

Market Commentary



A BUMPY QUARTER

First Quarter at a Glance – After what can only be described as an eventful quarter, both equity and fixed income markets turned in solid performances in the 1st quarter. The term *resilient* has been a frequent descriptor for the past 3 months. We agree with this assessment given the markets' downdraft and subsequent recovery in the face of such events as the increasing unrest in the Middle East, the devastating tsunami and earthquake in Japan and the specter of a U.S. government shutdown. To recap, stock market indexes turned in strong performances in the 1st quarter with the Dow Jones Industrial Average (DJIA), S&P 500 (S&P) and NASDAQ posting returns of 5.9%, 7.0%, and 5.6%, respectively. Fixed income also closed the quarter with positive returns in virtually all style classes.

A strong January kicked off the 1st quarter with reported company earnings results reinforcing growing conviction among investors that the economy had turned the corner. We were encouraged by the strength of the revenue line this quarter. This is indicative of the return of demand as a driver of earnings growth rather than cost cutting which drove results in earlier stages of the recovery. Companies continued to signal greater confidence with strong Merger & Acquisition (M&A) activity along with increased dividend payouts and share buybacks. Company management confidence was further conveyed by hiring as evidenced by the steady improvement in private payroll growth. This dynamic is a significant component of consumer confidence. As such, it is an important factor in the creation of a positive cycle where improved hiring leads to higher consumer confidence, which leads to higher consumer spending and so on. Improving trends in small business confidence, manufacturing and capital spending further supported a constructive economic outlook.

As January closed, events in Egypt captured world attention as anti-government protests erupted and, incredibly, led to the ousting of President Mubarek in a matter of weeks. This was subsequently followed by unrest and protest in Algeria, Bahrain, Iraq, Jordan, Syria, Oman, and Yemen. Libya is in the midst of an outright war with international forces engaged in a struggle to topple Muammar Gaddafi's regime. Against this backdrop, oil prices spiked 19% as investors and

traders raised expectations for supply disruptions of crude oil. This exacerbated already strong inflationary pressure in developing countries and contributed to increased investor concern around the potential for inflation contagion to impact markets worldwide.

In March, Japan was rocked by a devastating earthquake and tsunami. In addition to the tragic human loss, the country suffered the additional chaos and stress of a nuclear disaster. Manufacturing capabilities were handicapped as a result of physical damage along with the compromised power grid. This event had the impact of reducing global GDP expectations for 2011, with a commensurate "catch up" added in for 2012 as Japan recovers and rebuilds.

In reaction to these events and concerns, the S&P fell 7% from the highs made in February, only to recover and close up for the quarter. We are encouraged by this *resilience* as we believe it speaks to the underlying fundamental strength of the economy. The possibility of higher than expected inflation is a meaningful concern, though risk around this outcome is mitigated by continued slack in wage pressure and manufacturing capacity. With that said, we made tactical adjustments to our asset allocation to incrementally add inflation protection to client portfolios until more clarity arises around this issue.

Equities – We continue to have a favorable view of stocks given strong and improving fundamentals, still reasonable valuations, and increasing dividends, buybacks and M&A activity. Historically, strong money flows follow strong performance of an asset class. The S&P has more than doubled since the lows of March 2009, yet flows into equity funds are significantly below historical norms. As the economy continues to gain traction and investors factor in rising interest rates, we expect to see money flows to equities continue to strengthen and provide additional valuation and price support.

Sector and Style Emphasis – Despite the bumpy quarter, amazingly all ten economic sectors of the market posted positive returns. Energy led the way, up a whopping 16% as investors factored in rising oil prices and profit increases. Industrials and materials were also strong as a result of higher anticipated prices. The more defensive consumer staples sector trailed as investors fretted about higher input costs weighing on margins for these companies' products.

From a style standpoint, growth outperformed value among the small and mid cap stocks, while value slightly outperformed growth among large company stocks.

Asset Allocation Changes – We made changes to our asset allocation in the first quarter to reflect our current outlook. First, we increased our allocation to large cap stocks in order

to take advantage of the very strong balance sheets and fundamental characteristics of high quality, “blue chip” stocks. Relative to small and mid cap stocks, the valuations of large company stocks are very attractive. Also, we have seen correlations compress as the economic cycle matures; this means that investors are being more discerning around the quality of company fundamentals and this should serve large caps well. After strongly contributing to outperformance in 2010, we reduced our small cap exposure as these stocks are less attractive based on valuation.

In addition, we increased the portfolio’s weighting toward value, reducing our overweight to growth. This was in response to our inclination to gain more exposure to the energy and financials sectors, while “taking profits” in traditional growth sectors such as consumer discretionary and technology. As noted above, we are compelled by the improving fundamental picture for energy companies as a result of strong commodity prices. The financial sector is also of interest given the earnings rebound we expect to see as loan demand increases and credit quality improves. In addition, we expect dividend increases to be a meaningful tailwind for financials as companies continue to rationalize their capital structures following the dislocations associated with the financial crisis.

Fixed Income – Fixed income markets posted a solid quarter with nearly all style classes except U.S. Treasuries (-.2%) posting positive returns. High yield corporate bonds led the way with gains of 3.9%. The weakness in U.S. Treasuries reflected selling pressure related to expectations for a downshift in the Fed’s accommodative policies.

The performance of the fixed income markets reflected investors’ heightened anxiety and desire for relative stability in the face of 1st quarter volatility. As global GDP estimates were ratcheted down, largely as a result of events in Japan, investors took a more skeptical view of the timing of a rate increase cycle by the Fed. Also, money flows which had begun to migrate out of fixed income in the latter part of 2010 reversed course this quarter with a renewed “flight to safety” by investors.

We remain cautious on bonds in the near to intermediate term. As noted, the Fed is expected to modify the accommodative quantitative easing program (QE2) initiated in the fall of 2010. This program has had the effect of boosting U.S. Treasury securities, as the Fed has been a sizable and steady buyer under QE2. We believe that as this support is decreased (expected mid 2011), bonds will face incremental headwinds.

Asset Allocation Change – We made changes to our fixed income asset allocations this quarter. For our taxable and tax sensitive portfolios, we increased our allocation to Treasury Inflation Protected Securities (TIPS) which have the benefit of moving with inflation and should serve to better protect

purchasing power in client portfolios. In the tax sensitive model, we added to high yield corporate bonds which have the attributes of high relative yield coupled with historically low default risk. These increases were matched by a decrease in investment grade corporate bonds as supply/demand dynamics and valuations (on a relative basis) are less attractive.

Within taxable portfolios, our increase in TIPS was matched by a decrease in U.S. Agency securities where we are incrementally watchful around potential selling pressure related to the withdrawal of QE2.

International – As with the U.S., international markets showed remarkable *resilience* in the 1st quarter. Europe (ex-UK) outperformed emerging markets, though all broad indexes posted solidly positive returns. Returns in Japan were negative for the quarter, though markets had rebounded sharply off the lows by quarter end.

This performance was impressive given the upheavals weathered in the 1st quarter internationally. From huge flooding in Australia to earthquakes in New Zealand to the massive triple disaster in Japan, economies worldwide were challenged by natural catastrophes. In addition, political unrest in the Middle East sparked significant change in the region and investor concern around the potential for it to spread further.

These events had the negative effect of increasing already strong inflationary pressures, particularly in food and energy. At the start of the quarter, developing nations were working to fight inflation by imposing currency controls and raising interest rates. We expect these initiatives to continue and are watchful around the careful balance that policymakers must strike in order to successfully curb inflation without stalling economic growth.

Developed countries rebounded over the course of the quarter, though headlines and risks around sovereign debt in Europe continue. Portugal suffered several downgrades and it is expected that the country (along with Ireland and Greece) will have to restructure their debt. The impact this might have on European banks remains a key uncertainty for the region, though expectations for a successful resolution have risen somewhat.

Asset Allocation Changes – We made no changes to our international stock allocations this quarter given the above listed concerns. We await further clarity on these issues before adjusting our underweight positioning in client accounts.

Conclusion – We remain positive on equities, cautious in the near term on bonds, and watchful as it relates to international securities.

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