

# PMFA MARKET PERSPECTIVES

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## Executive Summary

- ❖ *Stocks surged in March, pushing Q1 results solidly into positive territory.*
- ❖ *Bonds slipped fractionally during the month on signs of an improving economy, increased inflation concerns, and rising sovereign debt risk.*
- ❖ *Treasury yields continue to move higher, while the Federal Reserve begins to take its first steps toward slowly unwinding its accommodative policies.*
- ❖ *U.S. economic growth remains on a positive trajectory, while near-term inflation risks appear to remain well in check.*
- ❖ *March delivered the best monthly pace of job creation in three years, although the nation's unemployment rate remained unchanged at 9.7%.*

## Capital Markets

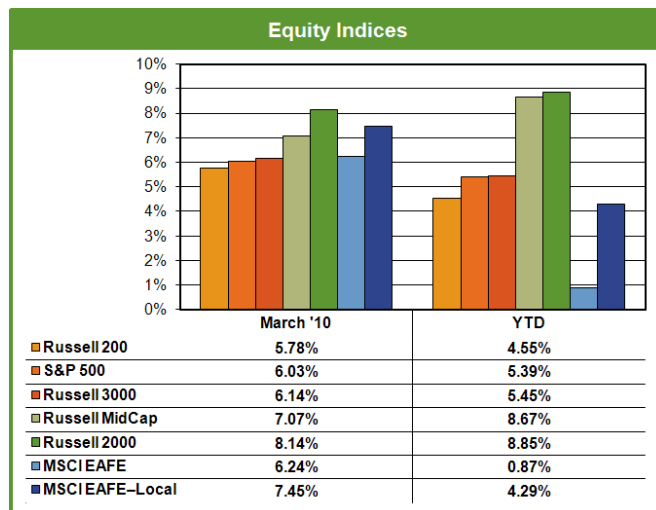
### *Of Seasons and Sovereigns*

Spring is what many would call a “transition season” here in the Midwest and one that the cynical among us might refer to as that all-too-brief period in April in which neither snow shovels nor sunscreen are likely needed. Winters here are characterized by the certainty of freezing temperatures and snow, with the primary difference from year to year being summed up in one question: “Was a snowfall record set, or did you just get more than you wanted?” While hot and typically humid, summer in the Midwest is still balmy than many other areas of the country, with the telltale first sign of the season often being the

orange barrels that line the roads being repaired after another cycle of extreme temperature swings has taken its toll.

Wedged between the extremes, Midwestern spring is that brief period during which the weather is in a state of flux, and one cannot find consistent comfort with the jacket often needed early in the morning and the short sleeves by the middle of the afternoon. As a transitional season, spring is characterized by a range of outcomes that challenges the planner in us all. Within the past four days alone, we've experienced thunderstorms, damaging hail, high winds, and temperatures north of 70 degrees, topped off most recently by overnight snow. Predictability goes out the figurative window, as even simple decisions become complicated. Should I plan a barbeque outside or is torrential rain imminent? Can I plant flowers now or will there be another freeze? It would be much easier to not have to worry about such things and just know what the best course of action would be. More often than not, we have to make a judgment call based on the best evidence available and our experience.

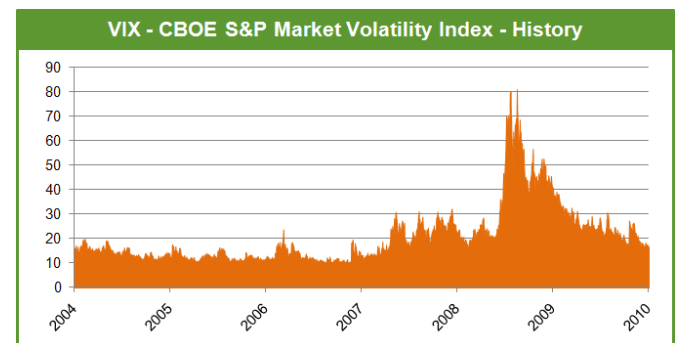
As we survey the current economic climate, we also have the sense that we are in the midst of a period of transition in the economy and capital markets. There are signs of positive developments, yet the potential for disappointing results as persistent, meaningful sources of uncertainty linger.



Source: PMFA

Stocks have provided massive returns since their cyclical low a year ago as sentiment has improved and the massive global stimulus efforts lifted the world economy from the precipice of potential depression. Corporate earnings have improved substantially since their cyclical lows as well, providing fundamental

support for higher stock prices. Nonetheless, stock valuations have also been driven higher during that period. The trailing 12-month P/E ratio on the S&P 500 Index has increased from 12.7 at the end of March 2009 to 18.7 one year later. Ultimately, stocks are nearly 50% more expensive on a P/E basis than they were a year ago, in part because confidence has improved and investors are willing to pay more to own risk assets. Certainly, the risk exists that stock market returns get too far out in front of the actual recovery.



Source: PMFA

At the same time, equity volatility continues to drift back down toward pre-crisis levels. The VIX Index ended the month of March at a level around 17.5, which is similar to its May 2008 pre-crisis level. While the tailwinds that carried stocks higher over the past year would not appear to be nearly as strong today as they were last March, neither valuations nor market volatility appear to be at extreme levels yet.

### Federal Reserve Mulls Exit Strategy

Market participants know that Fed rate hikes are coming. The question is when. This issue and a wide range of opinions about timing have been covered extensively in the press, which means that any surprises one way or the other could influence market trajectory, either positively or negatively. During the quarter, the Fed started to show some signs of incremental policy normalization by way of a 0.25% hike in the discount rate, which is the rate at which banks can borrow directly from the Fed. Additionally, they announced at least a tentative end to their quantitative easing efforts, having completed their planned purchases of Treasury, Agency, and Agency MBS debt.

Currently, market consensus (as measured by options on futures contracts) suggest a probability of only about 10% that the Fed raises the funds rate between now and August, although analyst opinion is quite divergent about the timing and nature of the Fed's next moves. Some economists and analysts have suggested that

rate hikes could commence within the next few quarters, while others expect that the Fed will not move to raise the funds rate this year. We take the Fed's comments at face value, which suggests that a Fed funds rate hike is not imminent, but that there is increasing disparity of opinion within the Federal Open Market Committee about how soon they should begin tightening. We view that as a signal that, absent some negative surprises in economic data in the months ahead, some incremental rate increases later this year appear likely.

The equity market response to the commencement of rate hikes remains to be seen; however, we believe that the market's overall assessment of the economy at that point will be more influential than the specific timing of the commencement of rate increases. If signs continue to point to economic growth domestically, in the context of still low interest rates, modest increases in borrowing costs may be easily absorbed. Such an environment should continue to support risk assets including stocks. However, if underlying economic conditions soften, profitability and investor confidence may be challenged.

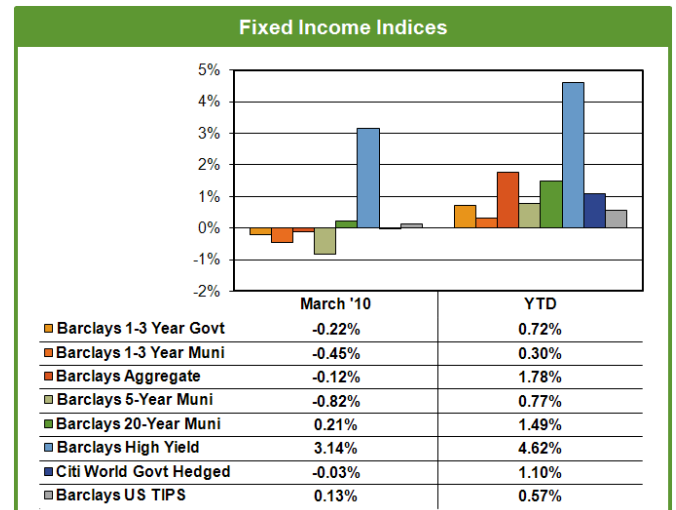
From a historical perspective, once the Fed starts to hike rates, it has not been uncommon to see equities trade in a range for a period of several months. Such an outcome may simply be a sign that investors are effectively digesting its impact on the economy and recalibrating their expectations for future growth and capital market returns. As we have stated before, the Fed will undoubtedly remain focused on the delicate positioning of monetary policy while balancing the need to act decisively to stifle inflation expectations with the need to avoid a premature tightening that could derail the nascent recovery.

### Sovereign Risk Rises as Fiscal Deficits Surge

Sovereign debt risk, particularly within developed economies, is an issue that has been a significant cause for concern for the markets in recent months. Investors have been carefully observing developments in Greece, as the risk of a potential debt default prompted a brief flight to quality and corresponding selloff in risk markets in February. Even as we write this, the situation in Greece is heating up again. The weight of the concerns stemming from Europe has helped the U.S. Dollar remain resilient relative to the Euro so far this year and has curtailed returns for U.S.-based investors in foreign stocks.

In recent weeks, certain short-term, quality corporate bonds have been yielding less than comparable maturity Treasuries. Inherently, this relationship is counterintuitive given the historical role of Treasury

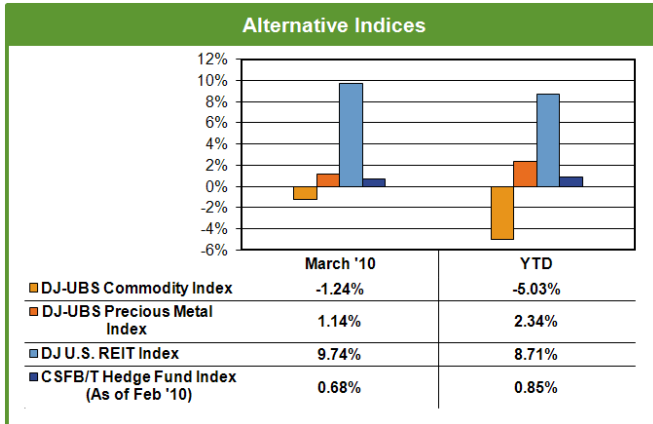
yields as the "risk-free" investment, with corporate (and other) bonds virtually always pricing in a higher rate to compensate investors for the incremental risk. While the risk of a U.S. default appears remote for the foreseeable future (and, arguably, beyond given the government's ability to print money), the public focus on our burgeoning federal deficit continues to intensify.



Source: PMFA

Regardless, we expect that heightened concern about the pace of U.S. deficit spending, the potential for a credit downgrade for the U.S., and upward pressure on Treasury yields are likely to persist for some time, potentially contributing to periodic pricing anomalies. While there has been upward pressure on Treasury yields this quarter as these issues have been unfolding, the pickup in rates since last quarter was relatively modest. While most government bond indexes slipped fractionally during March, returns remained slightly positive for the first quarter. Corporate bonds fared comparatively well during the quarter.

As we noted earlier, a premature move by the Fed to raise short term rates could be detrimental to growth. Similarly, a significant market-driven rise in long-term Treasury yields could push other rates higher as well. Higher mortgage rates would be a headwind to the housing recovery and consumer spending, while higher corporate yields would, at the margin, be a disincentive to business investment. Nonetheless, rising Treasury rates are not uncommon during economic recovery; a gradual cyclical increase in Treasury yields should not alone be sufficient to derail the expansion. However, a rapid upward move in the Treasury curve driven by intensification of investor anxiety about sovereign debt risks would be an additional headwind for the U.S. economy and could also push the Fed to act to rein in inflation expectations.



Source: PMFA

While the economy's path to recovery continues, sources of uncertainty are typically present. As the saying goes, "Stocks climb a wall of worry." Given the magnitude of the financial crisis and the unprecedented (in the post-World War II era) intervention by policymakers, the process of normalizing policies presents a challenge and the possibility for a misstep. Additionally, it is clear that other headwinds – including mounting fiscal challenges across developed economies – necessitate an appropriately cautious outlook.

We continue to believe that an "all weather" approach to portfolio construction remains advisable. Stocks and other "risk assets" should benefit if the economic recovery continues. Nonetheless, the prospect of heightened volatility and the potential for policy error suggests that diversification into asset classes and strategies that can provide some degree of downside protection remains prudent.

Structuring a portfolio to provide a balance between one's individual goals, resources, and tolerance for risk is critical. We believe that finding an appropriate balance between risk protection and upside participation in today's environment favors a mixture of traditional stocks, bonds, and alternative strategies that have shown diversification benefits through lower correlation to the equity markets over time. Such a blend can provide some protection during a bear market while allowing participation when the bulls are running.

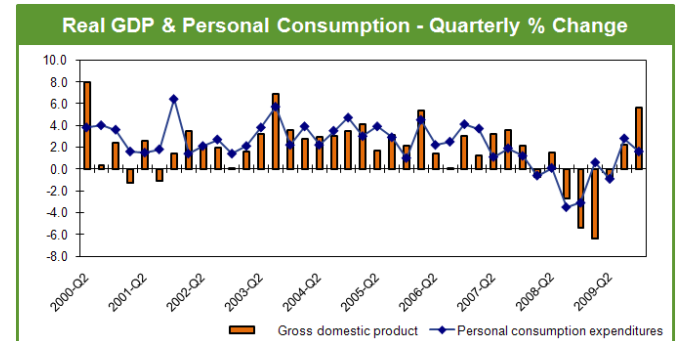
Just as spring is a transitional season marked by unpredictable variability in temperature and weather, transitional periods in the economic cycle can also be frustratingly unpredictable and periodically volatile. When faced with an "either/or" decision and the stakes are comparatively small – as with moving forward with that spring barbecue, planting flowers, or instead

betting on inclement weather – making a judgment call based on the best evidence available and personal experience may be sufficient. When the stakes are higher, as is the case with portfolio decision-making, an "all weather," diversified approach that balances offsetting goals of downside protection with upside participation remains a very viable solution, particularly when uncertainty is high.

## Economy

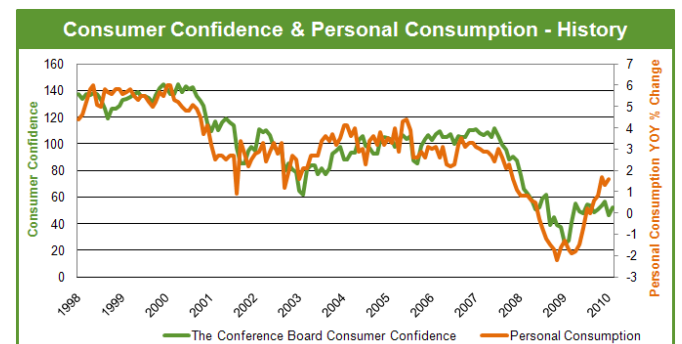
### GDP

The final GDP release for the fourth quarter of 2009 reported an annualized growth rate of 5.6%, more than double the third-quarter result. Estimated growth was adjusted downward by 0.3% from the second estimate, after revisions to inventory investment, consumer spending on services, and business investment in equipment.



Source: PMFA, Bureau of Economic Analysis (BEA)

While fourth quarter GDP growth was strong, personal consumption expenditures, which represents the largest portion of economic activity and reflects the consumer sector, slowed to an annualized 1.6% pace during the quarter.



Source: PMFA, BEA, The Conference Board

Consumer confidence rebounded slightly from its 10-month low reached in February, according to The Conference Board's Consumer Confidence Survey®. Should the employment picture continue to improve as many anticipate, consumer confidence should also gain in the months ahead, reinforcing a potential virtuous upward cycle.

## INFLATION

Headline inflation indicators were flat during the month of February, with both the CPI and the PCE deflator unchanged. Minimal declines in the energy index were offset by equally small increases in food costs. Core indicators, which exclude food and energy, were also relatively flat, with CPI increasing by 0.2%, while the core PCE didn't budge during the month. Producer prices were mixed in February, with PPI down 0.6% and core PPI up 0.1% over the previous month. On a year-over-year basis, both headline and core indicators continued to rise in February, building on the trend that started last November.

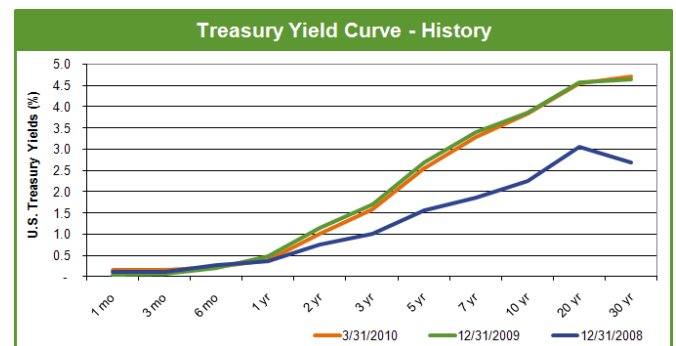
Index	Period Ending February 2010	
	One-Month % Change	One-Year % Change
<b>All Items</b>		
CPI	0.0%	2.1%
PPI	-0.6%	4.6%
PCE	0.0%	1.8%
<b>All Items Excluding Food and Energy</b>		
Core CPI	0.2%	1.3%
Core PPI	0.1%	0.9%
Core PCE	0.0%	1.3%

Source: PMFA, BEA, Bureau of Labor Statistics (BLS)

Core consumer prices remain mired near the lower end of the Fed's implied target range of 1%-2%, suggesting that inflation is unlikely to be a major concern in the near term. Commodity prices have been showing signs of perking up of late, but high unemployment continues to constrain wage growth and appears likely to continue to do so for some time. Although the recent pace of productivity gains is unlikely to be sustained, the improvement in the jobs market has been gradual and the high rate of joblessness should keep broad price levels from rapidly moving higher in the near term even as the cyclical recovery gains momentum.

## INTEREST RATES

In light of the passing of the healthcare reform bill, investor worry about budget deficits is becoming increasingly apparent in interest rates. Continued evidence of global economic recovery coupled with skepticism about the ultimate cost of the health care bill within the context of the broader risk of sovereign debt levels are converging to push Treasury investors toward higher risk alternatives. While insolvency on the part of the U.S. Government is virtually impossible (as would be the case anywhere the debtor also controls the printing press for the denominated currency), investors have begun positioning themselves in anticipation of a weaker dollar and higher inflation down the road.

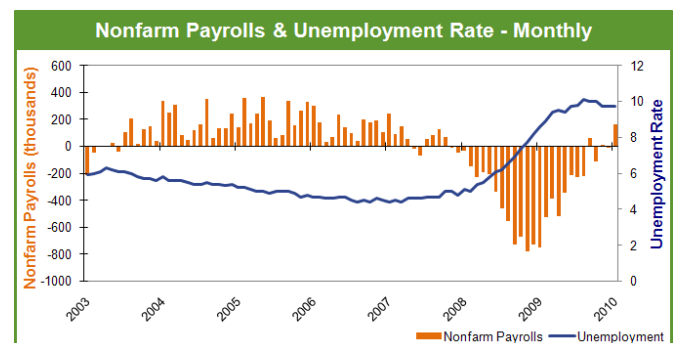


Source: PMFA, U.S. Treasury

The Treasury yield curve steepened further in March even as interest rates across the curve moved fractionally higher. The three-month Treasury yield increased six basis points, ending the month at 0.16%. The 10-year Treasury yield increased in March, ending the month up 22 basis points at 3.8%.

## EMPLOYMENT

March unemployment came in slightly better than expectations, remaining unchanged at 9.7%. Nonfarm payrolls increased in March, ending the month up 162,000, which was just short of expectations.



Source: PMFA, BLS

While the net addition of 39,000 government jobs was driven by the addition of temporary census workers, private sector job creation of 123,000 was better than many anticipated. The result was the best monthly pace of job creation in three years, but a sustained period of greater gains will be needed to meaningfully chip away at nation's unemployment rate.

### Gratuitously Unnecessary Statistic of the Month

#### Talk about Taxing

According to the Tax Foundation, the Internal Revenue Code (IRC) reached 2,139,000 words in 2005, up from 409,000 words in 1955. That makes it nearly four times longer than *War and Peace* and *Atlas Shrugged* and just as long as *The Grapes of Wrath*.

What's that? At a mere 464 pages, *Grapes of Wrath* can't be 409,000 words? Perhaps, but when we were trying to read it in high school, it felt that long—so long, in fact, that the Internal Revenue Code might have been a welcome alternative.

**Sources:**

[www.taxfoundation.org/research/show/1961.html](http://www.taxfoundation.org/research/show/1961.html)

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