Economic & Market Commentary

The U.S. stock market continued the rally that began a year ago March, ending the quarter up 4.9%. After suffering an 8% downdraft in January-February, caused by domestic economic and earnings concerns, Chinese economic policy fears, and political concerns in Euroland, stocks resumed their upward march, and more than recouped their earlier loss. The healing trends that benefitted financial assets earlier reasserted themselves in the quarter, providing for the good performance. Evidence that our economy is recovering from a sharp contraction is visible with increasing frequency. Recovery from the "Great Recession" probably started in the second half of last year (the National Bureau of Economic Research Cycle Dating Committee has not declared so yet, but no doubt will soon), even though labor and capacity utilization remain at extremely depressed levels. Real GDP was reported positive for the final two quarters of last year:

Q3 +2.2% - virtually all from government stimulus
Q4 +5.6% - more than half from inventory change

Expectations for this year's first quarter are for growth to be slower (3% area), but of higher quality, with consumer spending (final sales) and corporate spending on equipment and inventories expected to provide the largest gains.

The largest conundrum in today's economic puzzle is the U.S. consumer – representing 70%+ of domestic economic activity. Other than a fleeting period of shock early last year, the consumer has been a positive factor in the convalescence of the economy. This in spite of the well-known problems facing this sector:

- the massive unemployment leading to little growth in personal income; average weekly hours worked and average hourly earnings have been in declining trends over the past year;
- the overleveraged position of the consumer's balance sheet, which is just beginning to unwind, and will take years, not months to do so;
- the low savings rate which has been in place for several years, and needs to be rebuilt;
- the decline in housing and financial asset prices that severely reduced consumer's wealth;
- weak consumer confidence data which usually is a precursor to weak personal spending;
- unprecedented mortgage delinquencies and defaults; and
- accelerating personal bankruptcies.

All of these are logical reasons for consumers to put their hands in their pockets, and not spend – but they haven't. Quite the contrary, after declining in late 2008 - early 2009, consumers turned the corner at mid-year and were positive contributors in the final two quarters of 2009. The general expectation is for a continuation of this trend into 2010. There appears to be two major reasons for this seemingly contradictory behavior. First, the historic rally in financial assets, particularly equities, and the apparent stabilization in housing prices have begun to repair the consumer's balance sheet – household net worth has increased. Second, government transfer payments have helped the consumer's income statement, replacing earned income. Transfer payments have increased from about 10% of disposable personal income to close to 20%. Morgan Stanley recently pointed out that American households in aggregate are now receiving more in cash benefits from the government than they're paying in taxes. These fiscal policies have taken the pressure off the consumer's need to save, and the saving rate has declined from its peak to about 4% currently. Many of these factors could be considered non-recurring. Transfer payments will subside and, there is evidence, through delinquencies and foreclosures, that housing could suffer another setback. The still extended level of private debt means that deleveraging will be with us for some time which implies that savings rates should climb. All of this mitigates future consumer strength. The point is that with these factors in place today, the economy has "bought time" to heal. The employment picture is improving. The most recent jobs report showed only the third increase in non-farm payrolls in the last 27 months, and the largest increase in 35 months. If this continues, as we think it will, earnings will begin to replace transfer payments, allowing modest spending gains to continue. As a pundit recently said, "the consumer doesn't need to lead the parade, but they do need to show up."

Our expectations for the other components of economic growth haven't changed much over the last 3-6 months:

Business – inventory build should continue for a few more quarters – there is plenty of evidence of a stretched supply chain.
Capital Spending – shows signs of life for tech hardware and software – the search for productivity enhancement fuels this.
Exports – should be a positive as long as the dollar does not strengthen for a protracted period.
Government – the current stimulus will run its course after mid-year. State and locals are under great stress and will provide no help. This could present a problem in the second half.
Policy – at this point policy (taxes, health care) and regulation (increasing) agendas do not appear to be growth oriented.

Netting this out, we conclude that Q1 and Q2 should show modest growth periods, and that the second half can continue to grow, but at a slower pace. Many of the problems created over the past few years will take time to work themselves out, which we think will lead at best to sub-par growth for a number of years. This could be called a "Goldilocks Outlook" – neither too hot nor too cold, and assumes no negative exogenous factors. In our view, moderate growth is the most favorable outcome for financial assets as it constrains both inflation and interest rates, allowing them room to move up gradually without disruptive impact.

Profit growth during this recovery has been strong for most companies (as reflected in the S&P 500 data). Margins have returned to a "high" level after cratering in late 2008. Most industrial companies came through the downturn in good shape. Peak operating earnings for the S&P 500 were close to $90 in mid-2007, while trough was $40 in the four quarters ending September 2009. Last year GAAP earnings came in close to $52 (operating close to $62). Q4 was strong, and if "unusuals" are taken out, the pro forma annualized number was $73 according to UBS. Book value is back over $500, so a normalized ROE of 14% yields earnings of $70. Margins have rebounded with cost cutting and productivity enhancing moves. If some of these things remain in place, there is room for further expansion as revenue growth resumes.

As mentioned earlier, first quarter stock markets were robust. The character of the quarter's results was similar to that exhibited during much of 2009. More volatile (higher beta) and lower quality stocks outperformed the broader market, particularly in the last month, while large cap, high ROE and growth, and dividend payers lagged. From where we sit the “market” is neither cheap nor expensive, selling at 15-16x current year’s estimated earnings. However, gaining more than 75% in the past 13 months, without a meaningful pause, raises a yellow flag. This is particularly true given the lack of clarity we see for the second half of year.

The P/E expansion phase of this market recovery is probably drawing to a close, and earnings growth will be the focus going forward. We, too, will be focused on earnings growth, both near-term and normalized, in the moderate growth environment we foresee. As always, we will put that in the context of appropriate valuation metrics, to find attractive candidates for portfolios.

FIXED INCOME

Once again, risk paid off for fixed income investors during the first quarter of 2010. The Barclays Aggregate Index total return for the period was 1.78%. Breaking down this return into some of its components, Treasuries returned 1.12%, agencies 1.19%, mortgages 1.54%, and corporates returned 2.30%. Within the corporate sector, Baa-rated corporates were the best performers with a return of 3.25%. The best-performing fixed income asset of all during the first quarter, however, was commercial mortgage backed securities. These bonds provided investors with a 9.10% return in the first quarter in spite of double digit commercial vacancy rates. Nevertheless, investors continued to accept increased risk in this and others sectors of the bond market as they looked for higher yields. Spreads over Treasuries on mortgages and corporates narrowed as a result.

Treasury yields were roughly 10 basis points lower at March 31, 2010 than they were at December 31, 2009 in the 2 year and 5-year sectors of the market. Ten-year yields were essentially unchanged during the quarter while 30-year yields were 7 basis points higher than at year-end. The path to this relatively subtle move, however, has been a rather volatile one. Two-year yields moved 38 basis points between their high and low for the quarter (keep in mind that the absolute yield is just over 1%). Five-year yields moved 46 basis points during the quarter. Ten’s and 30’s moved roughly 25 basis points each during the quarter. While the Federal Reserve did not adjust the Fed Funds rate, it did increase the discount rate during the quarter. This was a sign to many that the end of very easy monetary policy was about to begin.

The move lower in yields in early February was largely the result of the turmoil in Greece and subsequent weakness in both the euro and pound sterling as concerns over sovereign balance sheets grew. After investor concerns about a European meltdown faded, US yields rose to near highs for the quarter by the end of March.

The municipal bond market continues to generate strong returns as the demand for tax-free yields outweighs poor economic fundamentals in many states and municipalities. While the recent decisions by Fitch and Moody’s to revalue their municipal ratings higher should help the market, the budget gaps throughout the nation and the need to raise funds through additional bond offerings will eventually wear on the municipal bond market. This is especially true in states and cities rated well below AAA.

Going forward, we expect Treasury yields to increase over the course of 2010 and into 2011. The combination of Treasury issuance and the end of quantitative easing should require investors to demand higher yields for the almost $2 trillion of new supply coming to market during 2010. The spectre of Fed action to increase rates will likely keep the bond market from rallying significantly as well. Even if the Fed does not increase rates in 2010, the thought that rate hikes are coming may be enough to keep rates on an upward trajectory. Mortgage spreads are likely to widen as Fed buying comes to an end and higher Treasury rates slow mortgage prepayments. Municipal bond prices are likely to remain relatively firm in spite of weak fiscal finances as investors continue to have a healthy appetite for tax-free incomes.

Finally, corporate spreads are likely to remain at or near current levels as investor demand stays high. However, there are certain factors that could threaten corporate bond performance. Even though corporations have shown strong earnings over the past few quarters, the easy comparisons with late 2008 and early 2009 will end. Businesses will then be forced to show the market that performance is based more on growth of revenues and profits than simply a result of cost cutting. These more difficult comparisons later in the year could put pressure on corporate bonds if companies miss more challenging earnings targets.