

The stock market rose in the first quarter. Bonds were higher as well.

Financial Markets Review

When the Federal Reserve met on January 27, there was no suspense. However, after their March 16 meeting, there was a bit more anxiety. Although the Federal Reserve did not meet in February, in testimony prepared for the House Financial Services Committee, Chairman Bernanke said “the Federal Reserve may raise the discount rate “before long” as part of the “normalization” of Fed lending, a move that won’t signal any change in the outlook for monetary policy.” Interestingly, “before long” turned out to be after the close on February 18th; the discount rate was raised 0.25% to 0.75%. The March meeting turned out to be benign.

The stock market was extremely sensitive to news items; less so to earnings. Strong manufacturing led to an early rally; concerns about a debt crunch in Europe and China’s moves to curb bank lending cooled the advance, but better news out of Europe reignited the rally.

Bonds, led by corporates, were slightly higher. Profit taking, plus concerns about the European debt crisis, caused some selling of spread product early in the quarter, but as the latter eased, corporates sprinted ahead. Treasuries were mixed as their safe-haven status was offset by supply and fears of higher rates.

The U.S. Stock Market

In the March quarter, the S&P 500 rose 5.4%, while the NASDAQ rose 5.9%. Growth underperformed value.

U.S. small stocks (Russell 2000) outperformed the S&P 500 (+8.9% vs. +5.4%). Within the Russell Index, the value component outperformed growth (+10.0% vs. +7.6%).

Stocks began 2010 where they left off 2009: moving higher. Stronger manufacturing and optimism about a global economic recovery, overshadowed a weaker than expected employment report. Anticipation of improved earnings also added to the upbeat mood. By January 19th, the advance ranged from 2.3% (NASDAQ) to 3.8% (Russell 2000).

That all changed when earnings were reported. Materials (ex. Alcoa), industrials (ex. Caterpillar Inc.), financials (ex. Morgan Stanley and Citi) and information technology (ex. IBM and Qualcomm) earnings were not up to estimates. In addition, and more importantly, China’s moves to curb bank lending and Greece’s budget woes, rattled investors. The sell-off through February 8th (-8.0% to -9.6%) was the worst since the rebound began on March 9, 2009. Those losses were reversed in short order. A resolution of sorts in Europe, a drop in jobless claims and job losses, and solid housing starts, retail sales and manufacturing, encouraged investors. Despite some bumps along the way due to sporadically reported less than stellar economic news, the markets moved higher over the balance of the quarter. In fact, by March 23, the market reached September 2008 levels.

For the quarter, within the S&P 500, small stocks with low price/book value and high beta performed best. The average stock rose 8.3%, 290 bps. better than the Index itself. The 10 largest holdings had a return of +4.3%; six made money. The best was G.E. Co. (+21.1%), which rose on signs of a turnaround in their businesses. The worst was AT&T Inc. (-6.4%), which is experiencing heavy competition for its products.

There was a huge range of sector returns within the S&P 500 (-4.3% to +13.1%).

Industrials (+13.1%), led by G.E. Co. (+21.1%), was the star of the quarter; the company is showing signs of “earnings momentum slowly building” and may raise its dividend. Another strong performer was financials (+11.2%); commercial banks (+19.8%) benefitted from the stabilization of the credit markets.

The only two sectors to decline were telecom (-4.3%) and utilities (-3.5%). Both are defensive and do not have visible catalysts for growth.

The largest sector, at 19%, information technology (+1.9%) had lackluster results due to profit-taking after 2009’s return of +61.7%.

The International Markets

For the quarter, the U.S. Dollar was stronger (+4.1%) vs. a basket of major currencies. Early on, as markets rose, the Dollar fell (12/31 – 1/14: -1.5%). Higher stocks and lower volatility encouraged investors to take on more risk. For the next 10 weeks, the Dollar rallied strongly (1/14 – 3/25: +7.0%). Credit concerns in the eurozone, and the potential for higher U.S. interest rates, played a major role in the advance. As concerns in the eurozone eased and it became less likely the Fed would tighten any time soon, the Dollar gave back some of those gains. For the quarter, the Canadian dollar was strongest (higher commodities), and the British Pound was weakest (uncertain politics).

CURRENCY	12/08	12/09	1/10	2/10	3/10	%Change*	
						Month	YTD 2010
British Pound <i>(in U.S. \$)</i>	1.4593	1.6170	1.5986	1.5238	1.5184	-0.4%	-6.1%
Japanese Yen <i>(per U.S. \$)</i>	90.68	93.01	90.27	88.93	93.46	-4.9	-0.5
Euro <i>(in U.S. \$)</i>	1.3971	1.4321	1.3863	1.3631	1.3510	-0.9	-5.7
Canadian <i>(in U.S. \$)</i>	0.8205	0.9494	0.9342	0.9508	0.9849	+3.6	+3.7

* Versus U.S.\$

EAFE (+0.9%) underperformed the U.S. markets. The higher U.S. dollar had an impact on local returns (+4.3%).

The Pacific region (+6.3%) outperformed the Index. Japan (+8.2%) rose on bargain-hunting and hope that their economy is starting to rebound. Local returns were +5.9% and +8.6%, respectively.

Europe (-1.8%) underperformed the Index; local returns were +3.5%. France (-3.9%), Germany (-2.7%) and Spain (-15.3%) underperformed. The U.K. (-0.6%) held up better. The troubles in Greece (-13.2%) spread throughout the eurozone.

Sector leaders included information technology (+12.0%) and industrials (+5.8%). Telecom (-4.3%), utilities (-4.0%) and energy (-3.4%) lagged.

The Bond Market

In the March quarter, bonds were higher. Corporates outperformed Treasuries. Returns for the BC Aggregate Bond Index and the Gov't./Credit Index were +1.8% and +1.6%, respectively.

Early in the year, Treasury bonds were soft, as better than expected manufacturing, a strong equity market, and a looming auction of bonds worried investors. By January 8th, yields on Treasuries rose (prices fell), or held steady at high levels; 30-year rose 8 bps. (to 4.72% from 4.64%), while the 10-year held at a five month high of 3.83%. For the next month, Treasuries more than erased those losses. An on the sidelines Federal Reserve, China's move to slow bank lending, Greece's economic woes and a stock selloff, led to flight-to-quality gains. By February 8, yields fell to 4.50% and 3.56%, respectively. A trading range prevailed over the next five weeks. However, the last two weeks of the quarter saw a dramatic rise in yields. The prospect of Fed tightening, reduced concern about the eurozone, higher stocks, and a lukewarm reception to the government's auction, caused yields to rise to June 2009 levels by March 29 (30-year: 4.77%; and 10-year: 3.87%).

Short-term Treasury (2-year) yields followed a much smoother pattern, and wound up little changed.

For the quarter, Treasuries (+1.1%) lagged corporates (+2.3%).

Shortest term bill yields did not move much. During the period, yields ranged from 0.04% (1/12) to 0.17% (3/16).

Yield curve spreads remained sharply positive. In fact, the 10-year/2-year Treasury spread reached an all time high of 291 bps. on February 22.

Treasury Yields (%)

MATURITY	12/06	12/07	12/08	12/09	1/10	2/10	3/10
30-Year	4.81%	4.45%	2.68%	4.64%	4.49%	4.56%	4.71%
10-Year	4.70	4.03	2.21	3.84	3.59	3.61	3.83
2-Year	4.81	3.05	0.77	1.14	0.82	0.82	1.02
90-Day	5.01	3.24	0.08	0.05	0.07	0.12	0.16
Spread	-0.20	+1.21	+2.60	+4.59	+4.42	+4.44	+4.55

The range of returns among the various maturities was fairly narrow: intermediate corporates outperformed in the first quarter.

	Total Returns					
	March			Year-to-Date 2010		
	Tsy.	Mort.	Corp.	Tsy.	Mort.	Corp.
Long-Term	-2.5%	0.0%	0.0%	0.2%	1.6%	1.8%
Intermediate	-0.7	0.1	0.4	1.1	1.6	2.5

Corporates (+2.3%) outperformed Treasuries (+1.1%) and mortgages (+1.5%) in the first quarter.

Outlook

2010

- US GDP growth will be 3.0%.
- The Fed will raise rates after the November election.
- The unemployment rate will fall below 9.0%.
- US will significantly outperform EAFE.
- US Dollar will appreciate at least 10%.
- Quality growth will outperform in large cap.
- Large cap will perform in line with small cap.

2010 Return Objectives

<u>Equity</u>		<u>Bonds</u>	
US	+10.5%	Treasuries	+4.0%
EAFE	+4.0	Corporates	+2.0
Em. Mkts.	+6.0	High Yield	-15.0