

Quarterly Market Commentary – Q110

Presented by Sean Gross

A strong quarter to start the year

- Equity markets pushed higher: it was the strongest first quarter for the Dow Jones Industrial Average (the Dow) since 1999 and the strongest for the S&P 500 since 1998.
 - The Dow returned 4.82 percent.
 - The S&P 500 returned 5.39 percent.
 - Industrials and financials led the way, up 12.98 percent and 11.50 percent, respectively, buoyed by an improving economy and better than expected earnings.
- International markets were also higher, though failed to keep up with U.S. markets, in part due to a stronger U.S. dollar.
 - The MSCI EAFE Index gained 0.87 percent.
 - The MSCI Emerging Markets Index advanced 2.11 percent.
- Fixed income markets, now almost fully recovered from the credit difficulties of the past two years, continued to show signs of strength.
 - The broad market, as measured by the Barclays Capital Aggregate Bond Index, gained 1.78 percent.
 - The Barclays Capital U.S. Corporate High Yield Index pushed 2.68 percent higher, as lower-quality credits continued to benefit from the improving economic environment.
 - Municipal bonds gained 1.25 percent, according to the Barclays Capital Municipal Bond Index.

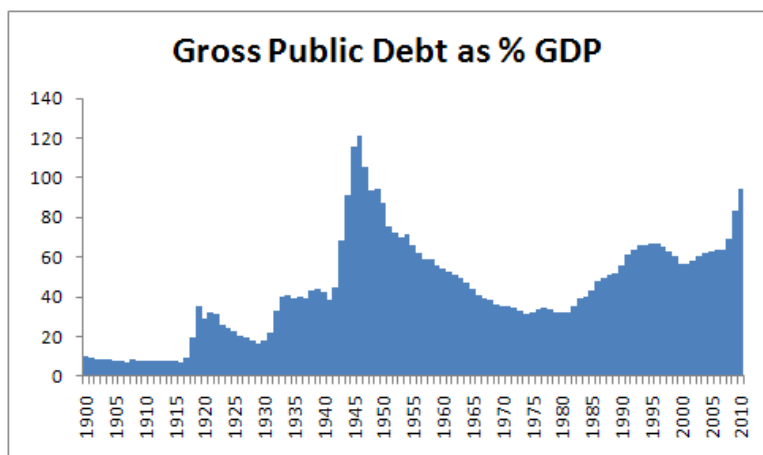
The health care bill becomes law: What about the price tag?

- Stealing much of the spotlight for the quarter, however, was the historic passage of the \$940 billion Health Care Reform Act.
 - Markets paid particular attention because of the bill's massive price tag and the potential impact of the front-loaded spending on an already bloated deficit.
 - After passage, bond markets sold off and the yield on the 10-year Treasury increased by 25 basis points in two trading days, though this increase was also a result of a large supply of new issuance from the Treasury.
 - Tepid response to the issuance drove bond prices down.
 - We believe this could begin to shape the interest rate outlook going forward.

The massive debt situation

The U.S. has entered a phase of historical deficit spending, accruing some of the largest deficits on record.

- The fiscal 2010 deficit is projected at \$1.75 trillion dollars, amounting to more than 10 percent of the total federal budget of \$14.6 trillion; this is on top of a national debt of \$12.6 trillion.
 - Many Americans, as shown in the polls, are worried that the excessive debt burden will hurt the economy moving forward.
- The government needs to finance all of its deficit spending—and its financing needs are substantial.
 - But the current low interest rates have been extremely beneficial to government efforts to refinance the outstanding debt and future deficit spending.



Source: United States government data

No magic formula for predicting interest rates

There is no magic formula for predicting future interest rates, but outlining the situation puts the problem in context. In assessing portfolios:

- It may make sense to keep a sharp focus on interest rate risk, looking more to shorter maturities, where interest rate changes have typically had much less of an impact on the underlying bonds.
 - Moving from historically lower interest rates, there could be a push higher, particularly if inflationary pressures appear.
 - These concerns are not immediate; moreover, they should be reviewed as the rate environment evolves throughout the year.
- Be mindful of diversification, particularly as retail investors have been shunning stocks and fund flows have almost exclusively gone into fixed income mutual funds.
 - Other income-oriented investments, such as income-producing stocks, can help diversify portfolio risk.*

Economic scorecard

We have seen an improvement in the economy.

- One clear measure is gross domestic product (GDP), which has been positive for the past two quarters and revised to show a 5.6-percent annualized growth rate as of Q409.

- The economy has been shedding fewer jobs.
 - Weekly unemployment claims have shown that fewer people have been joining the ranks of the unemployed.
 - The challenge has been job creation—the unemployment rate still was 9.7 percent at the end of March.
 - The April 2 jobs report showed gains of 162,000 new jobs—definitely a step in the right direction.
 - The bottom line: it is critical to improve the employment outlook, so that consumers can continue to help spur economic growth.
- The government has been aggressively trying to stabilize housing prices.
 - During March, for the first time in more than a year, housing prices remained the same.
 - But after the host of government programs and tax rebates disappear, we are concerned that further erosion may occur.
 - Existing home sales had fallen for the previous three months, to a level of 5.02 million units in February.
 - A further decline could indeed put renewed pressure on the economy.

Summing it all up

We are in the midst of an improving economic environment, but it has not been a strong recovery thus far.

- Government stimulus has been a key factor in leading to the improvements, and, as the stimulus winds down, we believe it is likely we will see some erosion in the economic growth outlook.
- To us, this suggests that investors will remain focused on risk, and we believe that they will look for yield-oriented investments to help cushion potential volatility in the financial markets.

**Diversification does not assure a profit or protect against a loss in declining markets.*

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The Barclays Capital U.S. Credit Index is comprised of the U.S. Corporate Index and the non-native currency sub-component of the U.S. Government-Related Index. It includes publicly issued U.S. corporate, specified foreign debenture, and secured notes denominated in USD. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital Municipal Bond Index includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than \$50 million.*

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