index reflected a continuing lack of improvement in private housing construction. This lack of activity was likely influenced by the continuing extreme inventory overhang in the housing markets. Not many economists expect any significant improvement before acceleration in foreclosures and sales of foreclosed houses.

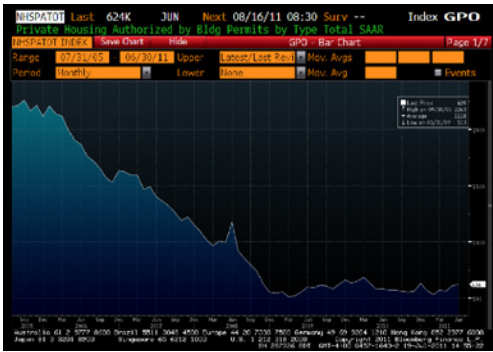


Figure 3 - Buildings Permit Index (Private Housing Authorized by Buildings Permit Index).

Source: U.S. Census Bureau, Bloomberg.

The Baltic Dry Index (Figure 4) provides an assessment of the price of moving raw materials by sea. Because of the Chinese government's efforts to slow their economy and control raw materials and food inflation, it is difficult to interpret the BDI's pattern and understand its current relationship to the global economic growth. If anything, the BDI might currently reflect some success in slowing demand for raw materials from China, but probably not anything more than that.



Figure 4 - The Baltic Dry Index.

Source: Baltic Exchange, Bloomberg.

Unlike the indicators I discussed above, the three indicators most directly related to industrial production all present a much more encouraging picture. While there was clearly a slowdown in demand during the second quarter of this year, there is little evidence of a continuing decline in demand. Quite the opposite, the evidence supports an accelerating recovery is under way. The Core Capital Goods Orders Index is considered to be one of the best leading indicators of business

investment spending. The index has recently turned from its typical volatile pattern into one that clearly supports the idea of improving business investments (See Figure 5).

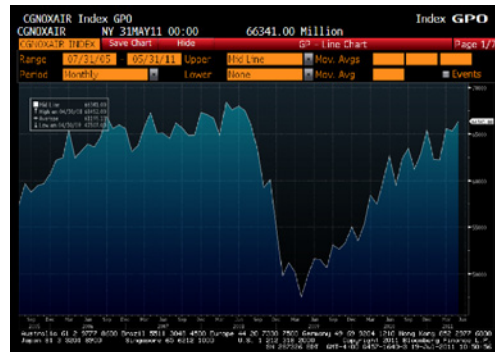


Figure 5 - Core Capital Goods Orders Index (New Orders of Nondefense Capital Goods Excluding Aircraft & Parts).

Source: U.S. Census Bureau, Bloomberg.

The Producer Price Index for Crude Goods (Figure 6) taps the earliest stages of capital goods production. The index pattern clearly presents last year's period of slowdown and moderation in the first half of this year. At the same time, the most recent data points towards an increasing demand for crude goods, and the Index level is currently above its peak in 2008.



Figure 6 - The Core Crude Good Producer Index.

Source: Bureau of Labor Statistics, Bloomberg.

The Primary Metals Index (Figure 7) captures the raw materials being ordered by large manufacturers and, similarly to the Core Crude Goods Producer Index, addresses early stages of industrial production. Although the Primary metals Index is not yet at its 2008 high, the pattern clearly presents the

2010 slowdown, early 2011 decline in demand, and most recently, a more consistent increase in demand for raw materials.

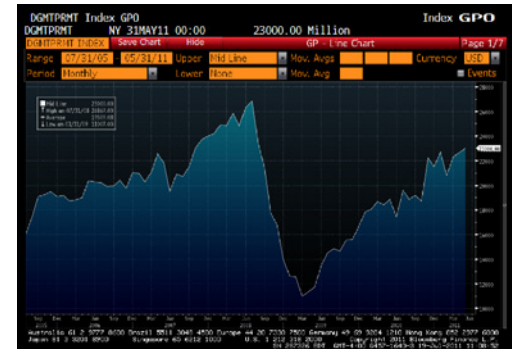


Figure 7 - The Primary Metals Index (U.S. Durable Goods New Orders).

Source: U.S. Census Bureau, Bloomberg.

This positive early economic indicator data will have to be corroborated by companies' results and their future expectations during the earnings season. So far, outside of the U.S. financial institutions, there is little evidence of pessimism, and a majority of the companies expect continuation of the global economic growth.

Over the last few months it became very clear that our politicians could greatly benefit from education about the causes of the debt increase, and the potentially catastrophic effects of not increasing the debt ceiling and defaulting (regardless of for how short of a time) on U.S. government payments. In this overheated atmosphere filled with sound bites from a never-ending parade of microphonephilic politicians, an interesting and very unusual item arguing against education caught my attention. It was the most recent *Investment Outlook* from William H. Gross, Managing Director and Co-founder of PIMCO, and possibly the best-known and most successful fixed income investor. Every month his commentaries are read by and influence a large number of investors around the world. Despite their clear bias towards PIMCO's investing ideas of the moment, I have always read them with great interest. I believe that Bill Gross' *July 2011 Investment Outlook* was supposed to present his support for increasing government involvement in the economy during an economic crisis. Instead, it deteriorated into a rant against education and a "four-year vacation interrupted by periodic bouts of cramming or Google plagiarizing." Apparently, and quite surprising for a Duke University graduate, Bill Gross believes that "For those who made it to

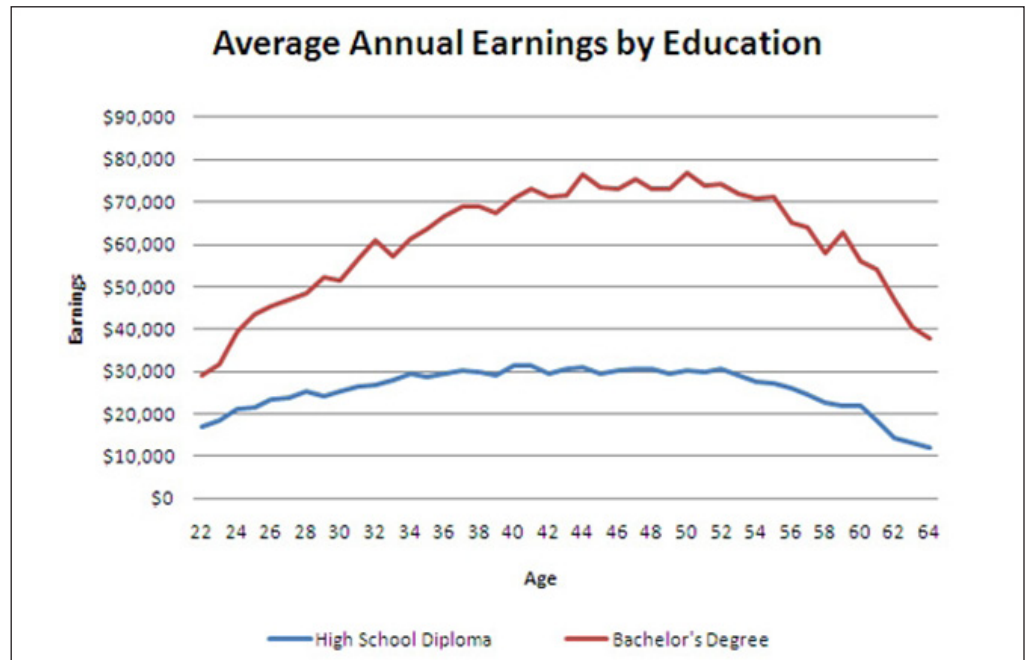
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the good schools, it proved that your parents had enough money to either bribe administrators, or hire SAT tutors to increase your score by 500 points.”

Quite shocking of a statement for a founder of a company that is widely known for an extremely rigorous recruiting process targeting top educational institutions, whether for undergraduate or MBA hires. Somehow I doubt that targeting top schools was driven by PIMCO’s effort to recruit “graduates who could ‘party hearty’ for long stretches of time, and establish social networking skills that would prove invaluable later on at the office cocktail parties.” Bill Gross’ misunderstanding of the European system, which much earlier on separates those academically-oriented (with a goal of graduate education), from those acquiring a professional skill or a trade, created a curious critique of the “ivy-laden ivory tower” establishment.

He cited Thiel Fellowship as an example of a trend towards abandoning education. It is certainly an interesting idea. The fellows receive \$100,000 to not attend a “regular” college (or graduate school) for two years, under the caveat that they focus on developing business ideas instead. In fact, despite the focus on entrepreneurship rather than pure education, the Thiel Fellowship provides a structure not dissimilar to a college environment - with an established peer group network of more than 100 Silicon Valley mentors, and regular monitoring of their progress. I guess one could call it a Silicon Valley College. Despite a quite reasonable idea that some brilliant entrepreneurial students may be better off leaving college altogether, several of the fellows said they would consider returning to school when they have completed the fellowship. I should add that the Thiel Fellowship was created by Peter Thiel, one of the most successful entrepreneurs and early stage venture capital investors, so this venture is not exactly purely philanthropic. As an aside, Mr. Thiel earned a B.A. in Philosophy from Stanford University, and a J.D. from Stanford Law School, where he occasionally teaches on globalization and technology. He also served on the board of overseers of Stanford University’s Hoover Institution.

Bill Gross’ facts that college tuition has increased at a rate 6% higher than the rate of inflation for the past 25 years, and that the average college graduate leaves school with \$24,000 in debt, are both correct. What he missed is that the \$102,000 average investment into college education (that includes tuition and fees, as well as the opportunity cost of



NOTE: Sample includes all civilian U.S. citizens, excluding those in school. Annual earnings are averaged over the entire sample, including those without work. Source: March CPS 2007-2010.

Figure 8 - Average Annual Earnings by Education. Source: Brookings Institution Hamilton Project.

foregone wages during the four years of college), results in a \$570,000 in earnings advantage by age 65 over someone with only a high school diploma. According to the recent Brookings Institution Report addressing this issue (*Where is the Best Place to Invest \$102,000 – In Stocks, Bonds, or a College Degree?*), this earnings difference yields a 15.2 percent rate of return per year, vastly superior to an investment in stocks, corporate bonds, long-term government bonds, gold, or home ownership during the last 60 years.

The idea that to address increasing global competition we need an army of people with good technical skills, but limited college education, is misguided at best. The result would be not a competitive labor force for an increasingly sophisticated world, but a large number of semi-educated unemployables that will need continued government support in their fruitless effort to compete against better educated developing markets competitors for technologically sophisticated manufacturing jobs.

Bill Gross graduated from Duke University in 1966 with a degree in Psychology. After serving in the Navy he earned an MBA from UCLA in 1971. In 2005

he had donated \$23.5 million to Duke University, \$20 million of which was set aside for financial aid.

Despite 2011 college graduates struggling to find a good job in the aftermath of the recent recession, I believe that the time and expense invested in it was worth it. With some of the early economic indicators suggesting a return to a more consistent growth pattern, they are well-prepared to compete, and are likely to increasingly find the jobs they were thinking about when they started their college education. Full disclosure – I do have a bias towards academic education - I have earned both an M.A. and Ph.D. in Psychology from The New School for Social Research, and I also serve on its Board of Governors. I strongly believe in providing high-quality rigorous education as the basis on which people can build their future careers, regardless of what they decide to do in their lives.

The seemingly never-ending political bickering and threats of U.S. default have combined with a number of other global concerns to severely affect U.S. and global equity markets. This unusual volatility is likely to last until the U.S. and European politicians approve long-term resolutions that limit the risk

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of global contagion. I believe expected strong earnings will likely have a moderating effect during the earnings season, but are not by themselves sufficient to stabilize the markets in the long-term. Despite all these problems and anxious anticipation of last-minute political compromise, one positive note at the end might be a timeless quote usually attributed to Winston Churchill: "You can always trust Americans to do the right thing - right after they've tried everything else."



- Michael Obuchowski, Ph.D.
First Empire Asset Management, Inc.

FIRM UPDATE

The FEAM50 Large-Cap Growth Equity Strategy was once again ranked by Lipper Marketplace institutional investment manager database as one of the *Lipper's Best Money Managers*. The Lipper Top 40 Money managers ranking for 12 quarters returns ending on March 31, 2011 placed the FEAM50 Composite in 21st place in the universe of 207 U.S. Large Cap Growth Equity managers, and in 31st place in the universe of 605 U.S. Large-Cap Equity managers.

For more information, visit us at:

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DISCLOSURES

The foregoing letter is qualified by the following notes:

1. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market-value weighted index with each stock's weight in the Index proportionate to its market value. The Index is one of the most widely-used benchmarks of U.S. equity performance. The Russell Top 200 Growth Index measures the performance of the especially large cap segment of the U.S. equity universe represented by stocks in the largest 200 by market cap that exhibit growth characteristics. It includes Russell Top 200 Index companies with higher price-to-book ratios and higher forecast growth values. The companies also are members of the Russell 1000 Growth Index. The Russell Top 200 Growth Index is constructed to provide a comprehensive and unbiased barometer of this larger cap growth market. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics. The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The Index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics. The indices referred to herein are unmanaged and therefore do not have any transaction costs, advisory fees or similar expenses to which a client account would be subject. It is not possible to invest in these indices. The indices are for comparison purposes only. It should not be

assumed that a composite will invest in any specific securities that comprise the indices. The composites managed by First Empire Asset Management, Inc. may not be as diversified as the indices and may experience differing degrees of volatility. Performance for all indices includes the reinvestment of dividends.

2. Gross and net performance figures include the reinvestment of all income and actual trading and other costs incurred by each account in the composite, which varied based upon the client's directed broker or custodian. Gross returns are calculated gross of advisory fees. Net performance figures reflect the deduction of actual advisory fees charged quarterly in arrears. Differences in client trading costs will affect each clients' actual returns. Only clients invested in the FEAM50 composite with balances above \$100,000 are included in the performance figures. The amount below \$100,000 was not significant and has no material impact on these numbers. Performance up to September 30, 2008 was achieved while Chief Investment Officer, Michael Obuchowski, Ph.D., was at Altanes Investments. Dr. Obuchowski continues to remain the principal investment officer for the composite, and the investment strategy of the composite has not changed in strategies, policies or objectives.

3. There is no guarantee that the matrix of economic indicators (or each indicator individually) can accurately predict profits or losses in the markets or the composite. The matrix of indicators discussed herein is not intended to determine investment decisions. Such indicators were chosen by First Empire Asset Management, Inc. among many potential economic indicators. Other indices or economic indicators may reflect differing or contrary results. There is always the potential for gains as well as the possibility of losses.

4. At the discretion of the investment advisor, the FEAM50 strategy may have fewer than 50 portfolio holdings due to existing market conditions. The weighting of the portfolio holdings will vary based on market conditions and other factors; however, the strategy will be rebalanced periodically to restore the equal weighting.

5. Past performance should not be construed as an indicator of future returns or results. These results should not be indicative of the skill of FEAM and do not guarantee that similar results can or will be achieved in the future. As with any investment vehicle, there is always potential for gains as well as the possibility of losses.

6. This letter is not an offer or solicitation.

LIPPER TOP 40 MONEY MANAGERS DISCLOSURES

1. The Lipper Top 40 Money Managers results in the U.S. Large-Cap Growth Equity universe are based on net-of-fee returns (inclusive of cash) from 207 firms and the results in the U.S. Large Cap Equity universe are based on net-of-fee returns (inclusive of cash) from 605 firms. The rankings were based on net-of-fee returns for twelve quarters ending 03/31/2011.

2. The Lipper Top 40 Money Managers results are based on information collected through the Lipper Marketplace Investment Manager questionnaire.

3. The Lipper Top 40 Money Managers ranking is not indicative of future performance.