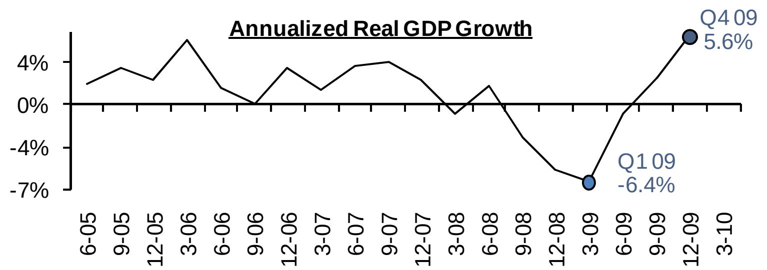
Your Quarterly Update on the Financial Markets
March 31 2010

1st Quarter

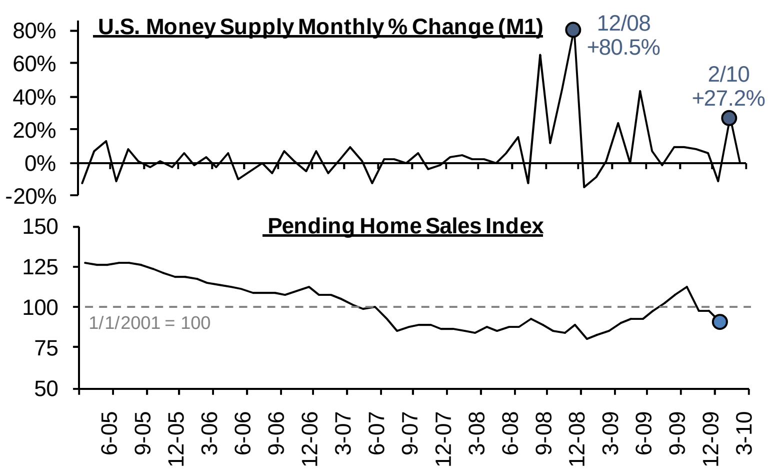
Market Recap

The Economy: *"Growth at an Unreasonable Price"*



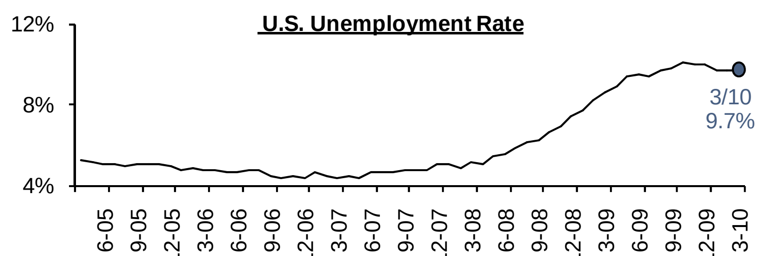
Economic growth surged in the fourth quarter of 2009 to a 5.6% annualized pace, the expected result of massive monetary and fiscal stimulus. As we reported in our year-end issue, manufacturing activity increased significantly toward year-end as producers began to replenish inventories; this is reflected in GDP through private inventory investment, which drove the growth spike. Increases in personal consumption expenditures, nonresidential fixed investment, and exports also contributed to increasing growth. While it is unlikely that this post-recession surge will continue apace, it is clear that this particular recessionary phase of the business cycle is over; NBER will likely make it official in short order. Unemployment continued to moderate on increased activity, although at a predictably slow pace as producers cling to productivity gains made during the recession.

The Federal Reserve closed most of the various special liquidity facilities created to stabilize markets during the credit crisis; the only remaining facility, the Term Asset-Backed Securities Loan Facility, is scheduled to close on June 30 for loans backed by new-issue CMBS. In other respects, however, the Fed continues to tap the gas pedal. At their March 16 meeting they maintained the fed funds rate at 0.00% to 0.25%, stating that subdued inflation and slack resource utilization is "likely to warrant exceptionally low levels of the federal funds rate for an extended period". Every biker knows the prudent thing to do when you pop a wheelie is to lay off the gas a bit; there is little evidence that the Fed is prepared to do that in a meaningful way, at least not soon.



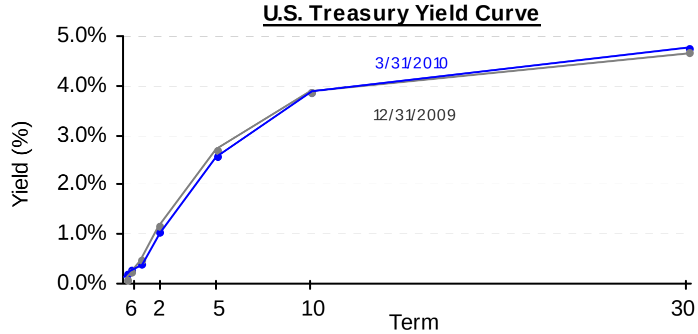
The fly in the ointment is the fragile US housing market, which continues to exert its influence on consumer activity and extend tentacles into the banking system. It remains difficult to predict the impact of rapidly rising rates on the system in its current state, leaving the Fed challenged to do what it can to keep rates low until the problem reaches a more manageable size, through increasing home prices, gradual defaults, and maturities. However, the real estate market has yet to cooperate, remaining the one asset market to defy the inflationary pressure of very loose monetary policy. Attempts to fix problem mortgages by methods other than forgiving principal have tended to yield only bigger and deeper problems, as homeowners with equity gaps simply cannot earn their way out of the problem.

Trouble is, other asset markets have already responded to stimulus. Add to the pot a fresh round of fiscal spending through a somewhat downsized yet still massive healthcare bill, and the specter of a 2012 presidential election cycle likely to be driven by employment statistics, our outlook remains inflationary.



The US Bond Market

Treasury yields ended the first quarter of 2010 roughly at their year-end 2009 levels, with the biggest difference coming at 5 years where yields fell by 14 basis points. At quarter-end, the benchmark 10-year yield was 3.83%. The difference in yields between the 2-year and 10-year notes was at 281 basis points, widening 11 basis points from the end of 4Q 2009 and having little impact on the shape of the yield curve.



Source: Bloomberg LP

However, the quarter-over-quarter comparisons don't tell the whole story. Yields on treasuries actually surged toward quarter-end as 2-, 5-, and 10-year note auctions drew a tepid response and prices fell. In prior weeks, demand had been robust as investors flocked to the relative safety of US debt amid the fiscal crisis in Europe where debt-stricken countries like Greece threatened to drag down economic activity across the region. However, as European policy makers worked out an agreement to back Greece, attention in the broader bond market turned to the fiscal outlook in the US. Treasury security issuance totaled $601 billion for 1Q 2010, compared to $454 billion for 1Q 2009, according to Barclays.

Corporate bonds, both investment grade and high yield, fared comparably well over the quarter as investors sought out better value than the negligible yields on treasury bonds. Risk premiums on corporate bonds were generally flat with a mid-quarter blip in high-yield. US corporate investment-grade bond issuance totaled $225 billion for the quarter, down from $345 billion in 1Q 2009. High yield issuance totaled $68 billion (with $35.5 billion in March alone), up from $11 billion in 1Q 2009 when the financial crisis had investors running from risk. Much of the issuance served to extend the maturity of existing debt and refinance bank loans.

Bond Indices - Total Return	1Q2010
BarCap Aggregate	1.78%
BarCap Interm. Gov't	1.12%
BarCap Long Gov't	0.97%
BarCap Interm. Credit	2.35%
BarCap Long Credit	2.02%
BarCap High Yield	4.62%

In the commercial MBS market, delinquencies reached 4.71% at the close of 2009, according to Fitch Ratings. This was an increase of 5 times over year-end 2008. With an increased amount of loans coming due over the next two years, the rate of growth in delinquent CMBS will likely continue with a potential peak of 12% in 2012 predicted. Further, as the occurrence of delinquencies grows, the size of delinquent loans is increasing as well. With the TALF emergency loan program expiring for new-issue CMBS in June of 2010 and already expired for legacy CMBS in March, concerns about the prevalence of this asset class in so many liability-sensitive fixed income portfolios seems well-warranted and likely to increase.

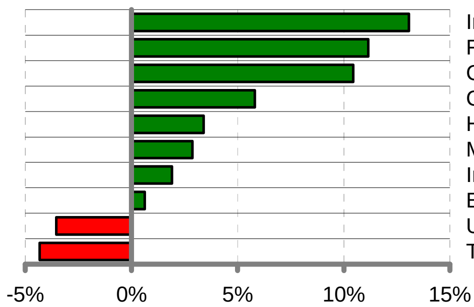
The US Stock Market

After a strong finish to 2009, the first quarter of 2010 marked a fourth consecutive quarter of positive returns in the major equity indices and one of the best first quarters in a decade. The Dow closed the quarter at 10,857, up 4.11% for the quarter. The NASDAQ Composite and S&P 500 ended the quarter at 2,398 and 1,169, respectively.

As in the bond market, investors were willing to take on more risk. Mid- and small-cap stocks beat out their large-cap counterparts with returns generally +50%. With smaller-capitalized names in favor, the Russell 3000 returned 5.94% in 1Q. The quarter saw another style rotation as value stocks came back into favor over their growth peers driven by strong performance in the Financials sector, where returns in regional banks and insurers more than made up for lackluster returns in real estate investment trusts (REITs). The Consumer Discretionary sector continued to benefit from incentives in the auto industry (this time around from the auto firms themselves), while Industrials led the large-caps as the significant increase in manufacturing activity for Q4 flowed through the market. The announcement from the Obama administration of a new off-shore drilling strategy came too late in the quarter to help oil stocks, and the Energy sector ended the first quarter toward the bottom of the heap. Telecommunications and Utilities were once again the two worst-performing sectors and the only sectors to post a negative return. Utilities extended their time out of favor as investors continued to seek out higher growth, more cyclical, less regulated sectors. Telecom stocks continued to be challenged by unemployment and the associated decrease in demand for services as well as an anticipated rise in taxes and regulatory fees.

Stock Indices - Q1 2010 Total Return			
Largecap Stocks		**Midcap Stocks**	
S&P 500	5.39%	S&P Midcap 400	9.09%
Russell 1000	5.70%	Russell Midcap	8.67%
Growth	4.65%	Growth	7.67%
Value	6.78%	Value	9.61%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	5.91%	S&P Smallcap 600	8.61%
DJ Wilshire 5000	6.04%	Russell 2000	8.85%
		Growth	7.61%
		Value	10.02%

S&P 500 Economic Group Components - Total Return



Sector	1Q2010
Industrials	13.08%
Financials	11.15%
Consumer Disc.	10.44%
Consumer Staples	5.82%
Health Care	3.40%
Materials	2.88%
Info Tech	1.91%
Energy	0.62%
Utilities	-3.53%
Telecom	-4.32%

Source: Standard & Poor's

With the performance challenges of 2008 and early 2009 a year back in the rearview mirror, many happily pointed to 1Q 2010 returns as a good indication of the year to come. According to CNBC, in years where the Dow, the S&P 500 and the NASDAQ Composite had positive first quarter returns, the indices posted positive annual performance over 80% of the time with average annual gains in excess of 12%. Add in a strong fourth quarter earnings season fueled by cost-cutting and top line growth of 8%, and it is not surprising that price-to-earnings ratios in the S&P 500 are running at 13% above their 5-year average. To further fuel this positive outlook, Thomson Reuters estimates the 1Q 2010 earnings growth rate for S&P companies at 37%, marking the second consecutive quarter of earnings growth for the S&P 500 after 9 straight quarters of year-over-year earnings declines. However, it is important to note that this robust growth comes off a very low base, particularly in the more cyclical sectors. For instance, the Financial sector is expected to report earnings of $20 billion in 1Q 2010 versus the $7 billion in earnings it reported in 1Q 2009 and nowhere near the peak of $50 - $60 billion reported in late 2006 and early 2007.

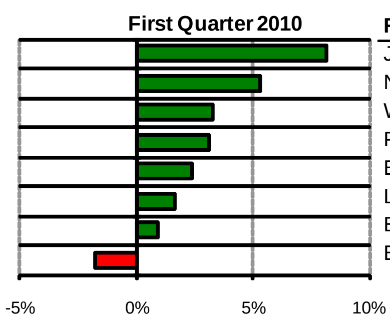
So will the positive returns in 1Q truly be an indication of a strong year to come? With unemployment still at early 80's recession levels, foreclosures rising in the housing market, and the federal government closing the programs that stimulated production, kept interest rates low and cushioned the real estate market, it seems unlikely that 2010 will end with broad market returns in excess of 12%.

Overseas Markets

Global markets, while subdued performance-wise, showed an uptick in volatility as European markets came under pressure from structural issues in the PIIGS (Portugal, Ireland, Italy, Greece, and Spain). Problems in Greece (discussed in this quarter's Focus section) threatened a spill-over into other regions. Emerging market performance, which for the last year had been very strong, moderated as investors sought the safety of more developed markets.

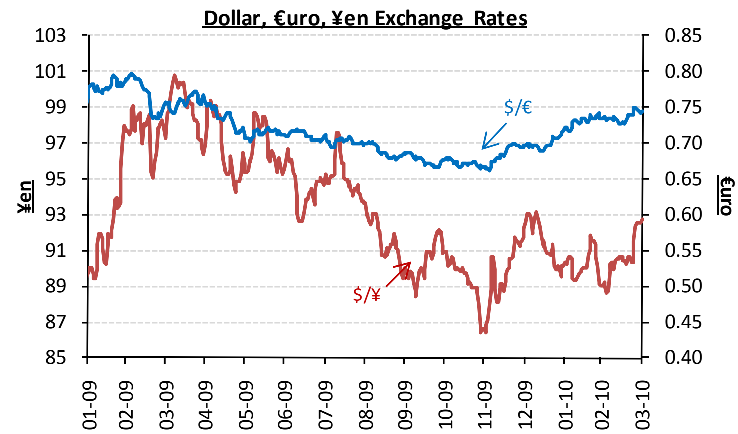
With growing panic that Greece, along with the other PIIGS, might default, the ECB left interest rates unchanged during the quarter after previously indicating a tightening bias. Greece initiated an "austerity" budget, with the endorsement of the EU, looking to drastically cut its deficit over the next 3 years. Greece's deficit had ballooned to 13% of GDP, well above the EU limit of 3%. Announcements of significant cuts in public spending including a freeze in public salaries, a retirement-age hike, and a rise in fuel tax, sent Greeks into the streets in protest of the measures necessary to keep the country afloat. Early in the quarter spreads on 10-year Greek government bonds widened more than 400 basis points over German Bunds of the same maturity. The circumstances in Greece also highlighted the issues facing a number of the so-called peripheral countries within the Eurozone as borrowing costs rose significantly for Italy, Ireland, Spain and Portugal. The impact of the PIIGS has been felt zone-wide as the Euro tumbled over 6% versus the dollar for the quarter. Issues in the peripheral countries overshadowed improving economic data in Germany and France, the largest economies in the zone. In Germany industrial production appeared to improve as orders have stepped up their pace. In France exports have outpaced imports year-over-year, nearly doubling the growth rate of imports. In spite of the improving economic picture the MSCI Germany and France Indexes were down 2.65% and 3.89%, respectively, as resolution of the issues facing the peripheral economies remains unclear.

Net Total Return of Selected MSCI Regional Indices



Region	1Q10
Japan	8.18%
North America	5.34%
World Index	3.24%
Pacific ex Japan	3.10%
Emerging Markets	2.40%
Latin America	1.64%
EAFE	0.87%
Europe	-1.80%

In Japan the quarter began precariously with an announcement by Standard & Poor's that it might downgrade Japan's sovereign credit ratings if data didn't improve or if the government didn't take steps to improve its fiscal and economic problems. The ratings agency placed a negative outlook on Japan's AA sovereign long-term credit rating, saying it could issue a downgrade to AA- "if economic data remain weak and measures to boost medium-term growth are not forthcoming, given the country's high government debt burden and its weak demographic profile." Concerns continue to abound in regard to the country's ability to deal with growing debt levels and deflationary pressures. The issue is to make sure its steps don't end up choking companies or the greater economic recovery. Japan's government debt is more than double the size of its gross domestic product – the highest debt-to-GDP ratio in the developed world. Japan's lower house of parliament approved a record 92.3 trillion-yen ($1 trillion) budget for the fiscal year that begins April 1, to be financed with a record 44.3 trillion yen in new bonds. Despite the views of S&P, the Japanese economy is doing better as exports have shown strength – growing 21% during the 4th quarter of 2009. Domestic demand has also turned positive helping the overall performance of the sector.



China began the quarter by sending a "tightening signal" to the markets as the central bank guided interbank interest rates higher, possibly laying the groundwork for an eventual rate hike. The People's Bank of China sold 60 billion yuan ($8.8 billion) worth of three-month bills at 1.3684%, four basis points higher than in December. The change in yield marked the first in its weekly open-market operations since the summer of 2009. Another signal came soon after as a Chinese banking regulator indicated that the nation's banks were expected to make fewer loans in 2010. According to China's top banking regulator, banks are expected to issue about 7.5 trillion yuan ($1.1 trillion) in new loans in 2010 compared to 9.6 trillion yuan in 2009, reflecting efforts to rein in lending. Regardless of the tightening measures, the Chinese economy continues to grow at a break-neck pace compared to the rest of the world. According to China's National Bureau of Statistics data showed economic growth surging higher in the fourth quarter, putting the full-year figure above forecasts, with inflation surprising on the upside, suggesting a continuing recovery but also indicating what many already know – that fiscal and monetary policy may need to be tightened. China's economy expanded 8.7% in 2009, exceeding consensus expectations of 8.5% and the official growth target of 8% for the year, as massive fiscal stimulus and bank lending helped sustain growth in the face of a drop in global trade. For the fourth quarter, China's gross domestic product expanded 10.7% from a year earlier. China's strong growth has prompted repeated calls for allowing its currency to free float, with the US among the loudest voices. The US indicated that it may impose trade restrictions if the country did not move away from its US dollar peg. Comments from the People's Bank of China Governor were interpreted as meaning the yuan's fixed rate against the dollar was a temporary response to the financial crisis and would soon be lifted. The yuan has appreciated more than 21% against the US dollar since Beijing launched currency reforms in July 2005. Currently a daily peg, a so-called "central parity rate," is set with the yuan's value against the dollar allowed to move no more than 0.5% in either direction during the day. Since mid-2008, the currency's value versus the dollar has remained nearly unchanged, despite rising about 7% in the previous two years. Obviously Beijing is worried about crimping exports, but they must balance this with mitigating strong inflationary pressures.

Emerging Markets rotated out of favor during the quarter with Latin American emerging markets showing mixed performance. In Brazil the central bank indicated it may raise interest rates for the first time in 18 months as inflation rose above its 4.5% target due to the rapid recovery of Latin America's biggest economy. Record low borrowing costs helped Brazil pull out of its recession in 2009. Now a revival of domestic demand may push the economy to its fastest growth in two decades. Inflation has already exceeded the central bank's target in 2010 and economists surveyed by the bank expect still higher prices by year-end. The MSCI Brazil Index was flat for the quarter. In Argentina indications of recovery were becoming evident as industrial production rose significantly. January output rose 6% year-over-year, according the Argentine Industrial Union, which represents the nation's leading manufacturers. In addition, Argentina announced plans to offer a new debt swap to the holders of defaulted bonds and while the government is meeting resistance in its efforts to use foreign reserves to make about $6.6 billion in debt payments its approval is expected. The MSCI Argentina Index was up 5.31% for the quarter.

Focus On: *Populistis and Swapasaurus – Modern Greek Monsters*

Perhaps no culture has provided a more interesting slate of monster stories than the Greeks; their mythology is replete with all manner of giant critters dead set on wiping out whichever unfortunate sailor, king, or city-state happened to walk into Zeus' cross-hairs. One timeless story is that of Scylla and Charybdis, a pair of sea monsters that struck terror in the hearts of Greek sailors.

Charybdis took form as a huge creature whose face was all mouth, swallowing and belching back vast volumes of water creating whirlpools. She lay on one side of a narrow channel of water with Scylla on the other side. Scylla was a monster with six long necks equipped with grisly heads, each of which contained three rows of sharp teeth. Her body consisted of twelve tentacle-like legs and a cat's tail and with four to six dog-heads ringing her waist. The two sides of the strait were within an arrow's range of each other, so sailors attempting to avoid Charybdis would pass too close to Scylla and vice versa. The phrase "between Scylla and Charybdis" is the origin of the phrase "between the rock and the whirlpool" (the rock upon which Scylla dwelt and the whirlpool of Charybdis) and may also be the genesis of the phrase "between a rock and a hard place."

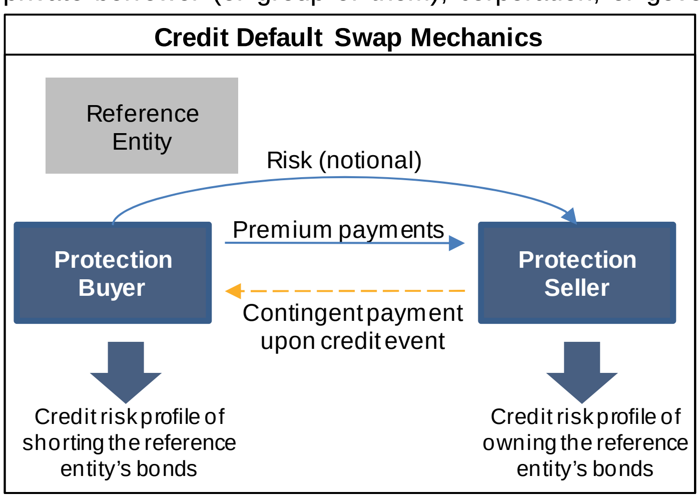
Today our old friends are back – but during their 3,000 year hiatus they've changed names and grown to global scale. On one side you have *Populistis* – a swirling mass of angry citizens used to an ever-increasing stream of welfare payments for an ever-decreasing amount of productive work. Consider the curious case of the hairdressers, who in Greece can retire at age 50 with a full state pension because their job is considered hazardous! Harmless enough when well-fed, Populistis becomes destructive when provoked – striking, flipping cars, and firing any leaders that dare tighten the fiscal belt.

On the other side we have a new creature, the *Swapasaurus*, which eats money and screams out a mighty roar of "bankruptcy" scaring away would-be lenders. With classic Greek irony the more you feed Populistis, the bigger and louder Swapasaurus becomes. Caught in the middle we have George Papandreou, prime minister of Greece and leader of the Panhellenic Socialist Movement party, along with Chancellor of Germany Angela Merkel and other European leaders chained to this drifting ship through the common euro.

The Credit Default Swap

In the first quarter of 2010 Greece's financing problems reached a critical level, causing market participants to seriously consider the possibility of default. Spreads on 1-year Greek sovereign CDS spiked to record levels, making it clear that Greece would no longer be able to turn to public markets for deficit financing. As negotiations ensued for a bailout package supported by other Eurozone countries and the IMF, European government leaders became harshly critical of the CDS market. Complaints echoed those levied against short-sellers and speculators in corporate CDS during the Fall of 2008, when many argued that their investment activities exacerbated the collapse of AIG and Lehman.

What are these devices, and what are they used for? A c*redit default swap* is a contract between two parties, where one insures the other against the default of a third party debt issuer (the "reference entity"). The reference entity may be a private borrower (or group of them), corporation, or government. One party is said to "buy" the swap (in other words, buy protection), for which they pay the other party a periodic payment in the form of a rate applied to a fixed notional amount. The other party is said to "sell" the swap; they receive the periodic payment from the buyer as long as the reference entity is solvent. However, if the reference entity defaults, the seller pays the buyer the notional amount in a lump sum. A CDS buyer is protected from default of the reference entity, and a seller is compensated for providing the protection as long as a default does not occur.

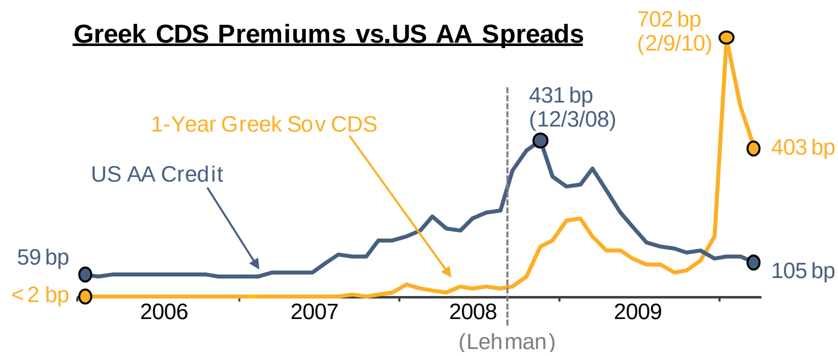


A seller of CDS acquires the credit risk of owning bonds of the reference entity, without actually owning any bonds. Why would an investor want to do this, as opposed to simply purchasing the issuer's bonds? Primarily because at any given time the market may not offer a bond of the issuer with the characteristics the investor wants, such as a particular maturity or coupon structure. For example, for US corporate pension plans, traditional-formula liabilities are calculated by discounting long-dated future cashflows using a AA-quality discount rate. The natural matching asset for this liability is a long-dated AA-quality bond. However, there is very little paper available with duration greater than 15 years and AA credit quality; the very long-term bond market is dominated by treasury issues. An investor can approximate a long AA bond holding by purchasing long-dated treasuries (e.g., strips) and selling CDS on AA-quality issuers. Other sellers may desire yield enhancement or improved diversification of their geographic or industry sector profile.

Similarly, buyers of CDS can use the swaps to convert riskier debt into less risky debt, without incurring the expense of selling their underlying bond holdings. This is particularly important if the buyer's desire to obtain a less risky profile is tactical or otherwise temporary. Common buyers are banks and insurance companies which need regulatory capital relief or otherwise need to manage credit risk. Note that the CDS market is generally more efficient and liquid than the physical bond market – swap buyers and sellers can often obtain their desired risk profile with lower transactions costs.

Would the Real Monster Please Stand Up?

It is important to note that many buyers of CDS do not actually own the underlying bonds. It is these "naked" CDS buyers that attract the ire of troubled debt issuers and, during a credit crisis, governments that are trying to support or bail out the issuers. Speculators in CDS tend to be hedge funds and proprietary trading desks, although other investors participate as well. Purchasing a naked CDS is an expression of a negative outlook on the creditworthiness of the reference entity. Increased demand for protection drives up premiums for the swap and, although the reference entity is in no way involved in the swap, it drives up credit spreads on their actual bonds as well. Swap rates and actual credit spreads must remain connected or arbitrage opportunities emerge, the quick exploitation of which drives spreads and swap rates back to parity.



Since joining the Eurozone Greece has run substantial budget deficits in order to finance very hefty social welfare spending. Ranging from -3% to -9% of GDP since 1990, the deficit surged to -12.7% in 2009 (following a deficit of -7.7% in 2008). Combined with evidence that the government had undertaken derivative positions to mask their financial position dating from their initial adoption of the euro, and a fresh memory of the rapid collapse of global institutions like AIG and Lehman, the markets said "enough." In February CDS premiums broke 700 basis points, effectively eliminating the possibility of Greece accessing public markets for capital. Rates have fallen since that time on news of a contingent bailout package constructed by Germany, France, and the IMF – but at the price of some measure of budget austerity.

During the crisis, European leaders pressed US regulators for greater oversight of the CDS market – code-speech for prohibiting naked CDS purchases in an effort to reduce Greek borrowing costs. The rhetoric paralleled that leveled against equity short-sellers by US regulators in 2007 as they bet against failing banks and quasi-banks. It was argued that those purchasing swaps were effectively precipitating the very failure of the borrower, and that protection purchasers have a nefarious interest in the failure of the state's economy – like owning a fire insurance policy on your neighbor's house.

Our principal counter-argument is that swap instruments offer a simple zero-sum game. For every party that wants to "bet" against Greek creditworthiness, there must be a counterparty that takes the opposite position – otherwise no swap contract can be formed. Unless the swap purchaser is in a position to actually impair Greek credit (say, by promising more pension benefits or undertaking expensive public works) we do not see a moral hazard. Rather, the CDS market adds liquidity and facilitates price discovery, a valuable function for those willing to listen to markets. Spiking rates send a signal to policymakers not to attack their problem with yet more debt, but instead to reduce spending to responsible levels. The irony here is the speed at which policymakers tend to crack down on free markets when the markets send signals that counter popular policy. While they may fear Populistis, it's the Swapasaurus for whom they reserve their wrath.

The Road Ahead for Greece – and Other Sovereign Debtors

Greece is unlikely to default in the near future – the Eurozone and IMF will privately prevent it, even if public statements create doubt to placate domestic voters and provide warning to other spendthrift nations. In the longer term it is hard to say, but we know for sure people and businesses there face at best a long hard road to recovery. It's hard to argue a case for taking equity or credit risk in an economy so dependent on public spending, when spending must be curtailed.

While blaming the CDS market may be a fine political strategy, leaders of all debtor nations would do well to heed the warning. In the long run no person, family, company, state, or nation can indefinitely spend more than they productively earn. The resulting deficits must be financed with debt or charity and eventually, inevitably, the financing runs out – usually with traumatic results.

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