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Perspectives

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Our view on the economy and the financial markets has not materially changed since last quarter. Globally coordinated, unprecedented governmental intervention has led to improved economic conditions and investor sentiment. The likelihood of low inflation, accommodative monetary and fiscal policy, and moderate economic growth remains substantial over the shorter term. Such conditions would likely continue to favor risk assets such as equities and corporate bonds over risk-free assets such as Treasuries. Longer-term, however, uncertainty abounds, as persistent high unemployment, soft real estate markets, and deleveraging threaten to subdue future growth. Investors should remain cautious and prepared for the possibility of volatility and more modest returns until such time as the longer-term economic uncertainties are favorably resolved.

REVIEW

Continued optimism surrounding the recovery of the U.S. economy, supported by above-consensus corporate earnings, helped the U.S. financial markets prolong their rally into 2010 – even in the face of ongoing weakness in the housing and labor markets. Yet, lingering economic and political uncertainties, stoked by the Greek debt crisis and signs of policy tightening in the world's emerging economies, led to increased instability and weighed on many of the international and commodity markets.

U.S. Equities. Fueled by improving corporate earnings, low inflation, and low interest rates, the U.S. equity markets continued their comeback during the first quarter of 2010. The rally, however, was led largely by lower-quality companies and was infused with some unpredictability.

The Dow Jones Industrial Average returned 4.8% for the quarter, its fourth consecutive quarter of gains and its strongest quarterly performance since 1999. The S&P 500 and NASDAQ Composite Indices also posted their fourth consecutive quarter of gains, returning 5.4% and 5.7%, respectively.

As has been the case throughout much of the rally, lower-quality, higher-beta companies were among the best performers. For example, the Russell 2000 Index of smaller, typically more volatile companies was up 8.9% for the quarter.

While the first quarter did produce significant gains, they did not come without resistance. The quarter began with a strong upward trend, but, toward the end of January, equity prices fell significantly on concerns about China unwinding its stimulus programs, Greece and other European nations defaulting on debt, and U.S. political activity surrounding bank regulation and health care. By February 9th, the Dow actually had *fallen* about 5% for the year. Then, as investors regained their confidence regarding China and Greece, stocks began an upsurge that ultimately produced positive quarterly results.

U.S. Fixed Income. Uncertainty, albeit on a reduced scale, similarly affected the bond markets during the first quarter. Corporate bonds began the quarter much the same way that they ended 2009 – with rising prices and increased issuances. As concerns mounted about the fiscal crisis in Greece and other European nations, however, corporate bonds, especially higher-yield or "junk" bonds, retreated. Nevertheless, toward the end of February, corporate debt regained its footing as fixed-income investors again sought out higher yields relative to the negligible yields offered by Treasury securities.

For the quarter, the Barclays Capital Intermediate Government/ Credit Index, which tracks a mix of government and corporate bonds, was up 1.5%. The Barclays Capital 1-10 Year Municipal Blend Index, which includes municipal bonds from around the country, was up 0.9%. The Barclays Capital Intermediate Government Bond Index, which focuses on U.S. government and agency securities, was up 1.1%.

Real Assets. As China and other emerging-market nations began to take measures to moderate their rapid growth and fears of weakness within Europe mounted, commodities generally pulled back after last year's gains. The Dow Jones UBS Commodity Index finished the quarter down just over 5%.

Oil, however, was bolstered by increased consumption, finishing the quarter at $83.76 per barrel for a gain of 5.5% – its fifth straight quarterly gain. Natural gas fell 31%, to $3.87 per MMBTU, due to increased supply levels; and gold ended the quarter up about 1.5%, at $1,113.30 per ounce, supported by increased demand for jewelry.

The housing market continued to show some signs of stabilization, as the Case Shiller indices reflected modest increases in home prices. Inventories for single-family homes, however, continued to rise, and the commercial real estate markets remained soft.

U.S. Dollar. During the first quarter, the U.S. dollar benefitted from relative weakness in Europe. As concerns about the debt crisis in Greece expanded into concerns that similar crises could arise in Spain, Portugal, and other countries, the euro fell approximately 6% against the dollar. In commodity-rich Canada, however, the Canadian dollar gained over 3.5% against the U.S. dollar, approaching parity for only the second time since 1976. Overall, the U.S. Dollar Index, which measures the dollar against a trade-weighted basket of currencies, finished the quarter ahead 4.1%.

International Markets. Weighed down by the debt crisis in Europe and uncertainty regarding fiscal and monetary policy, many of the international markets underperformed their U.S. counterparts during the first quarter, reversing last year's trend. The Dow Jones Global Index, excluding the U.S., was up just over 1.4% for the quarter in U.S. dollar terms, trailing the major U.S. equity indices.

Last year, benchmark indices in China and Brazil rose 79.8% and 82.7%, respectively. During the first quarter of 2010, concerns about these markets having become overheated and the prospects of tighter monetary policy and unwinding stimulus restrained investor enthusiasm. China's Shanghai Composite Index fell 5.1%, and Brazil's Ibovespa gained a relatively modest 2.3%. The MSCI Emerging Market Index returned 2.4% for the quarter.

The MSCI EAFE (Europe, Australasia, and Far East) Index of developed economies returned a meager 0.9% for the quarter. Not surprisingly, major indices in Greece, Spain, and Portugal all suffered significant losses. The United Kingdom's FTSE 100 Index, however, rose 4.9%, and Japan's Nikkei Index was up 5.2%. Germany's DAX Index gained 3.3%, but France's CAC-40 Index rose less than 1%.

ANALYSIS

Economic activity and asset prices have continued to stabilize in the current, remedial environment of policy stimulus and low inflation. Governmental support has largely succeeded in restoring confidence in the major financial systems, credit has begun to flow again (albeit at diminished levels), and fears of financial Armageddon have largely dissipated.

Corporate earnings have exceeded expectations, and, after yet another quarter of gains, the equity markets have recovered most of the losses they suffered after Lehman Brothers filed for bankruptcy protection in September of 2008. Many other asset classes, including corporate bonds, are now ahead of their pre-Lehman levels.

Yet, there remains considerable uncertainty about the longer-term sustainability of the recovery. Business and consumer confidence levels linger at relatively low levels, and not without justification. Consumers remain highly leveraged; unemployment rates are still high; credit flows have not been restored to normal levels; and the real estate markets have yet to recover. Perhaps more alarming is the fact that many governments are now burdened by increasingly large budget deficits.

Indeed, the National Bureau of Economic Research, which is responsible for ascertaining the precise timing of the nation's business cycles, has not yet declared when – or even whether – the most recent recession ended. On April 11th, *The New York Times* reported that, despite the fact that U.S. gross domestic product began rising in the second half of 2009, members of the NBER were of the view that "the evidence is not so easy to decipher" regarding the demise of the recession. One committee member, Robert E. Hall, offered the opinion that "the recession is over" and that "the odds favor the view that a true expansion has begun and that the recession beginning in 2007 is over." He then added, however, that "one cannot totally rule out the unlikely possibility that the economy might resume contraction again soon." Under this scenario, the recent upturn would be "only an interruption in a longer contraction, and not an expansion," although he noted that "currently, forecasters are assigning low probability to such a development." (Chan and Story, *Recession Arbiters, Wary of Certifying an Upturn*, p. B1.)

Our view is similar to that of Mr. Hall. The recession does appear to have ended, and, over the shorter term, the likelihood of an environment consisting of low inflation, accommodative policy, and moderate economic growth would suggest a preference for equities, corporate debt, and other risk assets over risk-free assets. Longer-term, however, a relapse remains a real possibility pending the removal of growth impediments such as high unemployment, housing weakness, high budget deficits, and deleveraging. Thus, while we currently continue to favor risk assets, we remain prepared to assume a more defensive tactical posture when necessary.

Interest rates should remain low until there are further signs of economic strength, but investors should prepare for eventual increases. BCA Research recently reported that, as of the beginning of this month, the markets are assigning a 50% probability of a 0.25 percentage point increase in the federal funds target rate within the next six months and an 85% probability of a 0.50 percentage point increase within the next year.

Nonetheless, even these restrained projections for rate hikes may be aggressive at this stage of the recovery. Inflation remains contained, with the Consumer Price Index rising only 0.2% during the first quarter and continued high unemployment and weakened housing markets serving as a check on inflation. In our view, recent news that Janet Yellen will be nominated to replace Donald Kohn as Vice-Chair of the Federal Reserve further supports the likelihood of a delay in significant rate hikes, as her speeches have reflected a consistency with Chairman Bernanke's sensitivity to the continued downside risks inherent in the economy.

Internationally, Europe and Japan also are likely to delay tightening their monetary policies, as they too consider an environment of low inflation and a slow-paced economic recovery. Commodity-producing nations such as Canada and Australia, however, have been or are likely to begin raising rates this year.

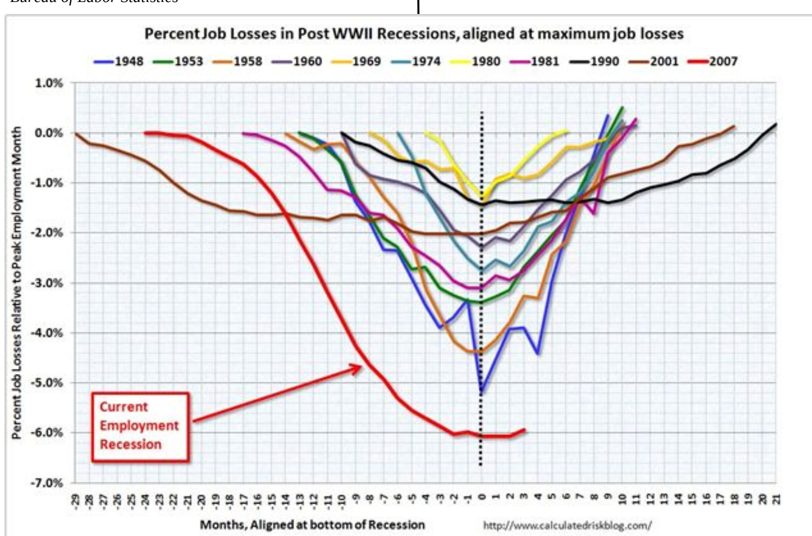
Fiscal policy remains accommodative, but, in our view, the period of maximum stimulus has probably passed. The Obama Administration continues to speak of ways to add stimulus, such as utilizing TARP funds to aid homeowners who are unable to pay their mortgages. Nevertheless, we do not believe that, during the current cycle, any future U.S. stimulus packages will rival those of the past two years.

Moreover, some state and local governments are now moving in the *opposite* direction, by cutting spending and raising taxes to balance their budgets. Similarly, on a global basis, many nations are facing increasing pressure to reduce spending and increase taxes, as deficits and public debt continue to accumulate. The trajectory of spending appears unsustainable in several countries, and Greece will serve as a test case for other fiscally challenged Eurozone countries such as Portugal, Italy, Spain, and Ireland.

While the U.S. unemployment rate appears to have stabilized, we remain concerned about the labor market's revitalization, which we view as central to a sustainable, robust recovery. After shedding over eight million jobs since the start of the Great Recession, the U.S. labor market remains approximately 6% below its prior level of peak employment, marking the largest contraction in post-World-War-II history.

We believe that a strong economic recovery cannot occur without the full and long-term support of the consumer sector, which, in turn, necessitates stronger employment and income-production conditions. Employers added approximately 162,000 jobs in March, but some 48,000 of those hires were temporary Census workers. In fact, over the next several months, the Census Bureau is projected to hire several hundred thousand more temporary workers, but we consider the private sector to be the key to any meaningful, lasting rise in employment levels. We estimate that, given current demographic trends, employment must rise by more than 150,000 jobs per month in order to reduce the unemployment rate, and we will be watching future labor trends carefully to see if that target is met.

Graph courtesy of: www.calculatedriskblog.com and the Bureau of Labor Statistics



We remain wary of continued tightness in credit availability. As we observed in our last newsletter, despite the expansive monetary policies implemented by many central banks, much of the money that normally would flow into the world's economies has remained trapped in banks that evidently remain reluctant to make loans. We consider the availability of credit an integral component of a sustainable recovery, and we will continue to monitor credit trends as a leading indicator of the pace and direction of the recovery.

Conditions appear to remain favorable for the U.S. equity markets over the next several months. Again, the equity markets have been bolstered by rising earnings, low inflation, accommodative policy, and moderate economic growth. They have also been supported by strengthening corporate balance sheets. By some measures, there has never been more cash on corporate balance sheets.

Importantly, however, the equity markets do not yet appear to be overheated. Historically, the median forward price-to-earnings ratio of the S&P 500 is 14.8. Based on analysts' expectations as reported by BCA Research, the current forward price-to-earnings ratio of the S&P 500 is still only 14.2.

Nevertheless, as valuations have been restored to more normative levels, we expect a transition back to more fundamentally-driven markets. After this transition, investors again should favor higher quality companies with superior relative valuations over the lower quality, higher volatility companies that have been at the forefront of the current rally. We also expect that equities have likely seen their best returns for this cycle and that future equity returns will be more modest.

We continue to favor selected risk assets over risk-free assets, but we believe that returns will be more modest and that volatility will increase until such time as there is greater clarity regarding the path toward long-term economic growth. As we have said before, we are forecasting only moderate economic growth over the next few years, but our view is that slower growth is not necessarily inconsistent with positive equity returns. In a slower-growth environment, inflation is more likely to remain contained, and interest rates are more likely to remain low. Sidelined cash, currently offering virtually no return, could also drive equity prices higher as it is invested by those willing to take on risk in order to generate greater returns. A summary of our current view on equities is as follows.

- The markets should increasingly reward stronger fundamentals, favoring higher quality companies with superior relative valuations.

- Future equity returns should be more modest, but volatility will, in all likelihood, persist.

- Opportunities for outperformance are presented by select larger companies with significant international exposure, as well as mid-cap companies that may benefit from increased merger and acquisition activity.

Corporate bonds also remain attractive, especially for investors that are unwilling to assume the risks associated with equities but that are also unwilling to settle for the relatively low yields offered by government bonds. (As of the close of the quarter, the 90-day Treasury Bill was yielding 0.15%.) Stronger corporate balance sheets and gradually improving economic conditions also remain supportive of corporate bonds.

Internationally, we continue to favor select developed and emerging markets. We also favor a wide range of commodities – particularly those that can benefit from increasing emerging-market demand.

CONCLUSION

Naturally, uncertainty regarding the economies of the U.S. and many other countries persists following the largest decline in wealth and the most financially destructive recession since the 1930s. Problems such as unemployment, housing sector weakness, restrained credit, high budget deficits, and deleveraging remain unresolved and cannot be ignored. Until these problems are dealt with, the strength and longer-term sustainability of the recovery will continue to be in question.

The recovery process does continue, however, and conditions currently favor seizing opportunities in select equities, corporate bonds, and other risk assets. Inflation remains low, while the economy grows at a moderated pace. Corporate earnings and balance sheets are improving. Monetary policy remains loose, and, while probably winding down, fiscal policy remains accommodative.

In these times, however, we must be alert and prepared to make tactical moves in response to any significant signs of deteriorating economic conditions. We will be especially focused on monitoring corporate earnings, the labor market, the flow of credit, and inflation trends over the next several months.

Sources: BCA Research, FactSet, Bloomberg, and the *Wall Street Journal*.