



Q1 2012: Stocks advance here and abroad

U.S. stocks posted solid gains in the first quarter of 2012. In market action reminiscent of 1995 – during the early stages of that decade’s dot-com stock bubble – share prices ground out steady gains punctuated by brief and shallow corrections. The less-volatile environment was a welcome relief from the wild swings investors endured in the second half of 2011. Further evidence of an improving U.S. economy and relative calm in Europe’s ongoing sovereign debt crisis were the primary factors driving the market’s gains.

The blue-chip Dow Jones Industrial AverageSM (the “Dow”) returned an impressive 8.83% for the quarter, but was a relative laggard among the major market averages. The large-cap S&P 500[®] Index (the “S&P 500”) advanced 12.58%. The NASDAQ Composite[®] Index, reflecting a hot information technology sector, rose 18.67% for the quarter. For the Dow and the S&P 500, it was the most-substantial first-quarter gain since 1998. The NASDAQ recorded its best first quarter since 1991. Small-cap stocks also had a solid quarter, with the Russell 2000[®] Index advancing 12.44%.

Technology stocks got a shot in the arm from Apple, which began the quarter slightly higher than \$400 per share and ended March just under \$600, for a gain of almost 50%. During the quarter, robust sales of its iPhone[®] smartphones and iPad[®] tablet devices drove better-than-expected revenue and earnings for Apple. Additionally, the company announced on March 19 it would begin paying a dividend and unveiled a \$10 billion share buyback program.

Foreign stocks in developed markets, as measured by the MSCI[®] EAFE[®] Index, also did well, as European markets benefited from investor optimism in the wake of the European Central Bank’s December launch of a program offering low-cost loans to the region’s ailing banks. The move eased concern about roughly €600 billion (euros) of bank debt scheduled to come due in 2012. There was also significant progress in Greece’s negotiations with its private-sector creditors that cleared the way for a second €130 billion bailout for the debt-strapped nation from the European Union and the International Monetary Fund. The MSCI Emerging Markets Index also did well during the quarter, advancing 14.08%.

Among the S&P 500's 10 sectors, financials joined technology as a performance leader, with both sectors gaining more than 21% on a price-only basis. Financials benefited from growing confidence in the European banking system and largely successful stress tests of major U.S. banks in March. Financials shares also responded positively following JPMorgan Chase's March 13 announcement that it planned to boost its dividend and roll out a new \$15 billion stock buyback plan. Utilities was the only S&P 500 sector to record a loss for the quarter.

Market Performance as of 3/31/12*

Index	1Q 2012	One Year	Five Years (annualized)	Ten Years (annualized)
Barclays Capital U.S. Aggregate Bond Index.	+0.31%	+7.72%	+6.25%	+5.80%
Dow Jones Industrial Average	+8.83%	+7.93%	+1.48%	+2.48%
S&P 500 Index	+12.58%	+8.53%	+2.01%	+4.12%
NASDAQ Composite Index.	+18.67%	+11.16%	+5.00%	+5.29%
Russell 2000 Index	+12.44%	-0.18%	+2.13%	+6.45%
MSCI EAFE Index	+10.86%	-5.77%	-3.51%	+5.65%
MSCI Emerging Markets Index	+14.08%	-8.80%	+4.67%	+14.13%

*Source: Morningstar Direct

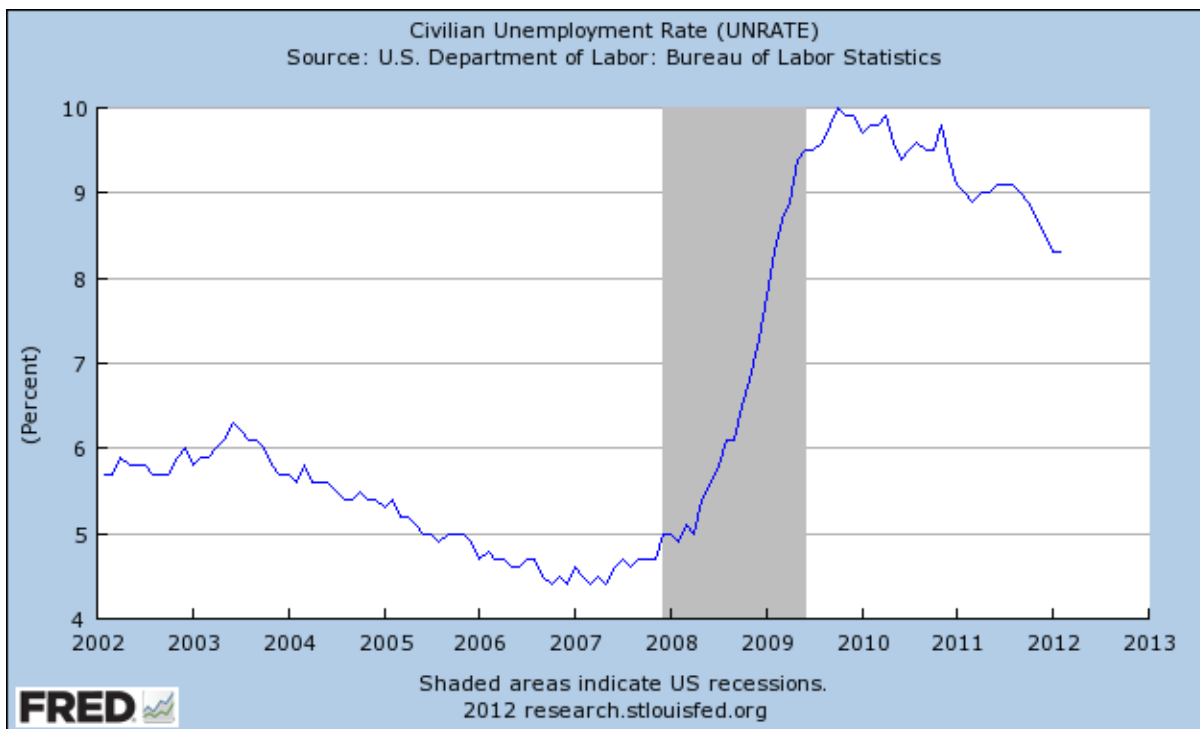
Returns among the three primary stock capitalization groups (small, mid, and large) were clustered in a fairly narrow range. A more significant divergence is evident in the outperformance of growth stocks versus value shares. The Russell 1000[®] Growth Index, a large-cap benchmark that returned 14.69%, was the top performer among the six size/style groups and solidly outperformed the Russell 1000[®] Value Index, which returned 11.12%. Similarly, the Russell Midcap[®] Growth Index's 14.52% gain handily outpaced the 11.40% result of the Russell Midcap[®] Value Index. Small caps followed suit, with the Russell 2000[®] Growth Index advancing 13.27%, compared with 11.59% for the Russell 2000[®] Value Index.

In the bond market, Treasuries yields traded in a relatively narrow range until mid-March, when they spiked higher on growing optimism about the U.S. economy. (Bond prices move in the opposite direction to interest rates (or yields); when yields rise, the prices of existing bonds fall – and vice versa.) By the end of the month, however, yields had retraced about half of their advance. The yield of the bellwether 10-year Treasury note stood at 2.23% at quarter-end, versus 1.89% to close out 2011. The Barclays Capital U.S. Aggregate Bond Index, which holds Treasuries and other investment-grade securities, returned 0.31% for the quarter. Against the backdrop of a persistent “risk-on” investor mindset, high-yield bonds were big winners in the fixed-income market, as reflected in the 5.33% gain of the Barclays Capital U.S. Corporate High-Yield Bond Index. For comparison purposes, the Barclays Capital U.S. 1-3 Year

Government Bond Index returned -0.02% for the quarter, while 13-week Treasury bills finished totally flat, at 0.00%.

Digging deeper into unemployment

In January, the U.S. unemployment rate, shown in the following chart, dropped from 8.5% to 8.3%, its lowest level in three years. On the face of it, that is a good thing, as it appears that more people are working. However, getting to the bottom of what is really going on with unemployment requires consideration of more than just the unemployment rate.

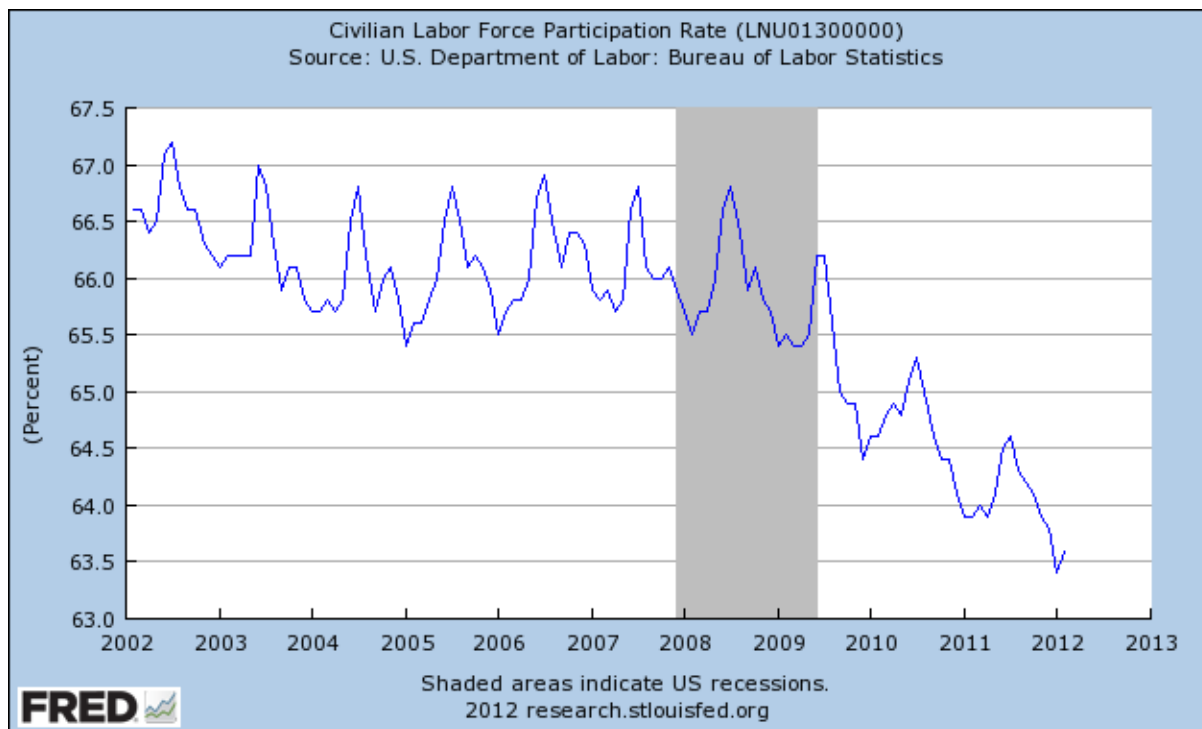


For example, there is the question of how the unemployment rate interacts with nonfarm payrolls, another key labor statistic typically unveiled on the first Friday of every month. As one may expect, when the unemployment rate fell in January, nonfarm payrolls rose by a relatively healthy 243,000. Yet, February saw an increase of 227,000 in nonfarm payrolls, and the unemployment rate did not budge. Why?

The unemployment rate depends, in part, on something called the civilian labor force participation rate – the participation rate for short – which is calculated by dividing the labor force by the total population. When the participation rate rises, as it did in February, it means more people are in the labor force, looking for work. And that boost in the number of job-seekers can offset a positive nonfarm payroll number, keeping the unemployment rate unchanged or, in extreme cases, even causing it to rise.

Conversely, when the participation rate declines, it means fewer people are searching for a job, so any increase in nonfarm payrolls packs more punch in terms of its potential to lower the unemployment rate.

The chart below shows the participation rate for the past 10 years. One feature that is immediately apparent is the overall decline in this rate since the Great Recession, which is a trend that would tend to push the unemployment rate lower, assuming sufficient expansion in nonfarm payrolls. The relationship between the unemployment rate and the participation rate can help explain the “puzzle,” recently noted by Federal Reserve Chairman Ben Bernanke, of a falling unemployment rate in the face of relatively modest economic growth.



Why is the participation rate declining? One possible reason is that job-seekers are becoming discouraged and discontinuing their search for employment, causing the labor force to shrink. The irony here is that, even though a falling participation rate is better than a rising one for the purpose of lowering the unemployment rate, a growing number of frustrated jobseekers dropping out of the labor force does not suggest an improving economy.

Another possible explanation for a falling participation rate is that aging baby boomers are reaching retirement age in greater numbers and leaving the workforce. The massive size of this generation, as it moves into retirement, could be enough to depress the participation rate. Ultimately, the real reasons for

the declining participation rate will likely not become clear until more data is collected and analyzed over a longer period of time.

The other interesting feature of this chart is the noticeable spike in the participation rate that occurs, seemingly like clockwork, over the middle of every year. This spike is likely seasonal in nature, the result of warmer weather prompting increasing numbers of people to re-enter the labor force in search of a job.

If 2012 follows the historical pattern, a seasonal spike should be occurring shortly. If this spike appears, it could temporarily make it more difficult for the unemployment rate to fall in the absence of strong nonfarm payroll growth. Beyond short-term seasonal influences, though, if the participation rate resumes its downward trend, that would support a declining unemployment rate, particularly if nonfarm payroll numbers continue to improve.

Outlook

Despite robust returns from stocks during the quarter, flow-of-funds figures indicate that investors continue to be cautious about investing in equities, preferring the more-conservative bond market. Many of these cautious investors missed the significant rally that began 2012, another testament against trying to time the stock market. If you work with an advisor and haven't yet met with him or her this year, we suggest you schedule some time to hold an annual meeting to be sure you are on track to reach your long-term financial goals and your overall strategy is positioned effectively to navigate these volatile markets. Your advisor can assist you with asset allocation and other decisions that can help refine and maintain the risk/return characteristics of your portfolio to be in line with your personal strategy.

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