

## P E R S P E C T I V E S

April 28, 2011

### Executive Summary

Many of the principal investment themes that dominated 2010 continued to prevail throughout the first quarter of 2011. Favorable economic conditions supported risk assets, but concerns surrounding the sustainability of the global recovery, exacerbated by events in the Mideast and Japan, led to continued volatility. While the financial markets proved resilient in the first quarter, pressures are mounting in the form of inflation, monetary policy, and stagnant housing activity. In addition, policymakers in the U.S. and Europe have failed to make meaningful progress on debt reduction, deficit spending, and other key issues. As such, we favor a relatively defensive stance until there is greater clarity regarding the above concerns, although our near-term outlook remains cautiously optimistic.

### Review

A recurring theme over the past few years has been the stimulative environment for risk assets created by global policymakers. In 2010, favorable monetary and fiscal policy bolstered the financial markets, leading to a second year for the bull market. This trend continued into the first quarter of 2011.

**U.S. Equities.** The stock markets ended higher for the quarter after a short retracement driven by rising oil prices (tied to violence in Libya) and supply chain concerns (caused by the disaster in Japan). This short-term pull-back was not surprising and was not expected to be the start of a protracted decline. The stock markets were predisposed to profit-taking, with the S&P 500 Index trading above its 50-day moving average for 130 days, the 7th longest streak in the index's history. While prolonged higher oil prices are problematic, Saudi Arabia indicated in the short-term that it would replace Libyan production. Moreover, although Japan is the fourth-largest trading partner of the U.S., it accounts for only 4.7% of U.S. exports and 6.3% of imports, amounts that have been in steady decline since the 1980s. While a national and hu-

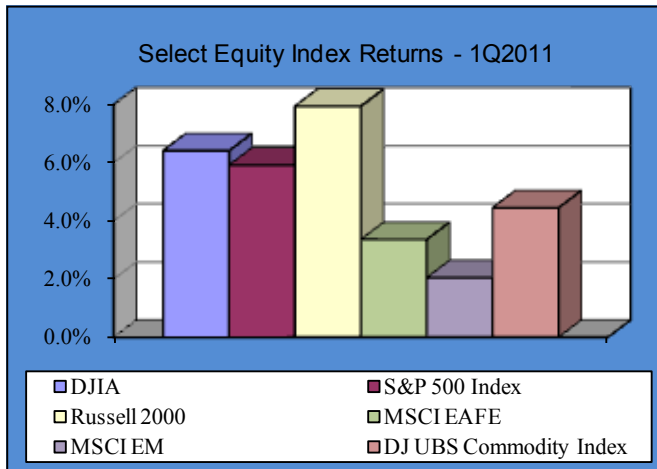
man tragedy, the devastation of the earthquake and tsunami in Japan is not expected to be a long-term drag on global economic growth.

For the quarter, the Dow Jones Industrial Average was up 6.4%, returning to levels not held since early 2008. The S&P 500 and the NASDAQ Composite Index also posted gains, returning 5.9% and 5.5%, respectively, for the quarter. The Russell 2000 was up 7.9%, nearing a record high.

**U.S. Fixed Income.** Consistent with the positive risk environment, bonds generally underperformed equities during the quarter. The yield curve steepened, with short-term rates falling and intermediate-term rates rising. Corporate debt continued to outperform government debt, fueled by the strengthening economy and expectations of higher rates with the end of QE2 (the Federal Reserve's latest program of quantitative easing) on June 30th. Municipal bonds saw the lowest level of quarterly issuances in 11 years.

For the quarter, the Barclays Capital Intermediate Government/Credit Index of government and corporate bonds was up 0.3%; the Barclays Capital Intermediate Government Bond Index was up 0.01%; the Barclays Capital Intermediate Credit Bond Index of corporate bonds was up 1.0%; and the Barclays Capital 1-10 Year Municipal Blend Index, which includes municipal bonds from around the country, was up 0.7%.

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**Real Assets.** Commodities continued their broad rally, reflecting the confluence of dollar depreciation, accommodative monetary policy, emerging-markets demand, and growing inflation expectations. The Dow Jones UBS Commodity Index rose 4.5% for the quarter.

Precious metals continued to reach new highs, with silver posting a 22.4% gain and gold rising 1.1%. Copper reached an all-time high of \$4.62 in February, having quadrupled over a 2-year rally, but then fell to end the quarter down 3.3%. Oil prices rose 16.8% over the quarter and remain elevated due to supply concerns. Agriculture prices were mixed. The DJ UBS Agriculture TR USD rose 3.0%, largely driven by cotton, which rose 40.5% to all-time highs. Real estate remains weak, and, despite earlier signs of stabilization, recent housing numbers were not encouraging as price indexes fell.

**U.S. Dollar.** The U.S. Dollar Index declined 4.0% over the quarter. The potential for a flight to quality in response to unrest in the Mideast was countered by anticipation of a rate hike by the European Central Bank and strengthening of the yen. That strength, however, was short-lived, and the yen has since fallen 12% back to the levels of last September.

**International Markets.** In general, global financial markets were up in the first quarter, but they underperformed their U.S. counterparts. The MSCI EAFE Index of developed economies gained 3.4%, while the MSCI Emerging Market Index gained 2.1%.

European stock markets were largely positive, but Asian markets largely fell. While the Shanghai Composite rose 4.3%, Japan's Nikkei Stock Average lost 3.8%, and India's Nifty Index fell 4.8%.

## Analysis

Our central investment thesis entering 2011 was that, at least in the short-term, an environment of accommodative policy and low inflation would favor carefully selected risk assets. We argued that the global recovery, though moderate, fragile, and uneven, could be expected to remain sustainable. Our outlook, however, was qualified – first by our shorter-term time horizon and second by our vigilance for any policy mistakes or major shocks to the economy. As we noted, “changing circumstance(s) are causing us to make a small allocation to more defensive investments and could force us to assume a more defensive posture at any time.” While the market experienced shocks and proved resilient in the first quarter of 2011, pressures continue to build in the form of inflation, commodity prices, monetary policy, and housing weakness. In light of these pressures, it is not clear that economies have obtained the necessary escape velocity to sustain current growth trends. We also remain concerned that there has been little progress on key policy issues such as debt reduction and deficit spending.

**Our bias towards an increasingly defensive positioning is based on a less sanguine view of the key risks that could interrupt the longer-term recovery process.**

*Inflation and Commodity Prices.* While the inflationary tinder is in place, as yet there is no clear evidence of a spark – at least in the U.S. As such, a compelling case can be made for both inflation and deflation. Without a spark, however, the nearer-term risk appears to be deflation. That said, we are attuned to inflation pressures, and portfolios may need to adjust accordingly.

In the U.S., core inflation, which excludes food and energy prices, remains low. Quantitative easing seems to have resulted in large bank reserves and higher asset prices due to weak employment and wage growth as well as reduced borrowing. As a result, higher commodity prices have not translated into broader inflationary pressures. The concern, however, is that headline inflation, which includes food and energy prices, without wage growth could result in lower overall spending by consumers as they are forced to spend more on food and energy. Our opinion remains that a strong economic recovery cannot occur without the support of the consumer sector.

In any event, inflation expectations are rising. Headline inflation is running over 5% since the launch of QE2 last November, and firms are beginning to pass through price increases. There is a risk that the monetary base grows rapidly and that the Fed does not identify or act

quickly enough to stem inflationary pressures. What are the likely factors that could ignite a serious inflation cycle?

- Significant wage increases could lead to a wage-price spiral. At present, while employment conditions are improving, there is still slack in the economy. This slack, however, is not uniform, and employment is highly skewed. Employment is higher among the most skilled workers, suggesting tighter supply, which could lead to potential wage increases.
- Improved business confidence could lead to increased money supply. Many companies have delayed hiring and making capital expenditures due to economic, tax, and regulatory uncertainty. Improving conditions and clearer policies could lead those companies to increase hiring, spending, and borrowing, thereby injecting additional reserves into the money supply.
- Price and wage inflation could be imported from China. In addition to its own growth-oriented policies, China also imports accommodative U.S. monetary policy by linking its currency to the dollar. These practices, in turn, have led to inflation in China, which increasingly has been passed on to the U.S. through Chinese exports.
- Another shock, or series of shocks, similar to those experienced in the Mideast could lead to supply disruptions and trigger higher inflation.

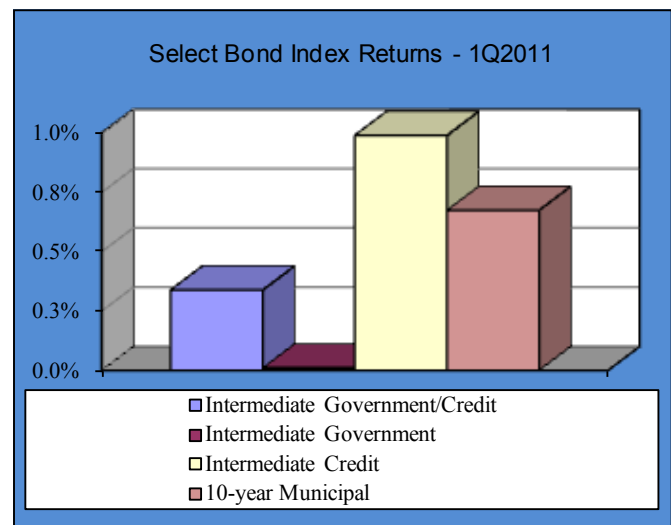
Of the above factors that could lead to inflation, the first two are the most likely causes and require heightened vigilance. The second two items would appear to present as much risk of deflation as they do of inflation. China faces a delicate balancing act. Historically, sharp increases in the cost of living have been linked to social unrest, so China will want to mitigate inflationary pressures. Yet, the steps needed to combat inflation also have risks. A sharp currency appreciation or increase in rates could hurt China's export business and state-controlled borrowers. Price controls tend only to be effective in the short-term, encouraging consumption and supply shortages and potentially resulting in longer-term inflation. As such, China is likely to continue to slow its economy as necessary through gradual rate increases, currency appreciation, and focused programs such as tightening mortgage credit and increasing supply to cool the housing market. More moderate Chinese growth should moderate commodity prices and ease inflation pressures. In fact, in the absence of wage infla-

tion, an exogenous shock that results in a commodity price spike, such as a weather-related food supply issue, could lead to deflation.

Nevertheless, oil could yield a geopolitical risk premium for the foreseeable future. As unrest spreads in the Mideast there does not appear to be a clear plan or the political will to address the underlying issues. In addition, even if reserves increase, extraction costs are expected to rise. Lastly, while substitutes exist for many uses, alternatives for transportation, which accounts for 70% of oil consumption, would not appear to be imminent.

*Monetary Policy.* There are significant questions surrounding the end of QE2 on June 30th, including who will replace the Fed as purchaser of Treasuries. PIMCO estimates that the Fed accounts for 70% of Treasury purchases. If additional purchases are necessary, or if the Fed seeks to shrink its balance sheet, it seems likely that public sector buyers will demand higher yields. Interestingly, another round of quantitative easing could also lead to higher yields. During both QE1 and QE2, nominal 10-year Treasury yields rose, largely due to higher inflation expectations. After signaling that quantitative easing has likely ended, the Fed recognizes that another round probably would have an even larger impact on inflation expectations. Unless the market has not fully incorporated expectations of the Fed exiting, the path of least resistance for rates remains to the upside.

*Housing.* The good news is that housing appears undervalued on a historical basis and mortgage rates are low. Recent housing numbers, however, are not encouraging. The problem is fundamental in nature – weak demand and excess supply. In brief, the demand problem is that households that want to move cannot and those that can move will not. Many households cannot move due to high unemployment and tight credit conditions.



Others will not move due to negative equity and a declining desire to own a house. If these factors persist or represent structural changes, then demand may remain weak for an extended period. Though housing starts are at historical lows, there is excess inventory, estimated to be four million above the long-term average, with continued supply arising from foreclosures. Overall, housing prices do not appear to have bottomed.

**Conditions vary dramatically among the world's economies, placing a premium on asset allocation.**

*Europe.* Europe continues to experience a slower recovery, largely driven by sovereign debt concerns. The peripheral countries remain weak, and, as expected, Portugal is seeking a bailout. The implied probability of default over next five years is estimated at nearly 60% for Greece and approximately 40% for Ireland and Portugal. These concerns are compounded by the recent ECB rate hike and the lack of a clear plan to handle peripheral sovereign debt, despite the claim of a "big step forward" at the recent European summit. Overall, the likelihood of debt restructuring appears elevated. There appears less political will to accept onerous fiscal constraints by the peripherals or to provide fiscal support by the core economies. As such, restructuring might seem the preferred option, as, historically, defaulting has not kept a country out of the markets for extended periods.

*Japan.* The earthquake and tsunami are likely to accelerate Japan's secular decline. The Japanese government is able to support government bond issuances as investors recycle savings and profits into government debt and rates remain low due to deflationary pressures. An aging population and lower corporate profits suggest these sources will decline, resulting in unsustainable debt levels and a necessary deleveraging. The earthquake and tsunami will likely accelerate this process as government costs increase with reconstruction efforts and corporate profits decline due to the disruption in activity.

*Emerging Markets.* Emerging markets remain structurally attractive and, having recovered rapidly, are now facing inflationary pressures. China is expected to maintain a growth focus, having tightened its policies to address inflation concerns. Commodity-driven economies are likely to slow with declines in commodity prices.

*The U.S.* Our opinion remains that a strong economic recovery cannot occur without the support of the consumer sector, which, in turn, necessitates stronger employment conditions. Weak employment and wage growth, combined with fears of a "double dip" in housing, pose a risk to the recovery. The U.S. has benefit-

ed from the quest for yield in a world of few options. Cash and cash equivalents continue to offer virtually no yield, intensifying the pressure on holders to seek a higher return on capital. Cash held by reluctant investors has found its way into riskier assets, including equities, driving prices higher. This presents a risk of outflows if alternatives (higher yields) present themselves.

## Conclusion

We are cautiously optimistic that the recovery will continue, but risks are building, and global governments appear in no hurry to address structural issues. Therefore, risks must continuously be monitored in 2011. While we remain positive on risk assets, we are inclined to be more defensive, diversifying across assets classes with increased exposure to uncorrelated strategies.

The quest for yield in a world of few options should continue to favor the U.S. equity markets. Internationally, we continue to favor select developed and emerging markets. The path of least resistance for interest rates is upward, and we expect Treasuries to underperform corporate credit. Municipal bonds also appear attractive on a relative basis. The municipal market fell on dire predictions of default, but, while demand and issuance remain muted, general revenue bonds and revenue bonds backed by essential services remain interesting.

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Sources: BCA Research, FactSet, Bloomberg, PIMCO, *The Wall Street Journal*.

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