Quarter Notes

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The Journey to Economic Recovery Slow But Steady

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Stocks Bounce Back

Investors have seen significant recovery in their portfolios. The Dow is up 4.1%, the S&P rose nearly 5%, small cap stocks are up 8.5%, and internatinal markets were nearly flat as the dollar strengthened relative to other currencies.

Roth Worksheets

We mailed Roth IRA Conversion worksheets to all our clients. If you want us to calculate the potential benefits of a conversion, please let us know.

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Is the economy recovering? Yes, the economy is growing again. GDP grew at a 5.6% annual rate in the fourth quarter, the fastest pace in six years. For 2010, first-quarter GDP figures are expected to show slower growth as Federal stimulus programs expire and the effects of the harsh winter weather are tallied. As the year progresses, we expect growth to accelerate, with a projected spring-quarter rebound closer to 4%. Later in the year, the rate of growth could level off. The going might be slow from there.

In the US, our massive infusion of cash into the financial system has provided current stimulus, but the long-term impact is uncertain. Positive indicators include, increased consumer spending, expanding manufacturing activities, and rising consumer confidence. However, unemployment and underemployment remain a significant impediment to growth. The Labor Department reports that initial jobless claims have been falling since March 2009 and layoffs are slowing, but rehiring is still sluggish. The rate of unemployment is still 9.7%; it will take years for the US to return to the full-employment levels of 5%.

Housing prices seem to have bottomed out. Sales are starting to recover, albeit at discounted prices. Commercial real estate is still a primary concern; 50% of all commercial real estate loans will soon be "underwater." The prospect of continued write-downs persists, but stronger companies are beginning to step in to take advantage of depressed market prices.

Mounting government deficits at all levels are frightening. Our country faces $50 trillion in unfunded liabilities — mostly for Social Security, Medicare, and Medicaid — which make up the bulk of America's roughly $62 trillion in long-term debt. Efforts to reduce unemployment and maintain our social safety nets are forcing governments to spend monies that can't be covered by

Index	3/31//2010	% YTD
Dow Jones Ind.	10856.6	4.1%
S&P 500 Index	1169.43	4.9%
Nasdaq Comp.	2397.96	5.7%
Russell 2000	678.64	8.5%
MSCI EAFE	1584.28	0.2%
10 Year Treasury	3.84%	

shrinking taxes and revenues. For the first time ever last month, Social Security paid out more than it took in. Despite the creation of a deficit commission to search for solutions, we don't see the political will or maturity required to confront these potentially crippling problems.

With heath care signed into law, an additional 32 million Americans will have access to medical care. The Congressional Budget Office projects the bill's combined effect will be to reduce government deficits over the course of the next decade. But the bill fails to address any meaningful measures to control the spiraling costs of medical care. In order to pay for the newly insured, taxes will be going up. With the expiration of the Bush era tax cuts, income taxes will be restored to their pre-2001 levels. For high-net-worth taxpayers beginning in 2013, unearned income (interest, dividends, and rents) will be subject to Medicare taxes.

For clients, higher taxes may mean repositioning and rebalancing assets. If you have significant taxable capital gains, you might want to sell investments to recognize gains this year while maximum long-term capital gains taxes are still at 15%. If you have loss carry-forwards, those might be more valuable in future tax years. We will also continue to identify tax-efficient investments and shift inefficient positions into retirement accounts.

What Is the Outlook for Bonds?

Bonds play an important role in our portfolios. We use them for diversification, for moderating risk, and for the interest income component of total return. Bond investors endured large losses in 2008 followed by a miraculous recovery in 2009. What does the future hold for bonds?

In response to the financial meltdown, the Fed aggressively lowered interest rates to near zero. Falling rates under normal circumstances would have been good for bonds. Instead, prices fell as the combination of a recession and near systemic failure of the US financial system increased the odds that corporate defaults would exceed levels witnessed during the Great Depression. Corporate bond prices plummeted because investors demanded higher returns for the extra risk and diminished liquidity. The reverse held true for Treasury bonds; their prices soared becuase investors were willing to pay large premiums for safety.

Recognizing the dire state of the economy, the Fed made credit cheap and available. Cheap and easy money increased companies' ability to refinance existing debt; credit concerns began to abate. Economic data began to improve, and corporate default rates fell below expectations. With some bonds priced at 50 cents on the dollar, coupon payments were effectively doubled. Eventually order was restored to the market, and yields today are back to pre-crisis levels. Entering the second quarter of 2010, the bond market is functioning well. The corporate bond market appears stable now, but concern over government and municipal debt is growing as deficits rise and weak tax revenues persist.

Select international bonds also pose a concern. Greece rocked the world when it declared it faced insolvency without foreign intervention. The European Central Bank, Euro Leaders, and IMF have been working diligently to solve the problem. The odds of a Greek default have subsided, but other nations including Portugal, Italy, Ireland, and Spain (the PIIGS) may be the next to seek aid. Increased speculation and worry over sovereign debt will cause country selection to be a primary determinant of future bond returns. This situation gives our international bond managers the flexibility to offer considerable value.

Over the past three decades interest rates have been in a general state of decline, but rates

(Continued from Column 1)

will almost certainly trend higher over the next decade. (The scenario under which interest rates do not rise, a multi-year bout of deflation, actually poses the bigger threat to investors.) Based on current economic data and the Fed's mandate to support maximum employment and price stability, a near-term large increase in rates is unlikely. Independent of the timing and size of any future rate hikes, bond prices will fall in relation to their duration and maturity. Most firms will not default, and investors will continue to earn interest and receive principal back at maturity. Investors will also be able to reinvest interest payments at higher rates. While a significant rise in interest rates could cause bonds to lose money over a 12-18month period, a growing stream of interest payments is expected to provide increasing positive returns over time.

Fiscal deficits and easy monetary policy are harbingers of future inflation. Today both of these are flashing red. At the same time, the economy is still recovering from a deep recession and actual inflation remains low because of excess manufacturing capacity, high unemployment, and depressed housing prices. The concern is that inflation will ignite if the Fed hesitates in draining money from the system as the economy continues to strengthen and bank lending accelerates. Fed Chairman Bernanke, however, has been candid about the steps he is prepared to take to withdraw excess liquidity. Despite the Fed's forecast of benign inflation caused by high unemployment, its low interest-rate policy doesn't mean that it is not taking any action. In fact, the effect of the winding down of the Fed's $1.25 trillion mortgage-backed securities purchase program will slowly begin to withdraw liquidity from the economy. Further, as stimulus monies are repaid, the Fed's balance sheet shrinks and money is drained from the economy. Based on the current environment, our outlook is that inflation will remain low for the near term but it has the potential to accelerate over the next five years.

Bonds will continue to play a critical role in our portfolios, but we are strategically positioning to prepare for a difficult environment. Domestically we are pursuing two strategies: overweight short-term bonds with low durations and add to managers we think have the skill and flexibility necessary to profitably manage through difficult times. We also use international bonds to take advantage of global growth trends and hedge dollar risk. Maintaining a globally diverse bond portfolio, including flexible active management, will help us weather a difficult bond market.

Other Notes

For Sale: The number of existing homes for sale at the end of February 2010 totaled 3.6 million. By comparision, 4.6 million existing homes were for sale in July 2008. *Source: National Association of Realtors*

When will rates rise? Not right away. In the two other recessions in the last 25 years, the Fed first raised interest rates no sooner than 31 months after the recession officially ended. *Source: National Bureau of Economic Research, Federal Reserve*

Unemployment has been worse: The unemployment rate peaked at 10.8% during the 16-month recession of 1981-82. The peak (so far) in this current recession was 10.1%. *Source: Department of Labor*