



Quarterly Investment Commentary

Equity markets continued to push higher during the first quarter of 2010, with the Dow Jones Industrial Average gaining 4.82% and the S&P 500 Index gaining 5.39%. This was, in fact, the strongest first quarter for the Dow since 1999 and the strongest for the S&P 500 since 1998. Leading the way were industrial and financial stocks, up 12.98% and 11.50% respectively, as both sectors were buoyed by the improving economy and better than expected earnings. International markets were also higher, though they failed to keep up with U.S. stocks, due in part to renewed strength in the U.S. dollar. The MSCI EAFE Index gained 0.87%, while the more risky MSCI Emerging Markets Index advanced 2.11%.

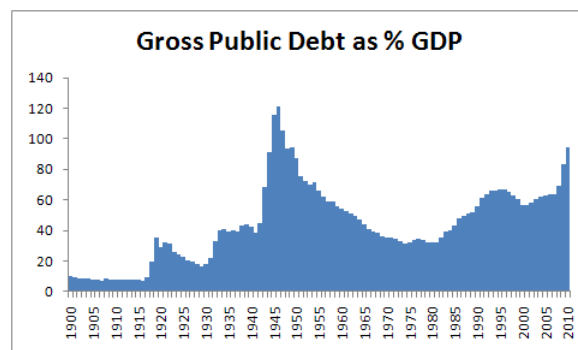
Fixed income markets also rallied, and are now almost fully recovered from the credit difficulties of the past two years. The broad fixed income market, as measured by the Barclays Capital Aggregate Bond Index, gained 1.78%. The Barclays Capital U.S. Corporate High Yield Index gained even more, 2.68%, as lower-quality bonds rallied more than their investment grade counterparts amid signs of an improving economy. The quarter was also favorable for tax-conscious investors, as municipal bonds gained 1.25%, measured by the Barclays Capital Municipal Bond Index.

The Healthcare Bill Becomes Law: What About the Price Tag?

Stealing much of the spotlight during the quarter was debate surrounding the historic \$940 billion Health Care Reform Act. The bill passed by a legislative technicality known as reconciliation, as neither House of Congress could muster the votes to approve it by the normally-required majorities. There has been much skepticism

Among politicians and individuals alike over the details of the new healthcare law, and final poll numbers show a country divided over its acceptance.

Markets paid particular attention to the debate because of the law's massive price tag and the potential impact on an already bloated deficit. After passage of the bill, the bond markets sold off and the yield on the 10-year Treasury increased by 0.25% in two trading days. This could be a harbinger for interest rates over the next few years, in our opinion, given the massive amount of debt the government must bring to market to satisfy budget needs.



Indeed, the U.S. has now entered a phase of record deficit spending, accruing some of the largest deficits in history. The fiscal 2010 budget deficit is projected at \$1.75 trillion dollars, which amounts to more than 10% of the total gross domestic product of \$14.6 trillion.

This is a staggering number in and of itself, not to mention that it is piled on top of a national debt of \$12.6 trillion. Like many Americans, we are worried that the excessive debt burden may ultimately crimp the output of our economy.

Economic Scorecard

In the more immediate term, however, it is evident that our national economy is on the mend. One of the clearest measures is gross domestic product, the broadest measure of economic activity in the U.S., which has been positive for the past two quarters and was revised to show a 5.6% annualized growth rate in the fourth quarter of 2009. (Five of the previous six quarters had shown a negative growth rate.)

The economy has also been shedding fewer jobs. The unemployment rate still stands at 9.7%, as of the end of March. But the jobs report released on April 2, just after the end of the quarter, showed gains of 162,000 new jobs, a definite step in the right direction.

Finally, the housing market is showing signs of stabilizing. During March, for the first time in more than a year, housing prices remained the same. (Existing home sales had fallen for the previous three months, to a level of 5.02 million units in February.)

All that said, the recovery has not been a strong one thus far, and government stimulus has been a key factor in leading to the improvements. As the stimulus winds down, we believe it's likely we will see some erosion in economic activity.

Crystal Ball Gazing: 101

The market's slow-and-steady advance has been a relief for investors, and it's likely that we'll continue to make higher highs over the short-term. This is because the environment for stocks is in many ways ideal right now, with interest rates still near record lows, the economy in recovery mode, and comparisons for corporate earnings still easy versus year-ago depressed levels.

However, investors should not be lulled into a false sense of security that market volatility is only a thing of the past. To the contrary, a variety of technical, fundamental and seasonal factors are suggesting that a bit of caution – though not outright bearishness – is now warranted.

For one thing, the volume levels supporting the recent market advance have been low. Generally

speaking, healthy (i.e., sustainable) bull markets are characterized by higher trading volumes on up days and lower trading volumes on down days. In the recent advance, however, the volume on up days has actually been lower than the volume on down days – the opposite of what we'd like to see – suggesting a possible lack of conviction behind the recent move.

Additionally, the markets are likely to face a new headwind before too long – that of a sustained period of rising interest rates. To some extent this will be a “good news, bad news” story, as higher rates will be indicative of a stronger economy. But higher rates will dampen economic activity by increasing the borrowing costs for consumers, in the form of higher rates on car, mortgage, and credit card loans, as well as businesses.

Stock valuations are also no longer cheap. At current levels, in fact, the S&P 500 has a cyclically adjusted price/earnings (P/E) ratio of 21 according to Yale Professor Robert Shiller. This compares to a long-term average for the market of approximately 16. As a result, it will be harder for the market to make meaningful gains from this point without a dramatic improvement in corporate earnings.

Finally, before too long, we'll be in the seasonally less-favorable part of the year for stocks. As documented by the *Stock Trader's Almanac*, since 1950, the six-month period from May 1 to October 31 has provided a market return in the Dow Jones Industrial Average of only 0.6%. The period from November 1 to April 30, by contrast, has averaged returns of 7.6%. Although this seasonal trend does not hold true every year (from 5/1/09 to 10/31/09, for example, the Dow Jones gained over 18%), it's a trend that's still worth noting.

So, while we have enjoyed the market's rally, we're keeping it in perspective, and emphasizing that a diversified, well-balanced portfolio may be especially important at this point in time. As the market continues to march higher, the risk of a correction increases. As always, our portfolio investment decisions will be based on balancing the risks and opportunities we identify.

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.