Quarterly Review and Outlook – First Quarter 2010

The current equity rally has now crossed the year mark and has continued to show impressive strength. The S&P 500 is off to a terrific start gaining over 5% during the first quarter. International stocks as measured by the MSCI EAFE index lagged the US markets but were up about 1%. The Barclays Aggregate bond index was up almost 2%. The markets continue to humble us as we wrote only three months ago that returns were going to be more challenging in 2010. So far, returns are plentiful as the bull market recovery marches on. We will see what the rest of the year has in store for the markets.

The Great Inflation/Deflation Debate

The market can be referred to as a discounting mechanism, but reading what it is discounting can be difficult. To us it appears that both the bond and stock markets are clearly discounting a recovery while assigning a very low probability of a double dip recession. This seems like a logical conclusion to us in the near-term as the data we continue to see show an emerging strength. Hopefully the recovery will prove strong enough to continue generating strong earnings growth as stimulative impacts from fiscal and Fed policy wane. We remain skeptical about housing and jobs which may prove to be major swing factors in this outlook.

One of the major issues affecting the markets and how we view valuations is the market's expectations for inflation. This seems to us to be a very relevant topic and we are asked frequently about it by clients. For every convincing piece of evidence that inflation is going to be a serious problem we find another piece that suggests the opposite. We do not view inflation as a major problem over the next few years due to the Fed's diligence in preventing it as well as major deflationary forces that may mitigate any potential inflationary pressure.

In our view, the markets seem to agree. The CFA Institute published a paper recently by Van R. Hoisington titled "The Debt Deflation/Inflation Debate" where Hoisington pointed out that "the average long-term Treasury rate from 1870 through the second quarter of 2009 is 4.3 percent and the average annual CPI ("Consumer Price Index") for the same period is 2.1 percent." With the 30 year bond hovering around the 4.5 to 5 percent range, what does this imply about inflation? We believe the market doesn't see inflation much higher than it has been over the last 140 years.

One reason for this is likely due to a deflationary overhang due to excess capacity around the world and a substantial deleveraging effect that has been going on since this crisis began in late 2007. We believe that deflation (declining prices) is a bigger risk than inflation over the coming years. This is not a very common view, but many do agree that the risk is not insignificant. We need only look as far as Fed Policy to conclude they are guarding against the possibility of deflation. When we had our last deflationary scare back in 2002, the Fed took rates to 1% to prevent that undesirable outcome. Today, rates still remain at zero despite the worst part of our financial crisis being behind us. One can only assume that Ben Bernanke is hoping the economy can generate a little sustainable growth along with a little inflation and he wants to ensure that Fed policy encourages that. The opposite has been happening as inflation continues to tick down in recent months to around 1%.

We remain "cautiously optimistic"

In our view, not much has changed within the last three months to change our outlook. We believe that we should remain cautiously optimistic about the economy and the markets. One year ago we saw equity and fixed income markets that appeared cheap, but an uncertain economic outlook because we were dealing with the effects of a severe financial crisis. Today we see an economy on the road to recovery, but valuations that no longer offer a significant margin of safety.

While the economy certainly appears to be getting better, severe headwinds still exist. Good things are happening, but there are always risks on the horizon that we must be mindful of. At a presentation a few weeks ago David Kelly, Chief Market Strategist at JP Morgan, provided a good analogy of where he believed we are. I liked it for its simplicity so I wanted to share it with you. In the movie “Castaway”, Tom Hanks is stranded on a deserted island. Years pass and no rescue boat or plane ever finds him, so he concludes he must try and save himself. He builds a raft and attempts to set sail. He only gets as far as a reef where waves are crashing. Each time he nears the reef the waves capsize his boat and he swims back to shore disheartened. He does this time and again until he finally makes it over the crashing waves. Suddenly, he is in calm water looking back at the crashing waves he made it through. He looks forward at the horizon and wonders what else he is going to encounter as he tries to return to civilization and ultimate safety.

I believe this is where we are. We made it past the waves of financial crisis, the seas of the market are calm and helpful, but there will be more challenges as we move towards our goals.

Valuations Matter

We believe that valuations do matter and it is our responsibility to have a view on them. Some believe that the job of an investment manager is to make good asset allocation decisions and rebalance the portfolio back to that target allocation in a specified manner regardless of valuations. We agree on asset allocation and rebalancing but we believe we can be more effective if we take advantage of opportunities as they present themselves. It can be said that valuation metrics are merely a way to justify a previously made decision, but we view things differently. Understanding valuations and the assumptions supporting those valuations can affect how a portfolio is allocated.

We are not worried about valuations, but we want to be cautious as we move through this next phase of recovery. However, we are less enthusiastic about valuations and would consider a correction a logical probability. We are not so bold to believe that we can time when that correction may come, so we believe you are best served if we focus on what we can control. Warren Buffett reminds us the best way to deal with market fluctuations is to create a plan to satisfy your goals and objectives then stay the course when things get rough. This is our primary focus at BT Wealth Management by creating thoughtful asset allocation and investment decisions that are consistent with your goals and objectives. If we are successful in this area, then we believe the portfolio will be better positioned to withstand uncertainty in the markets.

Welcome, Scott Craig

We are pleased that Scott Craig has joined us as Director of Portfolio Management. Scott previously worked as a Portfolio Manager and Analyst at StableRiver focusing on fixed income portfolios. He is a Chartered Financial Analyst (“CFA”) and earned degrees from Emory University and Furman University. His expertise in the fixed income markets will be invaluable to us and we look forward to you meeting him in the future.

We appreciate your continued trust and confidence and look forward to hearing from you soon. Please let me know if you have any questions about your quarterly report or our outlook. Thank you.

Best regards,

Steven P. Barth, CFA, CPA
Chief Investment Officer
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