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Market Commentary

April, 2010

The stock market followed a volatile path that ended with solid gains during the first quarter of 2010. Specifically, as the first quarter began, the upward momentum of the fourth quarter of 2009 continued, with the S&P 500 rising until January 19. Over the following three weeks, stocks fell 8% as a combination of factors weighed on investor sentiment. Stocks fell to the low for the quarter on February 8 then posted steady gains demonstrating remarkable momentum through the remainder of the quarter.

We believe this pattern may repeat during the second quarter given the conditions and events likely to unfold. The momentum from the first quarter has continued into the first half of April. The rally, however, faces a number of challenges, including: the earnings season, the Fed, China, European credit conditions, and the uncertainty surrounding actions on financial reform legislation.

- **Market participants may sell the earnings news.** "Buy the rumor, sell the news" is an adage often used to describe stock market behavior. This adage well describes the market performance around the past several earnings seasons, when companies reported their financial results for the quarter. It is worth noting that the last three 5-10% stock market pullbacks occurred leading into or during each of the last three earnings reporting seasons. We are now in the midst of this first quarter earnings season.
- **Fed may signal coming rate hikes.** During prior episodes of rate hikes, the market responded when the Fed made a change in their statement signaling that rate hikes were to come. The Fed has already taken steps to "normalize" conditions during the first quarter. These have included raising the discount rate (the rate at which the Fed makes direct loans to banks) by 0.25 to 0.75 percent, closing four emergency lending facilities, and ending the massive $1.25 trillion Mortgage-Backed Securities purchase program. Market participants will continue to look to the Fed for clues on how rapidly interest rates will begin rising in the short- to mid-term.
- **China may take additional steps to slow growth.** Policy makers in China are reining in credit growth after banks lent one-fifth of this year's $1.1 trillion annual lending target in January. The accompanying money supply growth in excess of 25% has given rise to inflation pressures. China is forcing banks to hold more cash by raising capital requirements and hiking bank reserve requirements. Fears remain that the sudden

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withdrawal of stimulus to one of the world's biggest growth engines may be premature and tip the global economy back into recession.

- **Financial stress may continue to spread in Europe.** In contrast to the United States, financial stress is intensifying in Europe. Countries in peripheral Europe, most notably Portugal, Ireland, Italy, Greece, and Spain (the PIIGS), are experiencing tightening credit. Most of these countries are likely to agree to tough budget cuts to remain in the Eurozone. This fiscal austerity is likely to prolong the pain of recession in Europe. The combined Gross Domestic Product (GDP) in the 16 countries that use the euro rose by a weaker-than-expected 0.1% in the fourth quarter, and was down 2.1% on a year-over-year basis. This weakness, and the fact that there was no growth in any of the PIIGS, suggests that the recovery in Europe may have already run out of steam.
- **Financial reform bill likely to grab attention this quarter.** The financial regulatory reform bill passed through the Senate Banking Committee in March. The most contentious issue of this bill is the creation of a new government agency responsible for protecting consumers. Some would like the impact of this agency to be far-reaching, responsible for the safety and solvency of banks (and therefore balance consumer protections with profitability). Since banks are still healing from the financial crisis, legislation that impacts them or raises the uncertainty around their prospects will likely move the markets.

Data has shown that some areas of the economy have improved, yet the severity of the recession has led to further impairment in others. We expect many conditions to remain positive in the second quarter, including above-average economic growth, improving credit trends, low interest rates, and the return of job growth. Despite these factors, the economy is still very weak, and we maintain our cautionary perspective.

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