



Client Newsletter

Quarterly Economic Update

April 8, 2010

The Quarter in Brief

The opening quarter of 2010 can be summed up in four words: so far, so good. Despite persistent warnings of an imminent stock market correction, the likelihood of a “double dip” recession or a tepid recovery with sustained high unemployment, stocks continued the strong advance that began in the first quarter of 2009. It was a quarter in which major healthcare reforms became law, the dollar mounted a strong comeback, the housing market lagged and the global economy showed signs of a burgeoning revival. Somehow, in spite of all the political infighting about healthcare reform, paralyzing snow storms in the Mid-Atlantic and Northeast, devastating earthquakes in Haiti and Chile, and the potential contagion from Greece’s debt problems, it was a very positive time for investors across the globe.

Domestic Economic Health and Financial Markets

The economy has expanded now for three full quarters to include a revised 5.6% GDP in the fourth quarter of 2009 and an estimated 3% for the first quarter of 2010. The primary drivers so far include a burgeoning recovery in consumer spending, increased business activity and strong government outlays. While consumer spending increased 0.4% in January and 0.3% in February, consumer sentiment vacillated during the quarter. In the Reuters poll, consumer sentiment decreased from 74.4 in January to 73.6 in both February and March. The Conference Board survey of consumer sentiment read 52.5 for March, up from 46.4 a month earlier yet below January’s reading. Overall, it’s more important to track what consumers actually do, rather than what they tell the surveys (e.g., sentiment) they are going to do.

The ongoing debate about the prospects for increasing inflation was on the minds of investors, but it wasn’t affecting consumer prices much. The Consumer Price Index increased by 0.2% in January but was flat for February. At the end of February, the Bureau of Labor Statistics estimated that headline inflation had been 2.1% over the last 12 months, which is fairly benign in historical terms, and the more stable core inflation rate was only 1.3% for the year. In fact, the Fed and most economists would welcome more signs of moderating inflation, as the far more damaging effects of potential deflation are still of concern to policy makers.

As for business activity, the quarter brought some very good news. From January to March, the Institute for Supply Management’s manufacturing index readings were 58.4, 56.5 and 59.6, while its service sector gauge also went positive in all of those months, rising to a reading of 55.4 in March. Any reading above 50 is positive, so the trends in manufacturing and services are

positive. Also, durable goods orders soared 3.9% in January and increased another 0.5% in February for a third straight monthly gain. Retail sales advanced 0.3% in February after an adjusted 0.1% gain in January.

The official unemployment rate stayed at 9.7% throughout the first quarter. The notable development: the economy added 162,000 jobs in March, the largest month-over-month surge in payrolls in nearly three years. While the trend is turning positive, the unemployment rate is predicted to stay above 9% for at least the next two to three quarters and slowly decline by about 1% per year for the next few years.

Of course, the dominant political development was the passage of the healthcare reform bill. The public option died, but the reform bill lived, as the House passed the Senate version without one Republican supporting vote. The economic impact is still being discussed, as so many of the provisions and supporting tax changes/increases occur over several years.

After a rocky start in January and February, the S&P 500 Index rallied 6% in March to end the quarter up 5.4% for the best result for a first quarter in 12 years. Returns in the various fixed income sectors were all positive for the quarter, ranging from a baseline 1.8% for Barclay's Aggregate Bond Index and rising to 4.6% for High Yield bonds and a gaudy 8.95% for Investment Grade Commercial Mortgage Backed Securities. TIPS were the laggards with a 0.6% return, as inflation remained benign and supply weighed on this sector.

Global Economic Health and Financial Markets

The dominant story in the international arena was the government debt crisis in Greece and the heated discussions among the European Union members to devise a bailout plan that limits the spread of the credit problems to other countries. As March ended, the European Union indicated a bailout for Greece was forthcoming, easing the tensions in world markets for the time being.

The more positive story involved the surge in global manufacturing. PMI indices were up around the world, and Germany's index was way up at 60.2 last month. Some other notable March PMI readings showing growth picking up: Taiwan, 62.7; India, 57.8; South Korea, 55.6; Great Britain, 57.2; China, 55.1.

Performance for the quarter for international equity markets was generally well below those of the U.S., especially when translated in dollars. The developed countries in the MSCI EAFE Index gained 4.3% in local currencies, but only 0.9% in U.S. dollars. Emerging markets posted a 2.5% return, a respectable return but well below the heady returns for the three previous quarters. Pullbacks in China -1.6%, Taiwan -3.8% and Brazil -0.1% contributed to the more modest first quarter returns. Most global bond sectors experienced losses during the quarter due to the sharp rise in the dollar, although emerging market debt managed a gain of 3.6%.

Commodities Markets

Nickel is hardly precious, but this base metal was the hottest commodity of the quarter. Thanks to a drop in inventories and high demand (especially in emerging markets) for stainless steel, Nickel advanced 34.9% on the LME (London Metal Exchange) in the first quarter. Among the precious metals, Gold futures gained 1.5% for the quarter, silver futures rose 4.0%, platinum futures rose 12.0% and palladium soared 17.4%. As mentioned earlier the U.S. Dollar Index had a strong quarter, gaining 4.1%. As for energy futures, oil gained 5.5% and heating oil 2.2% in 1Q

2010, but natural gas futures fell 30.6%. The winter was rough on some notable crops: while orange juice gained 4.8% last quarter, soybeans were down 9.5%, cocoa 9.7% and corn and wheat both dropped 16.8%. Sugar did even worse losing 38.4%.

Housing & Interest Rates

The collapse of housing prices continues to be a major worry. Although analysts expected homebuyers to rush to take advantage of federal housing credits and federally-aided low mortgage rates, home sales were disappointing, leading analysts to wonder what they would be like next quarter without tax breaks and the Federal Reserve buying mortgage debt.

Existing home sales fell 0.6% in February for the third monthly dip in a row. New home sales dropped 11.2% in January and then 2.2% more in February to the lowest level on record. The bright light was pending home sales, particularly the February statistic from the National Association of Realtors: +8.2%, reversing January's 7.6% retreat.

Mortgage rates trended slightly downward, at least by Freddie Mac's measure. The average rate on a 30-year FRM was 5.09% in Freddie Mac's first survey of 2010 (January 7) and 5.07% in its April 1 survey. As for movement on other rates, here are the numbers across the same time span: 5/1-year ARMs, 4.44% down to 4.10%; 1-year ARMs, 4.31% down to 4.05%; 15-year FRMs, 4.50% down to 4.39%.

Second Quarter Outlook

While the year in the financial markets has started on a positive note and the economic recovery appears to have established sufficient traction, there are major uncertainties stemming from what we are calling "the Great Unwind" – that is, the process that will be followed by the government and the Fed in unwinding the massive stimulus programs that fueled the recovery. Beyond unwinding stimulus, there are additional risks/uncertainties associated with funding the new health care plan, dealing with the monumental federal budget deficit and depleted state coffers, all of which portend rising interest rates and inflation over the horizon. Longer term much depends on the efficiency and efficacy of policy makers in handling these challenges.

Over the intermediate term – the next two to three quarters – these issues are of a lesser concern. Rising rates from current levels should not derail the cyclical bull market in stocks, as long as they reflect stronger economic activity (and corporate profits), and inflation is not a problem. While stock market corrections after a sharp run-up can happen at any time (and we are probably overdue for one), we remain positive about the prospects for the economy and the financial markets.

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