

April 2010

INVESTMENT REVIEW AND OUTLOOK

Equity markets around the globe continued to grind higher in the first quarter of 2010, extending the recovery in risk assets that began in March of 2009. For the quarter, the U.S. was the best performing market of the majors, followed by Japan and the U.K. Since bottoming one year ago, global equity markets have risen almost without interruption, demonstrating a remarkable resiliency in the face of a still challenging array of economic concerns. Even the recent sovereign debt crisis in southern Europe has not been enough to derail the market's advance – at least so far. As we write this letter, the S.E.C. has charged Goldman Sachs with fraud in connection with the sale of mortgage backed securities. Will this set the stage for the first meaningful correction?

Within the U.S. market in the first quarter, stocks outpaced bonds, value beat growth, and small and mid cap stocks dramatically outperformed large caps. *The strongest groups within the S&P 500 included such surprise winners as banks, retail, restaurant and housing related shares.* Industrial stocks were also top performers in the period. Bonds, commodities, gold and cash were among the quarter's worst performing assets. In addition, the large cap quality growth and income theme, a key area of emphasis in Moody, Lynn portfolios, lagged the averages for the first three months. Interestingly, the underperformance of the large cap quality sector was a global phenomenon. For example, the MSCI EAFE index was up only .9% for the quarter and the S&P Global 100 index only 1.5%. We think this is a temporary setback for the quality sector, partly in response to the surprising strength in the U.S. dollar. Many of these companies had been thought of as weak dollar beneficiaries. Similarly, pullbacks in the energy and materials sectors reflected the reversal up in the U.S. dollar.

Climbing a Wall of Worry or a Worrisome Climb?

Is the market's resiliency in the face of a still daunting set of long term problems a sign of strength or weakness? Historically, the stock market's ability to shrug off negative news has been a sign of strength. The old Wall Street adage that bull markets "climb a wall of worry" was coined to explain the weak economy/strong market paradox. The idea is that bull markets always begin amidst widespread fear, anxiety, and skepticism, typically after painful recessions, severe stock market declines, or both. It is the gradual conversion of skeptics to believers and of sideline cash into risk assets that provides the fuel to keep the advance going. Certainly

expectations for the U.S. economy had been beaten down to all time lows as of a year ago. Until recently, many doubted the existence of *any* kind of recovery. Now, as the statistical evidence of recovery becomes harder to refute, there is much hand wringing about its sustainability. Many pundits are still dismissive of the rebound as merely “an inventory bounce” and there is still a good deal of talk of a “double dip” recession.

An Economy in the Sweet Spot, But for How Long?

Of course we share many of investor’s apprehensions about the economy and the markets. The secular problems of too much debt, unsustainable fiscal imbalances and stubborn unemployment are indeed grave. Meanwhile, baby boomers have already experienced two “once in a generation” beatings within a ten year span. They will surely remain very cautious in their saving and investment decisions, creating a long term headwind for economic growth. Combine this with rising tax rates and greater regulatory burdens and the case for lower future economic growth rates in the developed world is a strong one. ***Yet the existence of serious long term problems does not preclude a near term cyclical recovery, even a strong or “V” shaped one.*** Since there is a hardened consensus around the idea that this recovery will be substandard, it might pay to explore the counter argument – that economic growth will continue to surprise to the upside. After all, the most robust return opportunities are seldom found within the consensus. ***For starters, there is no denying that a strong rebound in corporate profits is underway.*** Companies have cut costs to the bone and volumes are starting to recover. ***Emerging economies are recovering briskly and they represent a much bigger piece of the global GDP pie than in prior recoveries.*** For many companies this could more than offset any sluggishness in their European operations. In addition, corporate balance sheets look very clean relative to those in the government sector. Corporate cash is at record levels and the credit markets, at least for larger companies, are functioning normally. The ISM manufacturing survey is at levels consistent with very strong GDP growth, raw materials prices are moving up sharply and retail sales have been surprisingly strong, even adjusting for an early Easter. Temporary help indicators are spiking up, indicating that the labor market may start to improve sooner than people think. Of course we have a long way to go in this department, but the first leg down in unemployment may surprise at the margin. Finally, while backing up slightly of late, interest rates remain highly stimulative. ***When you add it all up, the economy and the stock market may be in the so-called sweet spot.*** This is the point where low rates are stimulating economic growth, but not to a degree that would force the Federal Reserve to step in and spoil the party.

We are mindful that a sweet spot by definition is a finite thing. In this case it describes a cyclical, interest rate and earnings driven period, not a secular expansion in valuations as occurred in the 80s and 90s. Ironically, the better things get, particularly on the employment front, the more vulnerable we will be to a sudden shift in interest rate expectations and, hence, the closer we will be to the end of the sweet spot. This is the “good news is bad news” phase, or the inverse of the sweet spot. This phase could cause significant dislocations in the capital markets worldwide, but it is probably a worry for later in the year.

Summing it all up, we are positive on the economy for the next twelve months and cautiously optimistic on the stock market, although a correction is long overdue. By process of elimination, U.S. and emerging market equities look like the asset classes of choice, particularly relative to real estate and bonds. Areas of emphasis in the portfolio include:

- Globally-g geared leading companies – After a near term “pop” driven by a cyclical upturn in the U.S., the inferior long term fundamentals of domestically focused industries (consumer discretionary, financials), relative to their global counterparts, will reemerge.
- Energy and materials – Demand growth in emerging markets, government infrastructure spending and the desire to have a “hard asset” hedge against increasingly suspect paper currencies are among the reasons for our overweight in these stocks.
- Global industrials and capital spending beneficiaries – The sharp declines in business spending in response to the financial collapse of 2008 should reverse. General beneficiaries of rising living standards and high economic growth rates in the developing world.
- Technology – These stocks are generally global in scope and beneficiaries of the pent up capital spending theme. Strong balance sheets are typically a feature.
- Gold – A beneficiary of loose monetary conditions around the world, also offers protection against future inflation, geopolitical instability and currency debasement.

We welcome your comments and questions and are thankful for this period of asset recovery.