

## Financial Markets Commentary

April 2010

Neither natural disasters nor the near default of Greece could deter the markets from grinding higher during the first quarter. This was mainly because the global economy continued to improve, with a few exceptions, and corporate profits rose in line with best-case expectations. U.S. Treasury yields were basically unchanged at quarter end, held stable in part by support from the Federal Reserve, while credit spreads continued to compress. The inflation rate remained low, commodities prices were mixed and the U.S. dollar strengthened versus most major currencies. Though we expect some cooling off in the second half of 2010 and are concerned about government and regulatory changes now in process, we believe it is prudent to maintain current target allocations.

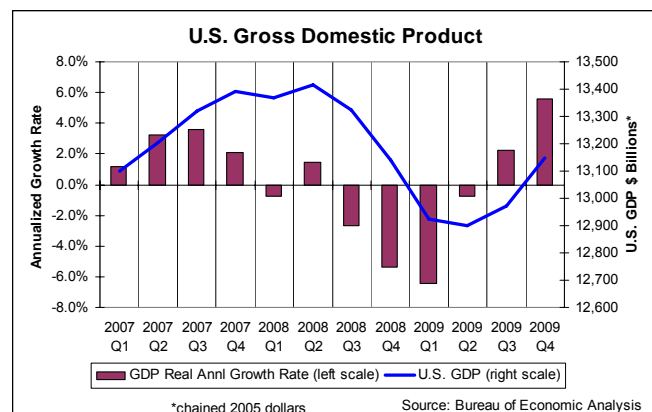
A summary of our recommendations follows:

- Although we expect increased volatility and a significant correction in stock prices this year, clients should ride it out, maintaining their equity allocations near long-term targets. Furthermore, stay with the tilt toward high-quality, less levered, cash flow-positive businesses, active investment managers and a globally diversified portfolio.
- Maintain allocations to bonds near your long-term targets. Avoid or reduce U.S. Treasury and other sovereign issuers in favor of corporate and municipal issuers and a portion of high yield bonds. Utilize active multicurrency managers.
- Maintain a target allocation to managers or funds that execute active global tactical allocation strategies as well as other alternative strategies.

### Economy

The economy continues to recover as well as could have been hoped. With the important exception of employment statistics, virtually all statistical measures of economic activity and future economic activity are improving. The ISM Purchasing Managers Index moved sharply higher in the first quarter finishing March with a reading of 59.6 which indicates solid economic expansion. The Fed's Industrial Production Index is recovering as is consumer spending. Combining a few of these factors with other market related indicators, such as stock prices, the Conference Board's Index of Leading Economic Indicators also improved in the 1<sup>st</sup> quarter. This relatively robust growth has been well within our expectations, as a result of a snapback in purchasing and manufacturing activity from its sharp drop during the financial crisis. The pace of economic growth during the second half of 2010 and beyond is more difficult to foresee, but we currently suspect that it may be much slower.

Officially, the Bureau of Economic Analysis (BEA) reported that the U.S. economy grew at an annual rate of 5.6% during the 4<sup>th</sup> quarter of 2009. Current estimates for GDP growth during the 1<sup>st</sup> quarter 2010 average around 3.1%, as do estimates for the full year. We expect GDP to be higher than that during the 1<sup>st</sup> quarter, but with significant slowing as the year progresses. So far, this growth has not significantly stimulated employment opportunities and the unemployment rate dropped only slightly to



9.7% (from 10.0%) during the quarter. Incidentally, the National Bureau of Economic Research (NBER) has yet to pronounce the recession over, although spokesmen have alluded that they think it was likely over in the latter half of 2009.

Economic growth outside the U.S. has been extremely varied. With few exceptions, Europe is basically stagnant and has not been experiencing a rebound in demand or an inventory rebuild. In addition, the fiscal problems emerging from Greece, Spain and Portugal are straining the relationships of the European Union. Even though these countries are small in relation to the overall European economy, the structural and cultural challenges they represent are significant. In addition, as we write, a cloud of volcanic dust is putting the damper on 2<sup>nd</sup> quarter growth.

Conversely, China continues to grow aggressively, according to its own Ministry of Finance, and its consumption is stimulating growth throughout the Far East. While specific numbers, such as the reported 11.9% 1<sup>st</sup> quarter growth, must be taken with a huge grain of skepticism, it is pretty clear that the Chinese economy is growing rapidly. This is largely due to massive government spending, and the Chinese apparently have plenty of reserves to continue this program. While government officials have publically noted that they are concerned about an asset bubble and have shown some willingness to put on the brakes, it is also clear that China is racing to stimulate and build a large middle class en route to a self-sustaining domestic economy. Hence, there is a lot of upside potential and downside risk in this adolescent economy.

## Stocks

Aside from a brief 9% drop beginning in mid-January, the stock market continued a strong drive higher in the first quarter, even accelerating in March. While this performance was better than we expected, notably it has been backed up by solid earnings growth. As mentioned previously, companies had aggressively slashed costs in late 2008 and throughout 2009 so that any increase in revenue expanded the bottom line.

The strong earnings results along with continued government stimulus to keep interest rates low overcame a few nagging problems and powered the market to a relatively broad, uneventful gain. Volatility moved lower as investors seem to be settling in to a view of steady recovery and corporate profit expansion. The VIX index, which measures the volatility implied in options contracts moved down to 16%. In the U.S. markets, 8 of 10 sectors delivered gains (as measured within the S&P 500), led by industrials and financials, up 12.45% and 11.82%, respectively. Telecommunications and utilities were the only two sectors to drop: -5.66% and -4.6%, respectively.

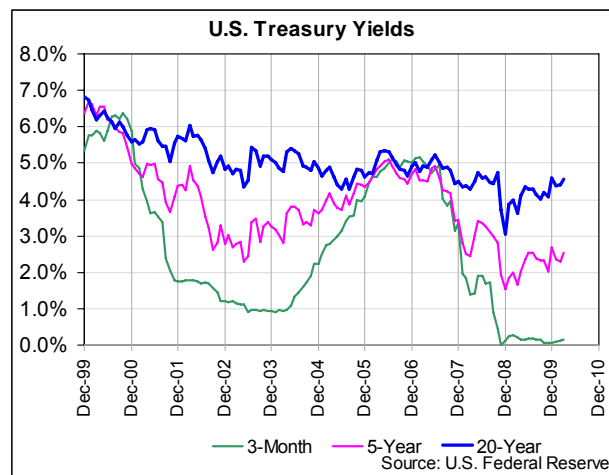
Foreign stocks provided a wide variety of returns during the 1<sup>st</sup> quarter. The Eurozone countries were among the weakest, as concerns over the solvency of Greece were at the forefront. Greece and other countries perceived to be in similar poor fiscal conditions, such as Spain and Portugal, fell significantly while the healthier countries such as Germany and France were put under pressure to aid Greece. Meanwhile, the euro currency traded lower due to the general uncertainty over how this and other similar situations would be resolved. Chinese stocks moved slightly lower as officials have begun raising interest rates in order to moderate the rapid growth it has been experiencing. Similarly, interest rate hikes in Australia and India among others, slowed their equity markets.

Small and mid-capitalization stocks handily outperformed large-caps during the 1<sup>st</sup> quarter, and, contrary to our expectations, low-quality companies (low ROE, negative earnings) significantly outperformed higher quality stocks, on average. Although that might suggest that investors are expanding their risk exposure, a view at mutual fund flows reveals that the large majority of net mutual fund purchases during the 1<sup>st</sup> quarter was into bond funds (taxable and municipal), while the net flow to U.S. stock funds was virtually zero. Within that group, large cap stock funds (which have the most assets by far) experienced net outflows while small, midcap and foreign stock funds experienced inflows. In addition, there were significant net cash flows into alternatives and commodities mutual funds. There appears to be a noteworthy migration toward more bonds and more diversification among mutual fund investors.

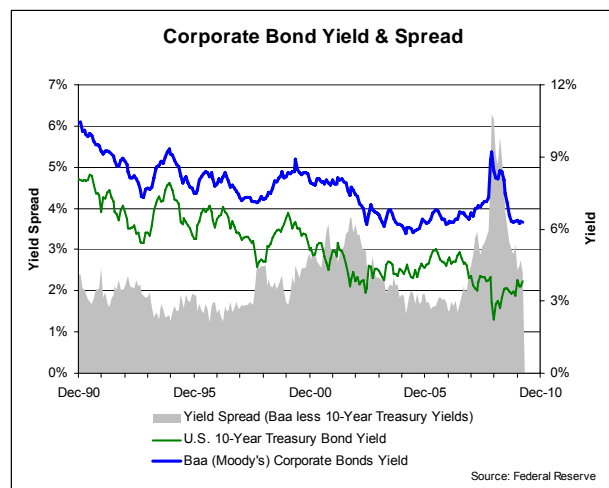
The S&P 500 Index returned 5.39% during the 1st quarter, while the S&P Mid-Cap 400 returned 9.09%, and S&P Small Cap 600 returned 8.61%. The MSCI EAFE index returned 0.87% and the MSCI EM Index returned 2.41% (US\$) for the 1st quarter.

## Bonds

At quarter end, the U.S. Treasury yield curve was virtually unchanged from its level and shape at the beginning of the year. However, that outcome masks a fair amount of movement and uncertainty throughout the period, particularly in light of the Fed's termination of its quantitative easing program at the end of March. The yield curve remains historically steep, reflecting investors' concern for inflation in the long-term, while the short-term yields reflect loose monetary policy with few immediate inflationary pressures. Hence, U.S. Treasury securities provided total returns similar to their yields during the 1<sup>st</sup> quarter. The Citi 10-year U.S. Treasury Index returned 1.05% during the 1<sup>st</sup> quarter, while the Merrill 3-month T-bill Index returned 0.01%.



Investment grade and high yield credit spreads continued to contract, reflecting the improved economy and corporate profits. Consequently, corporate bond prices rose slightly on average so that total returns were somewhat higher than current yields. Credit spreads remain moderately wider than their historical averages, but are now within a range we would call normal. The Merrill Lynch Corporate Bond Index returned 2.75% for the 1st quarter and the BarCap US High Yield Index returned 4.62%.



In addition to the improving credit landscape, bonds were helped by the aforementioned heavy inflows into bond mutual funds. This supported another quarter of strong corporate bond issuance, including record issuance in high yield bonds. Most of these deals were characterized as balance sheet repair (refinancing to lower cost and/or substituting short-term debt for long-term debt) but some were for the purpose of merger activity and we expect that this may increase going forward.

In contrast, the yield curve for municipal bonds rose during the quarter, particularly in March, and despite continued support from mutual fund inflows. Yields for AAA municipal bonds with maturities from 3 years to 10 years rose by about 30 basis points (0.30%) while 30-year yields remained stable. Yields for 10-year AAA munis are currently more than 80% of treasuries, and 30-year yields are almost 90% of treasuries.

Similar to the taxable market, credit spreads continued to contract and lower credit bonds performed better. The Build America Bonds Program (BABs), which enables some municipalities to issue taxable debt subsidized by the U.S. Government was extended and expanded to include more types of issuers. Consequently, BABs will continue to reduce the new supply of tax-free bonds, which is generally good for prices.

In the coming months Moody's and Fitch will recalibrate their credit ratings for municipal bonds. This will have no effect on the credit worthiness of the bonds and very little if any effect on prices, but will likely raise the amount of higher rated bonds.

The BarCap Municipal Bond Index returned 1.25% for the quarter while the shorter term BarCap Municipal 5 Year Index returned 0.77%.

Aside from the specific problem countries like Greece, whose bonds obviously dropped significantly, most foreign sovereign debt returns were more affected by currency movements than anything else. Given the 6% drop in the euro and British pound relative to the U.S. dollar, returns on European debt were negative. The BarCap Global Aggregate Bond Index returned -0.27% for the 1<sup>st</sup> quarter.

## Cash

Commercial paper markets continue to function and funding rates remain low. Three month LIBOR (London interbank offered rate) increased slightly from 0.25% at year-end to 0.29% at the end of March. Rates for commercial paper and bankers acceptances remain similarly low and the Federal Open Market Committee has maintained its target Fed Funds rate at between 0% and 0.25%. The Fed did increase the discount rate (the rate it charges commercial banks) from 0.50% to 0.75%, a largely symbolic gesture to signal its intent to tighten when necessary. According to iMoneyNet, the current yield for the average money market mutual fund is 0.02%.

## Alternatives

Reflecting favorable returns in most equity and fixed income markets, nearly all hedge fund strategies were profitable in the 1<sup>st</sup> quarter. According to the CS/Tremont Hedge Fund Indexes, only Dedicated Short Bias (-9.36%) and Equity Market Neutral (-0.72%) managers ended the quarter with a loss.

The top performing sectors were all credit related: Distressed (5.02%), Event-Driven (4.76%), Multi-Strategy Credit (4.58%), Fixed Income Arbitrage (3.57%) and Convertible Arbitrage (3.53%). Only a few notches below those performances were Long/Short Equity (2.79%), Emerging Market (2.63%), Multi-Strategy (2.59%), Global Macro (2.57%), Managed Futures (2.07%) and Risk Arbitrage (1.40%) managers.

Emerging and credit markets continued last years' winning streaks as foreign stocks and bonds edged higher and credit spreads continued to narrow. Directional traders also profited from favorable price trends (equities, dollar, copper, crude oil) as well as declining market volatility.

Investor flows have been slowly returning to the hedge fund sector this year, adding 4.4% in the 1<sup>st</sup> quarter, and have been mostly limited to seasoned managers. One area of investor focus is emerging markets where new hedge funds and funds of hedge funds have been launched targeting equities, debt (sovereign and corporate) and currencies. Total global hedge funds assets under management remain near \$1.7 trillion.

Private equity results have not been as attractive. Although final quarter 2009 returns are still not available, performance for all of 2009 was probably in the single digits, and the \$246 billion raised last year paled by comparison with the record \$646 billion collected in 2007. There still remains \$1.1 trillion of uncalled capital outstanding, committed in the peak bubble period of 2005 through 2007, ready to be deployed.

On a positive note, if the publically traded markets continue to improve, there is a large potential backlog of private equity ready to be liberated by public offerings. According to Dealogic, there is a current pipeline of more than 30 IPOs on the shelf from private equity backers and likely more waiting for a window to sell.

## Real Estate

REITs and publically traded REOCs continued to move higher along with the stock market despite the fact that commercial real estate remains in a difficult position with high vacancy rates. While hindsight shows this to have been an opportunity missed, we continue to believe that the commercial real estate market offers more risks than potential rewards, and still presents a significant risk to the banking system.

Residential real estate prices remained stable on average during the 1<sup>st</sup> quarter. The total number of existing houses sold has been volatile but clearly higher than the levels of 2008 and 2009. In addition, pending home sales and building permits seem to be on the rise. Higher volumes and activity is a positive, but we still do not expect home prices (on average) to rise meaningfully any time soon.

### **Commodities**

Commodities prices on average were slightly lower during the 1<sup>st</sup> quarter, but as usual, the returns varied widely across sectors. The S&P GSCI Index fell -0.89% for the quarter. Livestock and industrial metals rose 7.0% and 4.5%, respectively. Although various forms of oil rose about 4% for the quarter, with crude oil finishing at \$84 per barrel, the price of natural gas dropped sharply (-30%), leaving the energy index with only a slight gain. Precious metals also moved marginally higher with gold finishing at \$1,115 per ounce.

Agricultural commodities prices traded lower as all crops except for cotton and coffee move significantly lower. Most notably, sugar prices dropped more than 36%, correcting from an 86% increase during 2009. In addition to basic mean reversion the apparent explanation for the move was better growing conditions in India.

### **Looking Forward**

While there seemed to be an inordinate number of significant geological events (earthquakes and volcanoes), there were very few economic and financial market surprises during the 1<sup>st</sup> quarter. As a result, most of the themes we described in our January review, remain intact.

We were pleased to observe that corporate earnings (on average) have indeed met the growth expectations published by analysts and that some of the growth was accomplished through revenue gains, not just cost cutting. We note, however that these gains were achieved from a backlog of demand and with the benefit of significant government stimulus. In addition, the Federal Reserve's quantitative easing (QE) activities (in which the Federal Reserve purchased mortgage and U.S. Treasury securities) have been successful in stabilizing interest rates and in reducing market volatility. We are skeptical about the stock market's ability to continue to advance with limited volatility as the stimulus programs run down, the Fed eliminates QE and unemployment remains high. We suspect that the market is due for a correction and increasing volatility this year.

However, we know that we cannot time such an event, or predict the catalyst that may cause it. We'll leave it to the tactical allocators to seek those returns. Furthermore, we observe that the stock market's valuation is not extreme, that there is plenty of cash on corporate balance sheets and that a steep yield curve is supportive of profits and predictive of a growing economy. In addition, we expect an increase in acquisition activity which should be a positive influence on stock prices. Thus, we believe it is most prudent for clients to maintain their stock allocations in line with their long-term strategic allocations.

While it has not been recently fruitful, we continue to advocate a tilt toward high-quality companies with solid balance sheets and positive cash flow. Valuations for these companies remain attractive, and their financial positions afford them flexibility to prosper in a variety of scenarios. If the economy falters their liquid reserves will help them sustain operations. If the economy drops into an extended period of slow growth, which we believe is the most likely scenario, these companies will have the resources to grow through acquisition, grow EPS by reducing their outstanding shares or increase their dividend payouts. In an environment of robust growth, the most levered companies will have an advantage, but high-quality companies will deliver attractive results.

We continue to believe there is solid growth potential in emerging markets and that companies domiciled throughout the world can participate. This is a popular idea, however, and valuations in the emerging markets are stretched. In addition, we are increasingly concerned about rising protectionism among countries including China and the United States, which will impair world trade. These developments bear watching but should not deter investors from seeking geographic diversity in their portfolios.

### **Inflation/Deflation**

Until employment and capacity utilization recover to more normal levels, we see little chance of classic inflation. However, since the U.S. represents only a part of the global demand for commodities, there is a risk that we experience commodity price inflation as demand from the emerging economies increases. The best investments to confront this situation are stocks of companies in the materials and energy sector along with related service companies that will benefit from rising prices and increased extraction activities. For diversification from equity risk, some investments in commodity ETFs may be useful. In addition, alternative managers that tactically trade in commodities should prosper in this environment.

### **Currency**

As we postulated in January, the U.S. dollar appreciated versus most other major currencies, and given the disarray in the European Economic Union we believe there is a good chance that the dollar will continue to appreciate versus the euro. While we generally believe in the benefits of currency diversification that comes naturally along with geographic stock and bond diversification, we believe the euro and British pound should be de-emphasized in favor of the smaller developing market currencies and the U.S. dollar.

### **Taxes**

Nothing has changed with respect to our view that taxes will likely rise except for the passage of health care reform, which is most likely to put even more upward pressure on the government's need for tax revenue. In addition to encouraging our clients to take full advantage of tax advantaged and tax deferred accounts, we observe again that tax-free municipal bond yields are quite attractive relative to U.S. Treasury yields.

### **Rising Interest Rates**

With the end of the Federal Reserve's QE activities and no end to the increased supply of debt that the U.S. Treasury will need to issue, we expect interest rates to go higher not lower. Other sovereign issuers are in a similar or worse position, so we continue to advocate avoidance of U.S. Treasuries and most other foreign government bonds. High quality mortgage-backed securities are not particularly attractive either.

All that said, we still do not expect rates to climb sharply this year and we do not expect the Fed to tighten until the unemployment rate begins to drop in earnest. This leaves room for corporate bonds, investment grade and high yield, to provide acceptable returns this year. These bonds are trading within normal but above average spreads, and with the U.S. Treasury issuance expected, we would not be surprised to see corporate and high yield spreads move to below average. In addition, emerging market bonds continue to display attractive yields, combined with what we expect to be stable or rising currencies.

April 26, 2010

Thomas G. Hoffman, CFA  
Chief Investment Officer

*The information in this commentary is based upon current public information that we consider reliable as of the date appearing above, but may not be accurate or complete, and it should not be relied on as such. Information and opinions are as of the date of this commentary only and are subject to change without notice.*

*This commentary discusses general market activity, industry or sector trends, and/or other broad-based economic, market or political conditions, and should not be construed as research or investment advice. This commentary is intended for educational purposes only and to facilitate your discussions with Samoset Asset Management Company as to the opportunities available to our*

*clients. This commentary is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation to take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this commentary is suitable for their particular circumstances and, if appropriate, seek professional advice, including advice from their financial advisor and tax advice. The price and value of investments referred to in this commentary and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur.*

**Copyright 2010 Samoset Asset Management Company LLC. All rights reserved. No part of this material may be copied, photocopied or duplicated in any form by any means or redistributed without the prior written consent of Samoset Asset Management Company LLC.**