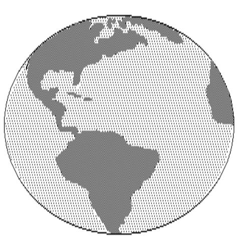
Market Watch
1st Quarter 2011

MOSAIC FINANCIAL PARTNERS, INC.
a Wealth Advisory firm

Summary

- This was another good quarter nearly across the board.
- Large U.S. stocks rose 5.9% and are now 104.5% above their March 9, 2009 low point .
- Small U.S. stocks outperformed large stocks for the quarter and the past year.
- International stocks also gained for the quarter and year, despite Japan's tragedies and Middle Eastern upset. Japan's markets dropped 5.9% for the quarter.
- Emerging markets slowed their rise this quarter but remained positive.
- REITs, both in the U.S. and globally, continued to move forward.
- Interest rates rose during the quarter, so bonds were weakened but still generally positive.
- Alternatives were led by timber, energy transportation and commodities.



Mosaic Financial Partners, Inc.

San Francisco/Lafayette

415.788.1952

www.MosaicFP.com

<u>Increased Volatility for the Financial Markets</u>

During the 1st quarter the financial markets experienced increased volatility, impacted by the geopolitical unrest in the Middle East and natural disasters in Japan. However, returns were bolstered by an improving U.S. economic outlook. The S&P 500, reflecting the largest U.S. companies, finished up almost 6% for the quarter and over 15% for the preceding 12 month period. Since the market's low point on March 9, 2009, the S&P 500 has now gained almost 105% and is only about 8% off its October 2007 peak. Small stocks have done even better and are now up 155% from their 2009 lows. Investors who remained fully invested at the low point have been well rewarded.

Foreign equity markets, based on the MSCI EAFE Index (the most widely used index for non-U.S. stocks in developed countries) rose over 3% in the 1st quarter and gained 11% over the preceding 12 month period. Emerging market stocks gained 2% for the quarter, and 19% for the 12 month period.

Investors have seemed largely unfazed by global events. Risky assets have continued to rally, with high yield and domestic equity markets all posting relatively strong returns. Oil was by far the best performing sector for the quarter. A number of producing countries, including Canada and Russia, benefited from the rise in oil price and their markets posted some of the highest returns.

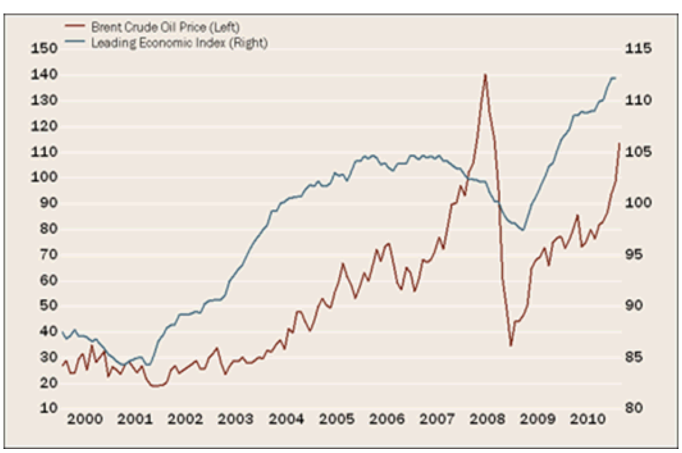
<u>U.S. Economy</u>

Economic indicators in the U.S. showed strength in the manufacturing sector and the improving labor market. In contrast, consumer confidence declined as a result of increasing concerns about inflation, housing, the events in Japan and the Middle East and Europe's continuing debt crisis.

The primary index tracking the **manufacturing** sector rose for the 20th consecutive month in March. Fifteen of the 18 manufacturing sectors reported growth. The Index of Leading Economic Indicators also continued to improve, posting its eighth-consecutive monthly gain at 0.8%.

New jobless claims and the **unemployment** rate both continued to drop this quarter, with most indications being those trends are likely to continue. Average hourly earnings grew minimally, while the Consumer Price Index (**CPI**) increased by 2.2 %, pushed higher by increases in energy and food.

Housing appears to be sliding again despite the efforts of the Fed and the federal government. A large inventory of unsold homes continues to plague the market, and which none of the programs appear to be addressing. Existing home sales declined another 9.6% and median existing home prices are now down 27% from 5 years ago (and only 12% above median prices from 10 years ago). Building permits have fallen to their lowest level in over 40 years, while new home sales fell 16.9% to a record low. That said, housing's influence on the economy has decreased substantially in recent years and its problems are less likely now to keep the economy from growing.



In its effort to generate growth, the Federal Reserve Bank has continued to hold **interest rates** at extreme lows while pushing liquidity into the economy. The Fed's dual mandate—maximum employment and price stability—stands in contrast to the single mandate of the European Central Bank, which is to fight inflation. One consequence of these diverging monetary concerns has been the continued weakening of the US dollar (making imports and foreign travel more expensive for Americans but giving a boost to our international investments).

While Japan has a significant debt burden with which to deal as it rebuilds from its tragedies, Europe continues to work toward a comprehensive plan to address the Euro zone debt crisis and the Middle East struggles to find resolution for its political and social ills, we believe there are solid reasons for optimism.

International Economies

While Japan has a significant debt burden with which to deal as it rebuilds from its tragedies, Europe continues to work toward a comprehensive plan to address the Euro zone debt crisis and the Middle East struggles to find resolution for its political and social ills, we believe there are solid reasons for optimism. Many developed countries seem to have transitioned to the expansion phase of the economic cycle, with Germany and France leading the way and the U.K. beginning to show critical job growth. Emerging economies are generally even further along in the cycle and are increasingly being affected by stronger inflation pressures and tightening monetary policies. China, Brazil and India are seeing rising inflation which will likely lead to slower growth.

We believe the direct effects of the Middle East unrest on the production and distribution of **oil** should be relatively minor. Libya is only the 17th largest oil-producing nation in the world and Egypt ranks 29th. Saudi Arabia has signaled that it can make up for any production shortfall, and, the turmoil in Egypt is unlikely to affect oil distribution since most oil shipping already bypasses the Suez Canal, which is too small for most supertankers. As the nearby chart on the left shows, when oil prices jump substantially, the growth rate of the economy has slowed. Oil prices jumped considerably in the last quarter and if they continue it will slow the economy, although the relationship is substantially less direct than it was during the oil crisis of the 1970's. The Fed believes the price jump is relatively temporary and has discounted its longer term economic impact.

1Q11
Russell 2000 7.9%
REITs 7.5%
S&P 500 5.9%
DJ UBS Cmdty 4.4%
MSCI EAFE 3.5%
Market Neutral 2.3%
MSCI EME 2.1%
Barclays Agg 0.4%

Investments – U.S. Equities

All **U.S. equity** sectors posted gains during the 1st quarter with small stocks outperforming large companies (7.9% vs. 5.9%) and value outperforming growth among large stocks and the reverse being the case for small stocks. All S&P 500 sectors enjoyed gains, with energy stocks leading with a 17% 1st quarter return, while consumer staples lagged with only 2.5% growth for the quarter.

Stock valuations seem to be reasonable, based on historical averages and information provided by JP Morgan. In the past 20 years, the average P/E (the current stock price divided by forecasted 2011 earnings) of the large stock Russell 1000 has been 16.9 while the small stock Russell 2000 P/E has averaged a similar 17.0. Currently large stocks, using Standard and Poors' forecasted earnings, are priced at 13.9 times earnings, suggesting that they are almost 18% cheaper than their historical average valuation. At the same time, small stocks are currently priced at 17.0 times forecasted earnings, which puts them right at their historical average. The large cap and small cap stock valuation relationship is consistent with typical recoveries—small cap stocks most often rise quickly, leading us out of a recession. Large stocks lag early but catch up later. However, it should be noted that earnings of large companies have already had a healthy increase; according to Bloomberg and S&P, the aggregate annual earnings of the S&P 500 large companies, for 2010, increased by 38% from 2009 profit levels.

Investments – International Stocks

Most international markets posted gains for U.S. investors during the 1st quarter, enhanced by favorable currency valuations. Generally, a falling dollar makes international investments more attractive. The MSCI EAFE index, the most widely used international index, returned 3.5% to U.S. investors but only about 1% to local investors. While Europe showed nice growth this quarter (about 9%), Japanese investments fell about 6% for U.S. investors.

Stocks appear to be fairly valued now with possible further room to rise as earnings grow

Emerging markets posted returns of about 2% to U.S. investors but slightly under 1% to local investors. Russia led the performance ranking for emerging markets this last quarter with a return of 16% to U.S. investors (and over 9% in local currency). China's markets rose 3.6%, while Latin America lagged and India lost 5%.

Global equity valuations for developed markets, using forward 2011 earnings (P/E ratio), for the MSCI EAFE Index is now at 11.2 times forecasted earnings, versus a 10 year average of 14.0. The Emerging Markets Index is now at 11.1 times forecasted earnings versus a 10 year average of 11.0. Both suggest stocks are fairly valued now with possible further room to rise as earnings grow, especially in non-U.S. developed markets.

Investments – REITs

The FTSE NAREIT All-Equity U.S. REIT Index was one of the best performing asset classes, with a gain of over 7.5% for the quarter and 25% for the most recent 12 months. Non-U.S. REITs gained over 4% for the quarter and were also up 25% for the 12 month period. All sectors of the U.S. REIT market had positive returns in the 1st quarter, with the top-performing sector being apartments.

Investments – Fixed Income

As you may recall, when interest rates rise bond values fall. Interest rates rose slightly in the 1st quarter, and as a result, bonds struggled to show positive returns. The BarCap Aggregate Bond Index, representing the overall bond market, showed total bond returns of 0.4% for the quarter. Two-year U.S. Treasuries remained virtually unchanged for the quarter; while 10 year and 30-year treasuries saw a slight 1st quarter decline of 0.4% and 1.8%, respectively.

During the 1st quarter, as investors sought riskier but higher returns, high yield bonds outperformed all fixed income asset classes, with a gain of almost 4% for the quarter and a 12 month trailing gain of almost 14%. Emerging Market Debt returned approximately 1.5% during the 1st quarter. Municipals bonds returned a bit over 0.5% on average for the period, but investors willing to risk default of states and regional governments are enjoying attractive yields.. Corporate bonds returned almost 1% for the quarter.

As you may recall, to protect against increasing inflation, we allocate a significant portion of our clients' intermediate bonds to TIPS. These bonds tie their coupon payments to inflation, producing returns over time equaling inflation plus a real interest rate. TIPS gained over 2% last quarter with a 12 month trailing gain slightly under 8%.

Investments – Alternatives

Our alternative investments are intended to help dampen the overall volatility of the portfolio while still contributing to portfolio returns. Most of our alternative holdings gained ground during the 1st quarter, with performance being helped by the declining dollar and increased demand for oil.

The best results for the quarter among our alternatives included a 17.6% gain for Plum Creek Timber, although it was only up 16.4% for the full year.

The Alerian Master Limited Partnership Index (investing in energy transportation and storage) returned almost 6% for the quarter, and 33% for the trailing 12 month period.

Due to the weaker dollar and rising global demand for resources, commodity investments (live stock, agricultural products, precious metals and energy resources) rose just under 4.5% for the quarter and were up over 28% for the trailing 12 month period. Oil prices ended the quarter at $107 per barrel impacted by the political unrest in the Middle East. Meanwhile, gold prices hit new highs, ending the quarter at $1,439 per ounce.

The Merger Fund, which invests in arbitrage situations involving the changing price of companies which are merging or being acquired, was up 2.2% during the quarter and 4.1% for the twelve month period.

Arrow Managed Futures, a fund that seeks to provide exposure to the global commodity and financial futures markets, gained about 3.5% for the quarter.

Summary

Overall, we remain optimistic about the economic and market recoveries. The global economy, remains intact and generally seems to be improving, although serious problems remain. Higher oil prices, a more cautious consumer, further weakening of the housing market, growing geopolitical tension, legislative stalemates in Congress and our state capitals, and the recovery from the tragedy in Japan could all threaten a recovery.

In light of these concerns, we believe it is important to stay focused on your long term spending, savings and investing goals and remember in particular that investing should not be a short-term activity. We continue to focus on maintaining an appropriate strategic asset allocation for your portfolio — the right mix of cash, bonds, stocks, real estate and alternative investments, given your unique time horizon, risk tolerances and financial objectives. These decisions don't shift greatly with the constant volatility in the market — rather, they provide an anchor to help you keep your eye on your longer-term objectives.

We thank you for the continued opportunity to be of service to you and your family.

MOSAIC FINANCIAL PARTNERS, INC.

sources: Morningstar, JP Morgan, Bureau of Labor Statistics, The Federal Reserve, Reuters, Forbes, Bloomberg, Standard & Poors, The Economist