

UP NEXT, THE HIGHLY ANTICIPATED CHAPTER THREE OF *THE HISTORIC RESCUE*

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If the first two chapters of the epic thriller *The Historic Rescue* were called “The Fallout of Summer ‘07” followed by “White Knight, the Government”, we expect the next one will be “The Hopeful Handoff”. It opens with the US government officially ending its \$1.25 trillion support of the mortgage bond market on March 31st, as planned, which helped struggling homeowners by keeping mortgage rates low.

Like the first two chapters, it will be long and complex. It will feature the government trying to unwind its support and passing the job of spending, lending, and saving to the private sector. Will the chapter end well, or will it have to be re-drafted, many times? As we discuss below, it’s off to an encouraging start, but plenty of plot twists loom. As usual, the unfolding story will present unexpected risks and opportunities for investors.

We offer three quick comments heading into this new chapter.

BOND INVESTMENTS: AS GOOD AS IT GETS?

In the early chapters, the government spent a lot of time and energy on stabilizing the credit markets. As the past year attests, it worked, and corporate bonds continue to rally.

If we had to guess, entering chapter three, we’d say the surging corporate bond market is now priced for optimism, the Treasury bond market is still priced for fear, and stocks are somewhere in between, despite their own rally.

For corporate bonds, consider that the spreads over Treasury bills (the “risk premium”) fell from historic highs in early 2009 back down to pre-crisis levels by August, and have continued to fall since then. At the same time, Treasury bill yields are the lowest they’ve been in 50 years and likely represent our Third Bubble; their relative return potential for both corporate and government bonds is very low, unless deflation prevails.

In what could be a tragic tale of the story, consider that, at chapter two’s end, we saw the majority of bond investment occurring since August ‘09, well after when bond prices had stabilized. Flows into bonds continue at a strong pace into chapter three, with little interest in domestic stocks. Unless deflation prevails, most bond investors are arriving late to the party, classically buying near the highs.

IT’S ALL ABOUT HOUSING AND CREDIT

While the government and its rescue play the most visible role in the story, the primary and most powerful characters are housing and credit. Government intervention can amplify (both positively and adversely) these two factors, but it cannot supersede them.

Chapter three opens with encouraging signs. Mortgage rates have not spiked even as the government ends its support. Rates still hover around 5% for a 30-year fixed conforming loan. Mainstream economists expect rates to rise to 5.25%-6%. Higher than 6% would be bad for the economy; many believe the Fed would step back in to support rates in that event.

Likewise, home prices have already fallen 30% from peak, and new housing starts are lower than they’ve ever been. Yet the plot thickens when you consider that foreclosure backlog remains high among banks and that most “reset” or modified mortgages are 60+ days delinquent again. If foreclosures indeed rise and the housing market can’t absorb the new homes, it means downward pressure on home prices.

So, it is likely to be a choppy handoff by the Fed. Mortgage rates will hopefully creep up (rather than spike) and housing supply will hopefully linger (rather than balloon). If that’s the case, we should be able to limp along at a decelerated growth rate until consumer debt levels gain equilibrium with income levels.

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WHAT DO WE DO WITH THIS INFORMATION?

Our starting point is that we set a long term allocation plan based on our clients' specific risk tolerances and financial goals, and we stick to it. It's impossible to predict the timing and duration of these complex events, and doing so leads to short term decisions, driven by guessing and emotion. At the same time, we seek to understand how future events present changing opportunities and risks for portfolios today.

We are mindful that deflation may persist near-term but that the probability of inflation (or, at minimum, higher rates) increases in four or five years. In fixed income, we therefore typically avoid Treasuries, preferring better yielding instruments like CDs and agency bonds, with nearer-term maturities. Among corporate bonds, we seek to spread risk across issuers and strive for maturities with short-to-medium term durations. For longer term bonds, where inflation poses a risk, we prefer inflation-protected Treasury bonds ("TIPS"). Where appropriate, we have diversified into complementary publicly-traded asset classes through exchange traded funds ("ETFs").

In stock selection, we continue to follow our disciplined research process based on Fundametrics®. We use our understanding of the credit and housing markets to stress-test our investments for cushion to manage debt and support dividends. During the current rally, we have actively trimmed positions in our outperformers, or even sold positions completely in favor of more contrarian ideas. Where possible, we are seeking stocks meeting our criteria which add diversification away from what helped us outperform in 2009, such as health care and utilities.

Adhering to a bearish or bullish prediction on the economy or markets misses the inevitable opportunities and risks that are unfolding in unpredictable ways, and leads to "market timing," with its dismal record. Our disciplined research and rebalancing continues to balance risk/reward with fundamentals and probable outcomes to help our clients meet their long term financial objectives in an uncertain time.