

The Oarsman Outlook

April 2010

Building on an already-impressive rally, stocks recorded a fourth consecutive quarterly gain in the January-March period. Domestic equity benchmarks rose 5% or more, though most non-U.S. markets posted smaller gains or slight losses. Treasury yields were essentially unchanged (the 10-year yield began and ended the period at 3.83%), although a further narrowing of credit spreads resulted in solidly positive returns for most categories of bonds.

Among U.S. stocks, the strongest three-month gains came from the Capital Goods, Consumer Cyclical and Financial Services sectors; generally weaker returns came from Communication Services, Energy and Health Care. Small-company stocks posted somewhat better results, on average, than their large-company counterparts; “value”-oriented stocks, as a group, outperformed “growth” names. Overseas markets mostly underperformed, although there were pockets of strength, including last year’s laggard, Japan. Domestic real estate securities turned in a strong showing, while those focusing on properties outside the U.S. were flat. The prices of oil and gold rose modestly, but many other commodities were flat or slightly lower.

Benchmark Performance – Equities

	<u>First Quarter 2010</u>	<u>Last Twelve Months</u>
S&P 500 Index	+5.4%	+49.8%
Dow Jones Industrial Avg.	+4.8%	+46.9%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+4.9%	+48.5%
Small-Cap Stocks (Russell 2000)	+8.9%	+62.8%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+2.0%	+61.5%

Benchmark Performance – Fixed Income

	<u>First Quarter 2010</u>	<u>Last Twelve Months</u>
Barclays Intermediate Gov’t/Credit Index (taxable)	+1.5%	+6.9%
Barclays Municipal Bond Index (tax-exempt)	+1.3%	+9.7%

Review

The first quarter unfolded in much the same fashion as the latter half of 2009. Economic news improved, albeit unevenly; corporate profits were, on average, better than expected; investor risk-aversion continued to abate; and, despite a mid-quarter scare that saw credit spreads widen and stock prices dip, U.S. bonds and stocks both posted healthy three-month gains, closing the period within a percentage point of 17-month highs.

The biggest dramas for the financial markets involved events far from home. Chinese authorities, concerned by frothy real estate markets and potentially too-strong economic growth, began to tighten monetary conditions in an attempt to avert a rise in inflation.

Although most observers assessed this as a prudent preemptive move, investors viewed the development with some trepidation, cognizant that most of the global economy was struggling to recover from deep recession.

What's Changed?

To provide insight regarding recent stock market performance, we can deconstruct the three-month return from stocks into three components:

- 1) Dividend Income (for three months this is the annual yield divided by four)
 - 2) +/- Change in Earnings Per Share* (average for S&P 500 Companies)
 - 3) +/- Change in Valuation (Price/Earnings Ratio)
- = Total Return**

** based on forecast earnings for next 12 months (Source: S&P Outlook)*

So, *what changed* during the recent quarter to give us the +5.4% S&P 500 total return?

First Quarter (January - March) 2010		
Dividend Income	+0.5%	+5.4%
+ Change in Earnings	+5.6%	
+ <u>Change in Valuation</u>	<u>-0.7%</u>	
=Total Return	+5.4%	

Our read: *The first-quarter rise in stock prices was fully explained by a rise in projected earnings; accordingly, valuation was nearly unchanged.*

More ominous were evolving worries about seemingly out-of-control 'sovereign debt,' highlighted by the precarious situation in Greece. Coming on the heels of the Dubai World near-default in late 2009, recent developments in "peripheral Europe" (including Portugal, Spain and Ireland) reminded us that investors will not indefinitely turn a blind eye to perceived fiscal profligacy, and can quickly become stern disciplinarians. Although the most acute phase of the Greek crisis seemed to have been successfully negotiated before quarter-end, we suspect similar events will be a recurring theme, as public-sector borrowing has ballooned in most developed economies.

Perhaps surprisingly, the culmination of the year-long push for healthcare reform in the U.S. was mostly a non-event for the financial markets. During the final weeks, as investors presumably divined that passage was becoming more likely, Treasury yields were flat to slightly lower and stocks staged a fairly sizable rally after a mid-quarter dip – neither suggesting undue dismay over the contentious legislation.

Outlook

Many of the factors supporting the 13-month stock-market rally are likely to remain intact over the near term. Most important are solid earnings gains, a gradually improving economy, and very low yields on competing investments. Reasonable valuation, moderate (i.e., not excessively bullish) investor sentiment and a mountain of un-invested cash round out the list of helpful circumstances.

As detailed in the *What's Changed?* box on the previous page, projections of near-term corporate profits, having bottomed in mid-2009, continue to rise smartly. With businesses quick to cut staff and postpone capital investments, productivity was surprisingly strong during the recession, preventing the usual steep decline in profit margins. As revenue growth returns during 2010, aggregate profits are likely to jump 25% to 30% on a year-over-year basis.

On the economic front, the clear but uneven gains seen since mid-2009 seem likely to continue. The manufacturing sector is showing the most marked improvement, aided by government stimulus and a sharp rebound in export orders. In contrast, consumers – whose spending comprises some two-thirds of total economic activity – remain pressured by persistent housing- and job-market weakness, as well as by the ongoing need to repair balance-sheets damaged by the massive decline in asset values. On balance, while the economy should continue to grow (very few economists are predicting a “double-dip” recession), these substantial headwinds are likely to hold the pace well below that historically associated with recovery from deep recessions.

As for competing yields, the combination of subdued growth, high unemployment, a moribund real-estate market, and still-dormant inflation all but guarantees the Federal Reserve will keep short-term interest rates near zero for some time to come. And although intermediate- and longer-maturity Treasury yields have been creeping higher (a sign that the recovery is gaining traction and investors are beginning to sense the eventual onset of Fed tightening), narrowing credit spreads should keep the overall level of interest rates at unusually low levels for a while longer.

Earnings growing at double-digit rates, an economic recovery gaining credibility with each passing month, and interest rates hovering near historic lows provide a solid foundation for stock prices. Despite dramatic increases over the past 13 months, domestic stock indices trade just a handful of percentage points above their long-term average on most measures of valuation – probably not sufficiently rich to dissuade investors who have missed much of the rally from gradually feeding their ample reserves of cash into the market in coming months. However, the current rally has proceeded uninterrupted by a meaningful “correction” (usually defined as a drop of more than 10%); there have been four dips of roughly six to nine percentage points, each followed by new post-crash highs. We would not be surprised to see a more substantial decline (on the order of 15%) materialize in the face of meaningful, negative news. But as we noted in January, we would be disinclined to view such a correction – particularly if it occurs during the next six months or so – as the harbinger of a new bear market.

While the next several quarters may feature relatively smooth sailing, we remain mindful of well known but nonetheless daunting obstacles to be negotiated in coming years. Major economies and the financial markets continue to receive substantial life-support from stimulative fiscal and monetary policies. It is difficult to gauge how much of the recent improvements can be directly attributed to these props, and likewise hard to predict the impact of their eventual withdrawal. Even more daunting are yawning fiscal deficits in most of the world's developed economies, whose origins lie in pre-crisis policies and unavoidable demographic trends, but which have been exacerbated by the deep and prolonged slump. These fiscal trends are clearly unsustainable – there is simply no way to avoid some combination of meaningful tax increases and spending cuts. However, we worry that, particularly in the U.S., those responsible will be unwilling to make the necessary but politically fraught compromises until a new crisis forces the issue. While this day of reckoning should be several years off, financial markets are notoriously forward-looking, and we could be surprised by how soon these issues come to dominate the investment landscape.

Please let us know if you have questions about our management of your investments.

Sincerely,

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