

## A Low Bounce for the Economy, as Stocks Advance

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After a pullback in late January and early February, stocks rallied to post positive returns for the first three months of 2010. The average diversified U.S. stock fund gained 6.1% during the quarter, according to Lipper Inc. Funds comprised of stocks of small companies did even better, gaining 8.0% on average.

International stocks did not perform nearly as well, due chiefly to the weakened euro. Diversified international stock funds managed to gain only 1.6% on average, according to Lipper. Concerns about the ability of euro-zone nations—most notably Greece

and Portugal—to avoid default contributed to the dollar's strength vs. the euro.

### The Economy: Real Progress, Yet Widespread Negativity Remains

Despite tremendous gains in stock prices since March 2009, concern remains among many investors that the U.S. economy will fall back into a recession later this year, or next. Obstacles cited often include:

- Unemployment remains high
- Higher taxes dampen consumer spending

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## Quarterly Performance Benchmarks

Passive Benchmarks*	Q1-2010	Y-T-D	1 Year	3 Year†	5 Year†
S&P 500 Index	5.4	5.4	49.7	-4.2	1.9
FTSE KLD 400 Social Index	5.0	5.0	52.9	-2.2	2.7
DJIA (reinvested dividends)	4.8	4.8	46.9	-1.5	3.3
S&P MidCap 400	9.1	9.1	64.1	-0.8	5.2
Russell 2000 (Small Cap)	8.9	8.9	62.8	-4.0	3.4
MSCI EAFE (Europe, Australasia, Far East)	0.9	0.9	54.4	-7.0	3.8
Barclays Capital Aggregate Bond	1.8	1.8	7.7	6.1	5.4
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity	6.1	6.1	54.4	-3.7	2.5
Large Cap Growth	4.2	4.2	46.2	-3.7	2.6
Large Cap Value	5.8	5.8	49.9	-6.2	0.9
Mid Cap Growth	7.9	7.9	62.2	-1.2	3.4
Mid Cap Value	8.3	8.3	64.9	-4.0	3.4
Small Cap Core	8.0	8.0	63.1	-4.5	3.0
International Equity	1.6	1.6	54.6	-6.5	4.1
Real Estate	9.6	9.6	105.0	-11.6	2.5
Intermediate-term Bond	2.4	2.4	15.7	2.0	4.5

Performance data represent past performance and do not guarantee future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks not directly available for investment. Lipper Mutual Fund Benchmarks are compiled by Lipper, Inc., a Reuters company. Information has been obtained from sources considered to be reliable; however, neither First Affirmative nor its agents guarantee the accuracy of the numbers reported.

\* Sources: *The Financial Times*, KLD ([www.kld.com](http://www.kld.com)), and *The Wall Street Journal*.

† The 3-Year and 5-Year returns are average annual returns for that benchmark.

# Bonds Are for Capital Preservation: Beware of Rising Interest Rates

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Like the equity markets, bond markets have reacted to the slowly recovering economy, but in the opposite direction. A strong rally through early March ended abruptly; yields began to rise and some pundits called it the “end of a 30-year bull market” in fixed income (remember, yields and bond prices move in opposite directions).

For the first quarter of 2010, the Bar-Cap (formerly Lehman) Aggregate Bond Index returned 1.78%, far behind the 5.38% gain of the S&P 500 Index. The municipal bond index returned 1.25%; the U.S. government sector returned 1.11%; and high-yield (which usually tracks the stock markets more closely than other bond markets) returned 4.62%.

Thinking about economic cycles is helpful for understanding bond markets. Over time, economies strengthen, plateau, weaken, and flounder. The forces that create each stage lose momentum over time, which leads to the next stage of the cycle. Indicators suggest that the economy stopped weakening last year, and is beginning to rebound, albeit cautiously, unevenly, and shakily.

When an economy is growing, demand for credit pushes the cost of borrowing up; the opposite occurs when an economy is contracting. To avert a complete meltdown of global economies in late 2008, central banks such as the Federal Reserve reduced the cost of borrowing to near zero to make credit available to businesses. Sooner or later, this very accommodative posture will end, but it is not clear when.

Economic factors are not the whole story. Investor psychology plays a huge role in credit market returns. When economies are strong, investors prefer risky assets to low-yielding government bonds. During periods of fear and uncertainty, investors seek to preserve principal by selling risky assets and buying conservative ones, the most conservative being short term U.S. Treasury bills.

The yield on three-year U.S. Treasuries dropped

to near zero toward the end of 2008, and has only just started to rebound. But the yield on 30-year Treasuries rose from 4.08% just six months ago to 4.74% at the end of March 2010. It's commonly believed that the yield on long bonds reflects investors' expectation of future yields on short bonds, which supports the sentiment that interest rates will rise.

Within the municipal bond market, there is an additional dynamic: underlying credit. State tax revenues, based largely on sales and income, rise and fall with the economy. The costs of state government, notably in social services, rise as the economy weakens, and fall when it strengthens. States must balance their operating budgets each year, which limits their flexibility to accommodate weak revenues and higher expense demands.

California is probably faring the worst of all 50 states. Hard-hit by the recession, the California constitution demands a two-thirds majority of the State Legislature to raise revenues; other initiatives mandate expenditure levels. While we do not expect any state to default on general obligation bonds, we are watching the political, financial, and economic news with concern and are investing with due caution.

Because we invest in bonds to preserve capital, produce income, and reduce overall portfolio volatility, we prefer the safe and simple to the risky and complex. Investment grade bonds and bond funds are positioned to preserve capital and reduce volatility even when interest rates are low. We discourage investors from reaching for high returns in a bond market that is not designed to deliver them without undue risk.

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- The still-struggling housing sector
- Barriers to obtaining credit, felt by consumers and small businesses alike
- Whopping state and local government deficits, forcing layoffs and cutbacks
- Another credit shock (will Greece and Portugal default?)
- Federal deficits projected well into the future

Despite these concerns, there is mounting evidence that the economic recovery now underway will gain momentum. The challenges listed above may well constrain whatever expansion may follow, but that is quite different from a double-dip recession.

## Evidence of an Economic Recovery

Although the unemployment rate is high, more jobs were gained in March than in any other month in the past three years. Initial jobless claims have dropped to the lowest level since September 2008. Construction and manufacturing jobs, which had previously been among the worst sectors for job creation, showed substantial gains, as did temporary help—a leading indicator for future job growth. Taken together, these numbers suggest that the painful unemployment and underemployment situation may have reached a turning point.

The Institute for Supply Management's (ISM) index of U.S. manufacturing rose again in March to 59.6 (readings above 50 signal expansion). This marked the eighth consecutive monthly advance. New orders and production posted index scores above 60, indicating strong momentum. The inventory index advanced for the first time following 46 consecutive months of liquidation, which suggests that manufacturers are expecting future demand growth.

The ISM March index of non-manufacturing businesses rose to 55.4, the highest level since May 2006. With the exception of the financial services sector, job

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## Big Losses Followed by Big Gains: The Math of Loss and Recovery

According to a Bloomberg National Poll conducted March 19–22, 2010, only three of ten investors owning stocks, bonds or mutual funds say the value of their portfolio has risen in the past year. Presumably, 70% of investors may be surprised that the Standard & Poor's 500 Index gained more than 73% since its low on March 9, 2009.

Several experts were asked what could explain such a huge gap between perception and reality. The reasons given had primarily to do with people's perceptions being colored by the weak economy and high unemployment. But, another reason may be that a significant percentage gain following a steep decline may not be enough to overcome the loss that people experience.

There is a tendency among investors to measure loss from peak portfolio value rather than from some other starting place, such as the date they opened an account, or from their portfolio's value as of five years ago. This tendency naturally accentuates the perception of loss.

Here's the "math" of loss and recovery: the S&P 500 was down 37% in 2008; it gained 26.46% in 2009. For every \$100 invested in the S&P 500 at the beginning of 2008, \$63 remained at the end of 2008. In 2009, 26.46% of \$63 was gained back (+\$16.67), leaving \$79.67 of the original \$100 invested. The S&P 500 Index actually shows a loss of 20% for investments made on January 1, 2008 and held through December 31, 2009.

Consider how much an asset must gain to recover after it loses 50% in value. If an asset valued at \$100 falls to \$50, in order for it to climb back to \$100, the \$50 must double in value—in other words, a 100% gain is required.

The mathematics of gains and losses may help explain why so many investors are still feeling beaten up by the stock market during the past couple of years, in spite of the tremendous market rally of the past twelve months. It also illustrates the importance of managing a portfolio's downside exposure.

gains were widespread.

According to The National Association of Realtors, **pending home sales** rose 8.2% in February, the most recently reported month. This is the second-largest gain on record and the single largest monthly gain since October 2001. Mortgage applications are up. Buyers are taking advantage of the extended federal tax credit. And, home prices are stabilizing. The **S&P/Case-Schiller home-price index** climbed 0.3% in January following a similar gain in December. This index was down 0.7% from January 2009, the smallest year-over-year decrease in two years.

**Stock prices**, a leading economic indicator, are forecasting recovery. The S&P 500 Index enjoyed its best first quarter in 12 years, posting a gain of 5.4%.

**Factory orders rose** in February for the tenth time in the past 11 months, with inventories and order backlogs climbing by the most in more than a year—a

**sign factory production** may continue to lead the economic expansion.

Consumer spending accounts for about 70% of U.S. economic activity. **Consumers increased spending** in February for the fifth consecutive month. As the employment picture continues to improve, we would expect consumer spending to accelerate.

## Economic Summary

Although many well-documented problems in the financial system remain, the broad economy appears to be in the early stages of expansion.

The Federal Reserve has indicated it will likely retain its accommodative monetary policy for several months—until employment growth signals that the economic expansion is sustainable and can withstand gradual tightening. Neither inflation nor deflation poses a great risk now, and we trust that the Fed will use the tools at its disposal to maintain this balance.

Meanwhile, corporate earnings are up sharply and will likely continue to grow. American companies are flush with cash, and hoarding may give way to spending as confidence improves.

For these reasons, we expect to see higher stock prices ahead, and only slowly rising bond yields.

However, we could be wrong. The prudent investor recognizes the risks and uncertainty in the marketplace and maintains a well-diversified portfolio. We strongly encourage investment strategies designed to avoid big mistakes rather than take big risks. These strategies have served us and our clients well during the past decade—through two of the biggest down market cycles in the past 75 years.

Kevin O'Keefe, First Affirmative's Chief Investment Officer, is responsible for due diligence and monitoring of mutual funds and separate account managers.

## Advice for Investors

1. To build wealth over the long term, expect uncertainty. Be prepared to handle inevitable, unavoidable setbacks along the way.
2. Attend to what is within your control.
3. Focus on what is important.
4. There are short-term strategies and long-term strategies. Don't confuse the two.
5. Understand that even the best investment managers produce below-average results periodically.
6. Chasing past performance (investing in last year's winners) is almost always a losing strategy.
7. Have a written investment strategy that includes asset allocation, ongoing due diligence of managers, and rebalancing.
8. Have conviction in your investment strategy. If necessary, change your strategy when things are going well—not during difficult times.
9. Are you getting value from your investment advisor? A good advisor won't produce miracles; a good advisor will help you adhere to sound investment principles.
10. Understand that opportunities and risks are often most present when emotions tell you otherwise.

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