TRILLIUM ASSET MANAGEMENT®

Market Commentary

Investing for a Better World® Since 1982

2nd Quarter 2011

Falling fuel prices should produce an upturn in US economic prospects sometime in the fourth quarter of this year or first quarter of next year. When US economic prospects improve so will the stock market. Between now and then the stock market will likely remain shaky.

Market Overview: Not Much

The US stock market showed very solid returns in the first half of 2011 with the S&P 500 gaining 6% for the half. Unfortunately, those returns were all made in the first quarter as stocks made no progress from April through June. As we noted in our last Commentary, the first quarter benefited from decent economic growth, low inflation and low interest rates—the trifecta of positive investment environments. We said then that if—and we emphasized the "if"—these conditions persisted stocks would continue to perform well. The short version of why the market stalled in the second quarter is: They didn't.

Specifically, headline inflation driven by fuel and food prices rose and the economy slowed. Given the tepid pace of economic growth in the US and the developed world in general, whenever the economy cools investors begin to question whether a recession looms (again) on the horizon. This dulls their appetite for stocks and the market loses steam.

Economic Overview: The (Not So) New Normal

As we've emphasized for some time now, consumers in the US and the developed world in general are undergoing a massive process of deleveraging. That is, they are paying down the excessive debt load built up over the prior 20 or so years. During those years increasing debt levels provided a tailwind for higher and higher levels of consumer spending, which in turn fueled strong economic expansion throughout the developed world.

Now that tailwind has turned into a headwind. Consumers pay down their debts by diverting income from spending to saving, slowing overall consumption and economic growth. This is particularly true in the US where consumer spending accounts for 70% of total economic activity—the highest percentage of consumption for any major economy.

While repairing our collective balance sheet is a healthy and, indeed, necessary undertaking, the price we pay for this repair, particularly in the US, is a chronically sluggish economy.

We've seen this throughout the current recovery as real economic growth in the US has hovered around the "stall speed" level of 2%. Last quarter we were encouraged by tentative signs of improvement in the job picture but those hopeful signs were reversed in the second quarter. This is typical of an economy hovering around stall speed. At this sluggish pace the economy doesn't add many new jobs or increase wages. So consumption isn't boosted by a growing or a richer workforce and the economy limps along without building up a head of steam.

Inflation

In a limping economy that doesn't grow jobs or wages, overall consumption is unusually sensitive to headline inflation (fuel and food). If what consumers are paying at the gas pump goes up, it siphons off dollars from other purchases. This crimps the rest of the US economy as more dollars flow overseas to oil producers. As the US economy is largely driven by consumption, in the current climate US economic growth and headline inflation are closely if inversely related. A gain in one will likely come only at the expense of the other.

So, while it's a bit simplistic to put matters this way, if you want to know how the US economy is doing, watch the prices you're paying at the pump. If they're going up, it's hurting the economy; if they're going down, it's helping.

Happily, it appears that fuel and food prices have peaked or are about to. This results from decelerating economies around the globe.

continues on reverse

Major Market Performance 2nd Quarter 2011

	2nd Quarter 2011% chg.	YTD 2011 % chg.
DJIA	1.42	8.59
S&P 500 (large cap)	0.10	6.02
S&P 1000 (small/mid cap)	-0.56	8.25
S&P 1500 (all cap)	0.02	6.30
NASDAQ	-0.27	4.55
Barclays State G.O. Municipal Bond	3.57	4.87
Barclays Gov/Credit Intermediate Bonds	2.12	2.47

© 2011 Trillium Asset Management, LLC

Inflation (cont'd...)

China is slowing intentionally as the Chinese government seeks to cool an economy that was growing too fast and stoking inflation. And, indeed, China and emerging economies generally are the primary drivers of food and fuel costs globally. The Eurozone is cooling unintentionally as governments respond to an ongoing debt crisis with austerity measures that slash spending. Japan all but ground to a halt in the wake of natural and man-made disasters. And the US, as explained above, cooled in response to higher fuel prices. Cooling economies mean less demand, especially for fuel, which brings down prices.

The Good News

The good news in all this is that with fuel and food prices peaking, their dampening effect on the US economy should also wane as we move through the rest of the year. As fuel and food prices fall consumers' budgets will be freed up for spending on other discretionary items, which should give the overall US economy a boost.

The stock market is already giving us a "tell" that these developments are on the horizon. Energy stocks have begun to flag as consumer discretionary stocks have risen. Energy stocks benefit from rising fuel prices. Consumer discretionary stocks benefit from falling fuel prices. That the latter are gaining while the former are flagging tells us that Mr. Market sees cooling inflation and better spending ahead. The question is: how far ahead?

While better performance from consumer discretionary stocks is a fairly reliable sign of better spending ahead it can operate with a long lead time. Our research suggests that falling fuel prices should produce an upturn in US economic prospects sometime in the fourth quarter of this year or first quarter of next year. When US economic prospects improve so will the stock market as it is essentially a vast economic forecasting mechanism. Between now and then the stock market will likely remain shaky. But with the cavalry on the horizon, as it were, we don't see dramatic downside risks posed by the economic cycle.

We can't, of course, rule out some form of exogenous shock to the system as the possibilities are legion. A Greek debt default. An interruption of oil supplies from the Middle East. Budget policy mistakes by a Congress drunk on Tea Party ideology. These, however, are known risks. It's the unknown ones that unsettle markets.

A Perverse Productivity

One of the perverse features of the current recovery in the US economy is the fact that while Main Street limps along with 9% unemployment and flat wage growth, Wall Street is booming. A recent study estimated that 88% of the revenue gains in the current recovery have gone to the owners of capital leaving a meager 12% for labor. This is most evident in the dramatic rebound in corporate profits, which has driven up stock prices more than 100% since the March 2009 bottom in the market.

Corporations have squeezed more and more output out of existing inputs, the most salient input being labor. This is called productivity growth. Economists typically expect rising productivity to lift the fortunes of both capital and labor as higher productivity means more profitable firms, which in turn used to mean more hiring of employees and more generous compensation for them. That has changed. The global outsourcing of labor has broken this linkage between higher profits and a richer US workforce. The result is a dramatic tilt in the playing field to the advantage of capital.

There's a downside to this advantage, however, which we've explained above. While capital's piece of the pie has grown larger, the pie itself has hardly grown at all. Without increased employment and/or rising wages the US economy is limping along at stall speed with the risk of recession ever at hand. So while corporate profits and margins are doing quite well—and we are benefiting from that as stockholders—the US economy is not. So while it may sound odd, we have to say we'd like to see a bit less productivity and a lot more employment and wage growth. Everyone, capital and labor, would be better off with a larger pie to divide.

What We're Doing

While the near-term looks shaky in the stock market, we see medium-term improvement from falling headline inflation and increased consumer spending. So we're maintaining our neutral posture toward stocks relative to bonds. Our emphasis within stocks, however, has shifted away from inflation beneficiaries like energy and toward disinflation beneficiaries like consumer discretionary.

Farnum Brown
Chief Investment Strategist

© 2011 Trillium Asset Management, LLC

Social Advocacy Highlights

After an embarrassing misstep and a series of high votes on a Trillium shareholder proposal, **CenturyLink**, the nation's third largest telecommunications company, finally owned up to its responsibilities regarding **Internet privacy and freedom of expression**. In 2008 CenturyLink, which recently acquired Qwest, became the subject of national controversy and the target of a major Congressional investigation when it entered into partnerships with an online advertising company, NebuAd. The partnership allowed for targeted advertising to customers based on which web sites the customers liked to visit and, most importantly, customers were required to "opt-out" of a program in which many were not even aware they were enrolled. This lead Trillium to file a proposal with the company asking the board of directors to explain how it would address public expectations of privacy and freedom of expression on the Internet and avoid this kind of civil liberties blunder in the future. That proposal received a 30% vote two years in a row and this year's filing finally brought the company to the negotiating table. In exchange for Trillium withdrawing the proposal, the company agreed to incorporate privacy and freedom of expression responsibilities into its governing documents. While this may sound a bit legalistic and wonky, it is the equivalent of making privacy and freedom of expression part of the company's DNA by assigning legal duties and accountability for these issues to the board of directors.

In April, Trillium's Susan Baker attended **PPG Industries'** annual meeting in Pittsburgh, accompanied by a member of Mossville Environmental Action Now, a volunteer community organization in Mossville, Louisiana. At the meeting, Susan presented a shareholder proposal for a second year, asking PPG to improve disclosure of its **community engagement practices**, and report on the environmental impacts in communities where it operates. PPG is one of 14 industrial facilities surrounding Mossville and management has declined to speak to the community. (Nor would PPG speak to CNN's Dr. Sanjay Gupta when he came to Mossville in 2009 to report on decades of environmental and human health effects). Our resolution garnered 7 percent of the shareholder vote, clearing the hurdle for resubmission next year and, more importantly, enabling a dialogue between community members and management. We are seeing some progress: PPG has expanded qualitative reporting on community issues, and established a Sustainability Committee with board-level oversight since our dialogue began.

The proposed Pebble Mine in Bristol Bay Alaska, if constructed, would be the largest **open pit mine** in North America, involving billions of tons of mining waste held behind a system of dams equivalent to the Three Gorges dams in China. As if that were not bad enough, the dams would be located in a highly earthquake-prone area which also serves as the breeding grounds for the largest sockeye salmon run in the world. Not surprisingly a broad alliance of Alaska natives, commercial and sport fishing interests, and environmentalists oppose what many are calling the "next Deepwater Horizon". However, the fortune to be made in this gold and copper prospect appears to be exerting an irresistible pull on the mining company with the largest stake in the project, **Anglo-American**. Despite the risk, expense and opposition, the company continues to push ahead with its plans. Currently the EPA is reviewing the proposed mine to determine whether it should veto the project under its Clean Water Act authority. Trillium organized a group of shareholders representing $170 billion to support the EPA review and issued a joint statement in April calling for the EPA to protect this vitally important national resource. The statement attracted a great deal of attention from the national media and within 48 hours of publication, EPA staffers in charge of the review requested a meeting with Trillium. At that meeting we had ample time to express our concerns and we were pleased that the EPA took our concerns seriously.

Responding to pressure from consumers and investors, **Costco** released to Trillium and Green Century Capital Management a substantially improved **seafood sustainability policy**. Costco will discontinue selling twelve wild species identified as "at great risk" by the Marine Stewardship Council (up from seven). Working with the World Wildlife Fund, the company also committed to bringing its shrimp suppliers into compliance with the Shrimp Aquaculture Dialogue standards. Similarly, Costco is working with its salmon suppliers and bringing them into compliance with the Salmon Aqualculture Dialogue standards. These standards are a result of collaborative efforts by environmental groups, customers and industry. We will continue to press Costco to place oversight of its sustainable seafood policy higher up in the company ranks to ensure greater accountability, but are pleased with progress the company is making to better align its purchasing decisions with standards to protect marine ecosystems.

© 2011 Trillium Asset Management, LLC