COMMENTARY 2011 Q2

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As we highlighted in our last commentary, we expect market volatility to remain high for the remainder of 2011. This was certainly the case in the second quarter. For the quarter, the S&P 500 declined only 0.40%; however, the index dropped over 7.0% from its recent peak in early May, then rallied nearly 4.2% during the final four trading days of June. Year to date, the S&P 500 has returned 6.0%, including dividends.

This quarter marked a major sector rotation as economically sensitive sectors (Financials, Energy, Materials and Industrials) all underperformed the market. These sectors had been the driving force propelling the market higher over the past nine months with each sector, except for financials, significantly outperforming the market. Defensive oriented sectors (Healthcare, Consumer Staples, and Utilities) outperformed during the quarter as investors sought safety in historically less volatile sectors.

A Meaningful Correction or a Sustainable Rally

Today the most frequent question the street is debating is whether the pullback in May represents the start of a more meaningful correction or whether the subsequent late June market rally is sustainable. Although we have experienced a few pullbacks over the market's two year plus charge higher, the S&P 500 has increased nearly 98% from the March 2009 lows with only one significant (greater than 10%) retracement. This rebound has clearly been impressive, yet the market remains 16% below its high reached in the fall of 2007.

Through the beginning of May, the market's rise was largely supported by robust company operating results and strong economic data. More recently, the strength of the economic data as well as investor sentiment has weakened. Consumer Confidence dropped to the lowest level since November of last year as gasoline prices remained in excess of $4.00 per gallon in many parts of the country. The unemployment rate unexpectedly ticked higher to 9.1% as job creation fell short of expectations. The possibility of a US credit rating downgrade has increased as Congress struggles with the looming debt ceiling. All of these factors are starting to weigh on the markets.

Even though the prospect of a Greek sovereign debt default appears to be temporarily avoided; the unwinding of the government's quantitative easing program, further deterioration in the US housing market, and weaker than expected job growth are all sizable issues we faced last summer that have yet to be resolved. These pre-existing concerns coupled with the recent geo-political uprisings in the Middle East and the devastation in Japan have increased the underlying volatility and risk profile of the broader markets.

While the global economy has sufficiently improved to weather these storms; difficult decisions will be required in order to see meaningful and lasting resolution to these issues.

The Glass Remains Half-Full

Although we think further short-term downside in the market could be justified given the magnitude of the index's gain and the recent weakening of economic data; we remain optimistic and think this is only a soft patch in the US economic recovery. GDP growth is expected to improve in the second half of the year and trend over 3.0% heading into 2012. Corporate earnings growth remains strong with nearly two-thirds of S&P 500 companies exceeding expectations last quarter. Merger and acquisition activity along with renewed share buybacks could accelerate as companies put their near record cash balances to work. New technology innovations should drive further productivity gains, and the market's valuation is attractive; trading at 12.5 times forward earnings versus its ten year historical average of 15.4 times.

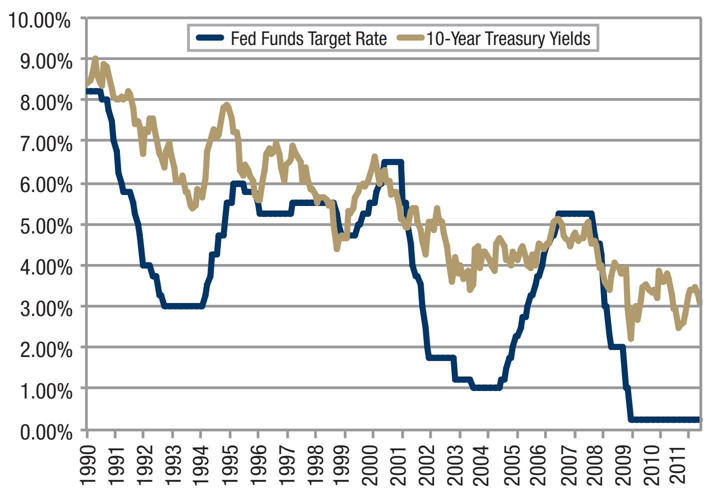
S&P 500 Index: Valuation Measures			Historical Averages:				
Valuation Measure	Description	Today	1-year Ago	3-year Avg.	5-year Avg.	10-year Avg.	15-year Avg.
P/E	Price to Earnings	12.5x	14.1x	13.0x	13.6x	15.4x	17.1x
P/B	Price to Book	2.0	2.2	2.1	2.4	2.7x	3.1
P/CF	Price to Cash Flow	8.3	8.9	8.3	9.1	10.5	11.2
P/S	Price to Sales	1.2	1.2	1.1	1.2	1.3	1.5
Div. Yield	Dividend Yield	2.0%	1.9%	2.3%	2.2%	2.0%	1.9%

Source: Standard & Poor's, Bloomberg, J.P. Morgan Asset Management. Data as of 05/31/11

Interest Rates, Commodities, and Inflation - Where Do We Go from Here…

Since the fourth quarter of 2008, the Federal Reserve has been extremely accommodative with their monetary policy in an effort to stimulate the economy via a low interest rate environment. Although the yield on the 10 year treasury bond has increased nearly 50% from record low levels (2.1% in December 2008) as equity markets and prospects for economic growth improved, rates are still extraordinarily low versus historical levels. Last quarter treasury yields declined for the first time in nine months as expectations for future rate increases were pushed out due to the recent downturn of the underlying economic data. While interest rates may ultimately be dictated by market forces (US economic growth, stock market appreciation, foreign governments purchasing of treasuries), we continue to think the Federal Reserve will focus on stimulating economic growth and will only raise its target interest rate when it feels GDP growth is sufficiently sustainable.

Fed Funds Target Rate and 10-Year Treasury Yields



Source: Federal Reserve, Bloomberg, J.P. Morgan Asset Management. Data as of 05/31/11

The value of the dollar continues to decline in the current low interest rate environment. Commodity prices have soared as global demand intensifies and the dollar decline persists. Agricultural commodities have risen dramatically. Over the past year, soybeans are up over 40%, corn is up over 50%, while sugar is up an astonishing 67%. Prices will likely remain elevated as flooding in the mid-west is expected to reduce the output of this year's US based soybean and corn harvests. Conversely, industrial based commodities (oil, copper, aluminum) have experienced sizeable price declines over the past two months as global growth may be slowing, led by a downturn in China.

> **We remain optimistic and think this is only a soft patch in the US economic recovery.**

Overall, inflation is becoming a bigger concern given the availability of credit and rising commodity input costs. The CPI Index has steadily risen since the start of the year and is expected to trend higher. Although the Federal Reserve contends that inflation remains relatively benign and transitory, companies are beginning to paint a different picture. Numerous firms have increased their prices of finished goods in order to offset rising commodity input costs. Perhaps more troubling, companies are starting to see margin compression as they are unable to pass along 100% of the input cost increases. As a result, we continue to focus on companies that are driving margin expansion and have sustainable pricing power.

Course of Action

We modestly added to our Healthcare and Consumer Staples holdings given their defensive nature and attractive dividend yields and selectively reduced our exposure to cyclical sectors (Industrial, Energy, and Materials) as valuations became stretched and global growth concerns increased. We remain underweight financials as we wait for further clarification on the impact new government regulations will have on banks' earnings power.

Going forward, we plan to take advantage of heightened volatility and build positions in names that we think offer compelling growth opportunities at attractive valuations. We believe many of these investments will be companies that are exposed to strong growth in the emerging markets, companies that are able to monetize their competitive advantage, and companies that are able to expand operating margins throughout the business cycle.

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