NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

Deleveraging

The current economic environment could be described as a broadening global recovery marked by improving corporate earnings, low interest rates, low inflation, improved business and consumer confidence and a healthier employment outlook. The S&P 500 Index ended up 5.4% for the quarter. The macro economic backdrop suggests to us that markets will be heading higher over the course of the current quarter, although there could be a correction in the latter part of April or early May. The most important task, near term, will be identifying the switch from markets being driven by the cyclical tailwinds of accommodative fiscal and monetary policy, to the secular headwinds of massive budget deficits, high debt levels and continued deleveraging. The current bear market rally is occurring in a secular bear market that began in 2000. Any significant decline could well trigger the resumption of the secular bear and investors should be prepared for that to happen sometime this year.

In our last letter, we argued that the U.S. dollar was bottoming and that we expected it to surprise everyone on the upside -- which it did, appreciating 9% from December 1, 2009 to its peak on March 25, 2010. At the same time, we advocated reducing exposure to investments that benefit from dollar weakness, such as international equities, commodities, energy and basic materials. The U.S. market outpaced many foreign markets in the first quarter of 2010; the benchmark international equity index, EAFE, rose 1%, while China's market was down 0.2%. Commodities, energy and basic materials also underperformed the S&P 500; natural resources gained just 0.1%.[1] While we did reduce our exposure, we still held underweight positions, which dragged on our relative performance. We also underweighted the financial and consumer discretionary stocks, which were the strongest sectors for the quarter. As a consequence, balanced portfolios, while up, did not do as well as the S&P 500. We believe the dollar will appreciate from current levels later this year, but near term it is due for a correction. So those areas that benefit from dollar weakness should be overweighted once again.

Volatility in the investment markets will increase for the rest of the year as countries gradually withdraw financial and monetary stimulus. Other consequences of this stimulus withdrawal are unclear; nobody

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knows, even the government officials who must make the changes! Our primary investment objective remains preserving capital. Positive returns should result from careful participation in market rebounds; however, we will not hesitate to raise cash or increase defensive hedges (cash, put options and/or inverse ETFs), if warranted.

Debt Deleveraging

Last year we all worried that big banks were going to fail; now we all worry that entire governments may go under. Anxiety about "sovereign" debt has been most acute in Europe: especially, Portugal, Ireland, Italy, Greece, and Spain. Greece is the current poster child in the news, but the other countries may not be far behind, with the addition of the United Kingdom. Since this "debt crisis" will be with us for many years, it is useful to know how countries have deleveraged (a reduction of the ratio of sovereign debt to Gross Domestic Product (GDP)) in the past. A recent publication, *Debt and deleveraging: The global credit bubble and its economic consequences*, by the McKinsey Global Institute (www.McKinsey.com/mgi) reviewed 45 instances since 1930, in which various economies deleveraged, or significantly reduced their total debt-to GDP ratio. Deleveraging has followed nearly every major financial crisis since the 30's. These episodes of deleveraging fit into one of four archetypes: the first, and most common, is austerity (or "belt-tightening"), when credit growth lags behind GDP growth for many years; the second type is massive defaults; the third is high inflation; and the fourth is growing out of debt through very rapid real GDP growth resulting from either: war, a "peace dividend" following war, or an oil boom.

"Belt tightening" accounted for 50% of the episodes: examples include the U.S. economy during the Depression years of 1933-40; Finland and other Scandinavian countries in the 1990s; and South Korea and Malaysia after the Asian Financial crisis in 1997. McKinsey argues that belt tightening is the most likely scenario to follow the current United States crisis. Most examples of belt tightening took six to seven years to resolve, but the enormous increases in U.S. government debt suggest it could take 10 to 15 years for the U.S. to deleverage. Economic growth would be reduced by 1% to 2% per year until the debt ratio bottoms out. The problem would be resolved over time, even though doomsayers say it is impossible. When Paul Volker became Fed Chairman in 1979, with the mandate to reduce inflation (then running at 10% plus), the consensus said the same thing: impossible! Inflation was a recognized problem and counter forces were put in place to rectify the situation - but it took many years to achieve success. Debt is now recognized as a problem and counter forces will once again be brought to bear, and, it will take many years to achieve results. The U.S. market, from 1933 until the late 40's, was range bound. Using similar percentage changes from trough to peak, the current U.S market is approaching the upper end of a range that could last another ten years. For stock investors, this is not necessarily an impossible investment environment, as long as they recognize this trading range and invest accordingly.

The "high inflation", deleveraging scenario occurred in 25% of the cases, and so cannot be ignored. High inflation deleverages by increasing nominal growth (real growth plus inflation), thereby reducing the ratio of debt over GDP. High inflation occurred in Chile from 1984 to 1991 and Spain from 1976 to 1980, and **typically reflects the absence of a strong and independent central bank**. If this happens in the U.S., real growth would probably be the same as under "belt tightening". Investors, by shifting to assets that benefit from inflation such as real estate, natural resources and technology, can do quite well in this environment. We favor the belt tightening scenario but cannot rule out the inflationary outcome. We can invest appropriately for either scenario as it unfolds.

Current Economy

United States Economy

The burst of energy the economy showed at the end of last year won't likely be repeated anytime soon. The Commerce Department reported a 5.6% growth rate for the last quarter of 2009.[2] Most of the growth came from inventory rebuilding, as businesses let their stockpiles dwindle to save cash; growth did not come from strong consumer demand. However, economic signs continue to improve enough to bolster a case for continuing growth in the 2% - 3% range. Payrolls increased in March (the most in three years), and chain stores turned in the best year-over-year performance since 1999.[3] Consumer confidence has improved, manufacturing has accelerated and home construction rebounded. The big future unknown is what happens as government stimulus wanes and Federal Reserve economic support programs end. The UCLA Anderson Forecast expects 3.2% growth in the first quarter of 2010, then leveling off to 2.0% - 2.5% for the balance of the year.[4]

World Economy

In contrast, emerging market economies are on a tear, particularly China and East Asia. The World Bank increased its forecast for economic growth in East Asia to reflect reviving demand, sustained fiscal and monetary stimulus, and a rapid rebound in consumer spending. East Asia will grow 8.7% in 2010, up from 1.3% in 2009.[5] In an about face, the Chinese government is preparing to announce that it will allow its currency to strengthen slightly. The Chinese decision to strengthen the renminbi would make similar currency moves more likely by other countries, particularly in Asia. Allowing some strengthening in the currency will make it easier for the Chinese central bank to fight inflation. A stronger renminbi keeps local prices down by making imports cheaper, and gives China's central bank more room to raise interest rates and moderate economic growth. China grew 8.7% in 2009 and is forecast to grow 10% in 2010. The World Bank forecasts the world economy will grow 2.7% in 2010 and 3.2% in 2011.[6]

Asset Allocation

U.S. Bonds and Stocks

In March, for the first time in U.S. history, some AAA corporate bonds yielded less than U.S. treasury bonds. Since then, corporate yields have risen back above Treasuries; it may be only a matter of time until AAA corporate bonds consistently yield less than governments. While it is hard to imagine this now, the trillions in new Treasury bonds to be issued over the coming years make for a plausible case. As Reinhart and Rogoff point out in their book, *This Time is Different: A Panoramic View of Eight Centuries of Financial Crisis*, government securities, following a financial crisis, are subject to huge increases in supply, and accordingly, significant increases in risk and yield levels, relative to very high quality corporate debt. We think the easy money has been made in bonds and investors should review their holdings carefully, both for credit worthiness and maturity (no bonds longer than 10 years). Investors should stick to high quality, short and intermediate corporate bonds, bond funds or bond ETFs. We would avoid intermediate to long treasuries as well as individual municipal bonds; we favor short and intermediate municipal bond funds or municipal bond ETFs. We also like the new Build America Bonds. **Build America Bonds** (BABs) are taxable municipal bonds that carry special tax credits and federal subsidies for either the bond issuer or the bondholder.

An environment of moderate economic growth, low inflation and extreme policy stimulus has been very supportive for the U.S. market. U.S. stocks should continue to outperform the meager returns from cash and government bonds. Since the dollar will be flat to weak over the coming months, it is time to again overweight those areas that will do well with a weak dollar, such as commodities, energy, industrials, technology, health care and biotech. Compelling valuations can be found by comparing PEG Ratios (Forward P/E to Long Term Estimated Growth) of companies to their own historic average. Technology groups dominate the list: take the Semiconductor Equipment PEG Ratio at 1.35 compared to its average PEG Ratio of 2.61 or the general Semiconductor Group at 1.22 versus 1.59.[7] Relative to the S&P 500 Index, the performance of chip stocks has been grinding higher recently. Chip consumption has continued to outpace supply, increasing average chip prices. As utilization rates climb and order books get replenished, a further rise in pricing power is probable. Forrester Research forecasts information-technology spending to grow by 8.4% this year while spending on computer equipment and software will show double digit growth.

International Stocks

A flat to weak U.S. dollar will help international stocks, especially in the Far East, China, India, Latin America and the commodity rich countries of Canada and Australia. Economic growth is strong in all these places. China, if it does strengthen the renminbi, looks particularly attractive. The Chinese market topped out on fears of increasing inflation and potential monetary tightening in late 2009; with that, Chinese stocks have lagged the S&P 500 Index and emerging market bourses. We expect the Chinese economy to decelerate gradually in the months ahead, easing off the first quarter's estimated 12% growth rate. As the fears of a bubble and a fiscal tightening subside, the market could see another leg up. The forward P/E ratio on the MSCI China index stands at 13[8] - an undemanding number for a market where corporate earnings averaged 11% annually for the last five years. We also think Canada is an overlooked stock market; a major beneficiary of strong resource prices, it also has a strong currency. Effective regulation helped Canadian banks avoid the massive losses that wreaked havoc in the U.S. and European financial sectors, and its fiscal picture is the best by far among the major developed countries.

Natural Resources and Energy

With accelerating global growth and a flat to weak dollar, it is time to be overweight energy, natural resources, commodities and gold. Crude oil recently hit $85; probably back on its way to $100. We favor oil and oil exploration companies, integrated oils, as well as companies in copper, iron ore, gold, fertilizers and coal. In our last letter, we also recommended buying gold as it corrected. The World Gold Council recently announced that in 2009, central banks in the Far East added the most gold to their reserves since 1964, amidst the largest rally in bullion prices since the 1970's. Central banks, who hold 18% of all gold ever mined, are further expanding their holdings for the first time in a generation. Gold is quietly, at the margin, becoming the world's second reserve currency, supplanting the euro and rivaling the dollar.

Real Estate

REITs did quite well in the first quarter driven by attractive yields and reports of month-to-month gains in commercial property prices. Relaxed accounting changes have helped REITs restore balance sheet "health". A bottoming in property prices have also enabled them to roll over existing debt, as deflation concerns abate. However, cash flows will remain negative this year due to plunging rents and high vacancy rates. We recommend an underweight position in REITs.

Summary

The current environment is one of a broadening global economic recovery marked by improving corporate earnings, low interest rates, low inflation, increasing business and consumer confidence and an improving employment picture. With continued economic growth and a flat to weak dollar, we favor investment sectors that benefit from dollar weakness: international equities, commodities, energy, technology, health care and biotech. We continue to underweight financials, real estate, retail, and consumer cyclicals. We recommend short and intermediate corporate bonds over intermediate and long treasuries and like Build America Bonds.

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