

Investment Outlook

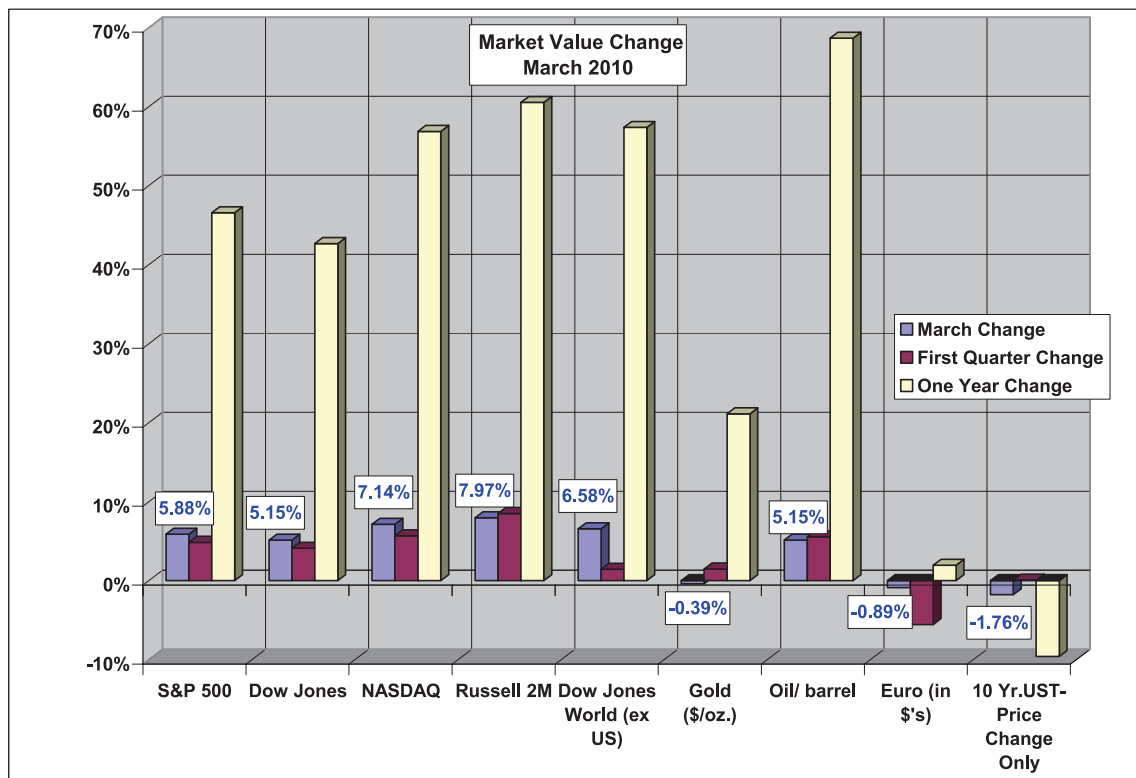
April 2010

Paths to prosperity



March Markets *A stealthy bull...*

Bulls, by their nature, are generally not thought to be either stealthy or graceful. Regardless, those seem to be the attributes of the ones that have stalked Wall Street for most of this year. In spite of conflicting and often lackluster economic data, a resurging credit crisis (this time featuring sovereign entities) and heightened political risks in many venues, equity prices continued to grind subtly upward through the first quarter of 2010 to close at 18 month highs, although still well below the pre-recession peaks of late 2007.



Investors' appetite for risk was evident in March as the small-company Russell 2,000 and technology laden NASDAQ outpaced the more sedate S&P 500 and Dow 30. International stocks (i.e. not U.S.) also did surprisingly well in spite of the stronger dollar (expressed above as a weaker Euro).

Commodities had uneven returns in March as oil paced the monthly return of the Dow 30 but gold lost a small amount of ground. As we have noted in previous issues, risk-aversion can also have a price, this time reflected in the price decline

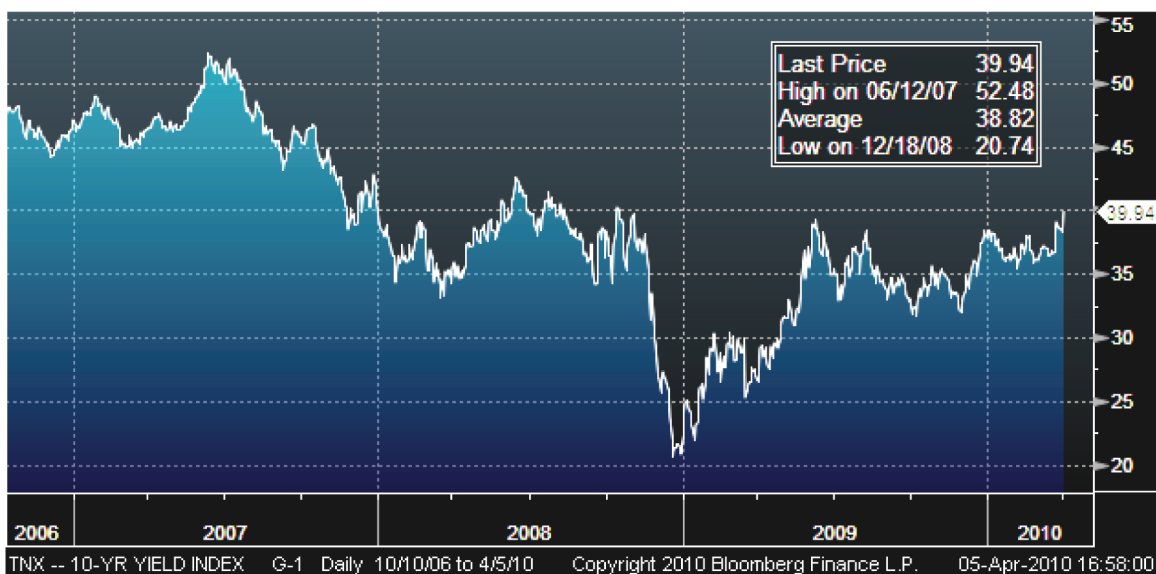
in “risk-free” 10 Year Treasury notes which declined -1.76% in March and have lost almost 10% over the past year.

Commentary ***The end of QE...***

Readers expecting comments on ocean travel can skip this part as the QE we’re referring to is not the famous Cunard Lines’ ocean liner named for the British Queen Mother, but rather the Quantitative Easing programs maintained by the Federal Reserve Bank which drew to a close on March 31st. *Quantitative Easing*, or QE as it is known, resulted from the Fed’s desire to provide further stimulus to the economy beyond that of the more traditional *Monetary Policy*; i.e. its control of short term interest rates and money supply.

Investors can be forgiven for not being overly familiar with QE as it was new to the Fed as well, with this venture being their “maiden voyage”. Basically the Fed brought assets onto its own balance sheet to provide liquidity for certain assets, maintain orderly markets and facilitate transactions; the latter referring primarily to Bear-Stearns and AIG.

By a large margin the bulk of the QE was intended to support the recovery in housing with the Fed purchasing \$1.25 *Trillion* in mortgage backed securities (MBS) issued by the two federal mortgage agencies. The Fed’s action was deemed necessary to facilitate the recovery of the secondary mortgage market given the, at least temporary, absence of the “natural buyers” for these assets. (For reference, the amount of MBS now on the Fed’s balance sheet is about equal to the entire current federal budget deficit.) The Fed also bought \$300 Billion of Treasury debt which also is still on the Fed’s balance sheet.



The “good news” comes in two parts here. First, the Fed created and successfully implemented the QE structure. Second, the Fed views markets, and the economy, sufficiently healed to allow the buying to cease.

While we don't see any immediate "bad news" here some important questions are apparent and bear watching for answers. The nearby chart plots the yield on 10-year Treasury notes over the past four years. The yield is charted as an index with the current value of 39.94 signifying 3.994%. The 10-year Treasury yield is significant as it serves as the basis, or benchmark, for most mortgage-related investments given the strong correlation between the life of the average mortgage and the maturity of these notes. It is also reflective of expected longer-term risk free returns.

The extent of the decline in Treasury yields (and rally in prices, as prices rise when yields fall) is clearly evident in late 2008 in the wake of the Lehman Brothers failure and subsequent freezing of credit markets. Investors sought the safety of Treasuries at any price to ensure the return of their money, regardless of the resulting paltry return on their money. The 10-year Treasury yield can also be seen as moving upward as confidence subsequently returned to markets and investors sought higher yields (note the comment on page one regarding the negative return for Treasuries over past year).

Among the issues to be followed here are:

- What is the "natural" rate for Treasury and MBS debt now that the Fed has ceased QE,
- What will be the source of demand for mortgage securities, i.e. who are now the "natural buyers",
- How will the retention of the QE assets on the Fed's balance sheet affect money supply and reserves and what are the resulting impacts when they are sold;
- How will that impact the economic recovery in general and residential real estate finance specifically to the extent that all of these seem to imply a path to higher rates for longer term debt?

At the time of this writing in very early April Treasury yields have moved higher with the 10-year yield recently touching 4.00% for the first time since October 2008. How much of this move is related to the end of QE, the improved first quarter-end economic data or the Treasury's continued deficit-funding debt issues is presently unclear.

What is clear is that higher yields will provide improved opportunities for new investments while pressuring the returns on existing ones. Alternately, a retreat from these levels, and accompanying rally in Treasury prices, would signify an acceptance within capital markets of a nominal return (i.e. return before any adjustment for inflation) of less than 4% for an intermediate period of time which is not a ringing endorsement of expectations for strong economic growth.

As noted, the market impacts and implications of the end of QE will need constant monitoring. In the meantime we do believe that a sustainable, although modest, economic recovery is in place which will continue to exert upward pressure on Treasury rates.

Outlook and Strategy ***Will April showers bring May flowers...?***

Equity markets entered April at their highest levels in eighteen months driven by economic optimism and a sustained recovery in prices from the twelve year lows experienced in March of last year. This optimism has the market “priced for perfection” as we move into the current corporate earnings season which will commence next Monday with Alcoa’s scheduled announcement. Expectations for above average earnings growth are understandable when compared to conditions that prevailed this time last year, coupled with the subsequent economic recovery and growth in productivity.

Some caution related to the sustainability of earnings growth in subsequent quarters seems in order as either the economic expansion will need to moderate or profit margins will be pressured by rising expenses related to meeting sustained demand. We also expect some investors to be disappointed if results fail to substantially exceed expectations given the generally lofty valuations that many have already factored into prices. The tendency to “sell the news” may be more evident this year given the desire to protect the significant gains that have accrued from last year’s low levels.

Having already noted a somewhat bearish view on bonds we will note that we see little reason for the Fed to raise short term rates any time soon and also reiterate our cautiously optimistic outlook on equities. With market gains for the first quarter about half of what we expect for the entire year there seems to be little need to aggressively buy into the current market. As noted in previous editions however, we do expect positive long term results and consequently would gradually add to equity positions if this “stealth rally” continues; while preparing to make a more substantial move on any significant pullback, something that has been long awaited by many but not yet forthcoming.

This strategy has served us well, not only in managing the recovery from last year’s lows, but also in outperforming the market looking further back to the pre-meltdown highs. Additionally, the ability of many market sectors to outperform the S&P 500 in March, as evident on the chart on page one, has benefitted our clients’ portfolios as well. While we will be reviewing these results with our clients in coming weeks, other investors wishing to have similar conversations are welcome to call.

S&P 500: 1,187.44
10 Year U.S. Treasury Yield: 3.98%

Mark Fingerlin
April 5, 2010