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HAVE WE SEEN THE BOTTOM FOR STOCKS?

Thank goodness for the stock market rally in March. Without it, first quarter portfolio returns would have been even uglier. Investors are still groping in the dark – looking for signs that the economy is beginning to bottom and there are a few scant signs like 4 consecutive weeks of increased mortgage applications to purchase or refinance homes. Home values in select markets have declined to a level where bargain hunters are beginning to come off the sidelines, but are negotiating prices aggressively. For those asking *"where is my bailout check?"* record low mortgage refinance rates are the partial answer but of no help to non-borrowers. Also note that a number of raw material and commodity prices have rebounded and they are often leading economic indicators. However, unemployment numbers (which are a trailing not a leading indicator) will likely continue to be grim for months to come.

We did begin to see some divergence in the performance of asset classes unlike the convergence of correlations witnessed in late 2008, but the variations are still very tentative and limited. In the equity arena, some financial stocks bounced, but most are still considered toxic. Mid sized companies beat their small and large brethren and some emerging markets outperformed all others. In bond land, the best performers were Fannie, Freddie and Ginny mortgage backed bonds - and why not with the Fed now buying this paper as well as treasury paper. The unprecedented Fed action referred to as ***quantitative easing*** was made official two weeks ago, but the Fed desk has been buying the agencies for weeks now. Corporate bonds are still in the penalty box with buyers concerned about ongoing credit quality deterioration. Municipals have held up reasonably well year to date even with large new supplies in the marketplace as individuals are steady buyers.

Going forward, we are tentatively treating the March stock market rebound as a rally in a bear market with the S&P 500 standing at 798 well above the 666 low of 2009. How stocks react to what will undoubtedly be very weak first quarter earnings reports in the days ahead will tell us a lot about the markets ability to discount bad news ahead of actual events. If we can move sideways or at worst hold above the previous low, it would not be surprising to see more of the enormous amount of cash on the sidelines be put to work in risk assets. Our preference that clients usually have maximum stock market exposure of 60% to 70% at the top of the risk range, and most often under 50% exposure has made **relative portfolio returns** of less negative consequence than our more aggressive and risk prone brethren. (If you doubt this reasoning, please refer to our early March mailing illustrating the four standard deviation decline in the S&P 500 index which declined over 50% from top to bottom).

We are not fixated on whether or not equity markets will begin a recovery but instead on the shape, timing and duration of a recovery. Right now our tentative expectation is for a long and slow rebound over the long term though we full well realize that very sharp initial surges such as seen in March, are not historically unusual, which is why we usually reject being all the way out of equities in most cases.

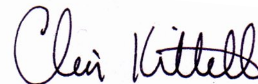
We can also use cash balances as a **tactical asset allocation** hedge for money that is most likely earmarked for equities. This cash can and should be deployed if and as prices decline although most individuals tend to get more defensive not less so as values decline. On the flip side of the asset scale, we continue to be very defensive with bond money preferring the highest quality and shorter term (low duration) paper in most portfolios. One exception can be in municipals for longer term yield seekers.

Finally, we are undoubtedly ahead of ourselves, but where appropriate, in some portfolios, we have slowly begun to nibble at what we call *reflation plays*. These are asset classes that would likely perform well when deflation fears subside and some inflation pressures are instead apparent, which could take several years yet to play out. Exposure here includes various natural resource plays but could also spread to agriculture related entities. In the past, commercial real estate exposure using REITs has worked well for us when anticipating inflation, but we believe it is still far too early to make that specific call, as deflationary pressures remain dominant for now.

Of course, all portfolio allocation decisions need to always be based on individual resources, risk tolerance, plus return needs and expectations. No investment strategy or system will work in every type of investment environment which makes custom tailoring always of importance. It is also crucial that we know and understand all of the pertinent facts related to any clients' financial needs and situation.

Going forward we do not expect markets or the economy to return to past patterns. Instead, we believe that we are in a new age, an age marked by deleveraging, greatly increased government regulations, and some de-globalization. The failure of the free markets to restrain from over leverage in the pursuit of ever greater growth and profits has and will cost us all dearly. This excess has now brought in the heavy and often fickle hand of the political class. This is not an outcome to be welcomed, but is the inevitable result of over reaching in the private sector. At this juncture, we tentatively conclude that old practices and investing norms have changed irrevocably. As we sort out the details driven by this outlook, expect to hear a great deal more from us about what we see as a new financial landscape.

Sincerely,



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