

INVESTMENT OUTLOOK

First Quarter 2010 Review and Outlook by Whitney Brown

- ◆ Stocks up in 1st quarter.
- ◆ Federal Reserve to keep rates low.
- ◆ Low interest rates, low inflation to benefit stock market.
- ◆ Unemployment, credit activity, and housing create headwinds for economic recovery.

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Stocks advanced broadly in the first quarter. Initially, a strong start to the year fizzled by mid-January, and gains turned to losses by early February. The market regrouped and pushed steadily higher from mid-February through the end of March. All of the major indexes logged solid single digit gains for the quarter. For a change of pace, foreign markets underperformed the U.S.

The market advance continues to feed on low interest rates, low expectations for inflation, and the prevailing sense that the economy is slowly but surely healing. The move off the extreme low of March 2009 has marked its one-year anniversary and shows few signs of

strain. The extraordinary surge of the spring and summer quarters of last year has yielded to a more modest, grinding type of bull market where the up days are not spectacular, but the down days are few.

From a technical standpoint, the uptrend is well-established. Although there are always standout performers, participation is broad among all types of stocks, and the telltale signs of volatility and narrowing breadth usually evident well before a typical market top are nowhere to be found. Any cyclical market advance will go through periods of correction, and we still expect a significant one at some point this year. However, barring another economic calamity, a correction should be manageable, allowing the market to finish the year on the upside.

Evidence of improving economic trends continues to build, but there are areas of concern. The labor market has been very slow to respond to the improving economy, and borrowing and lending activity remains very sluggish. The housing market struggles to recover as well.

These major headwinds for the economy should keep the Federal Reserve on hold with regard to interest rates. Despite legitimate concerns about inflation in the longer term, there is too much slack in the economy now for the Fed to risk causing a double dip recession by raising interest rates too soon. With interest rates low, valuations modest and sentiment positive but not euphoric, conditions for further market advance are in place. As the bull market matures and the economy stabilizes, look for large cap, higher quality and dividend paying stocks to lead the market in the months ahead.



<u>Market Measures</u>	<u>1st Qtr</u>		
S & P 500 (price)	4.87%		
Dow Jones Industrial Average	4.11%		
NASDAQ Composite	5.68%		
Russell 2000	8.51%		
MSCI EAFE	0.20%		
Barclays Capital Inter US Gov't/Credit Bond Index	1.54%		
	<u>3/31/10</u>	<u>9/30/09</u>	<u>3/31/09</u>
10-Year Treasury Bond Yield	3.84%	3.32%	2.67%
Three-month Treasury Bill Yield	0.16%	0.12%	0.21%

Bond Strategy Update

by Watt Dixon



For many people, investing in bonds is not as glamorous as stock investing. Bonds are generally a more stable, predictable type of investment. Bonds prices move inversely with interest rates. When interest rates go up, bond prices fall. When rates fall, the prices rise. Also, bonds with

longer maturities see larger price swings as interest rates move either up or down, while short-term bonds are more stable and less affected by moves in rates.

As was very evident in 2008, balanced portfolios that held bonds in addition to stocks were buffered on the downside when we saw a disastrous year for stock prices. In 2008, interest rates fell along with stock prices causing most bond prices to rise. Portfolios that were invested solely in stocks suffered much greater losses than those portfolios that held bonds as well.

Our current bond strategy is to maintain a laddered portfolio of high quality bond issues ranging from short to intermediate maturities. Laddering simply means dividing the bond portfolio among multiple bond

issues of incrementally longer maturities. For example, to build a ladder six years long, we would invest one-sixth of the portfolio in bonds maturing in each of the next six years. By staying relatively short in our bond ladder, the value of the bond portfolio remains more stable. In addition, when interest rates do begin to rise, our bonds will be maturing sooner, allowing us to reinvest at higher rates.

In March, the Federal Reserve reaffirmed that due to the weak economy they expect to hold interest rates low for an “extended period”. Most likely, as the economy strengthens and the unemployment situation begins to stabilize, interest rates will begin to show a more definite upward trend. At some point the Fed will begin to increase short-term interest rates in order to tamp down inflation. The initial period following Federal Reserve rate hikes is usually a difficult time for stock prices, but any rate increases by the Fed are not likely before the end of this year.

The chart below shows the long-term movement of the yield on the 10-Year Treasury Note, a commonly followed bond market benchmark. It is clear to see that

the 10-year yield peaked in 1981 at 15.84% and has been trending down for almost thirty years to its current level under 4%. While not even the best economists have a very good track record predicting interest rate movements, there is no doubt that rates have been falling for a long time now, and eventually will bottom out and start rising over the longer term. Our bond strategy of concentrating on higher quality, shorter maturities is prudent in these unsettled times when the next major move for interest rates is likely to be up.



Cheap Money is Driving Up Asset Prices

by Jonathon Grace

When and where is the next bubble? When investors borrow money to buy assets, they push prices even higher. Unfortunately, this also makes markets vulnerable to sudden busts, as investors may have to sell assets to pay their debts. According to a recent article in The Economist, the credit crunch of 2007-08 was the result of investors' excessive borrowing to buy assets, resulting in greater debt levels and more violent price swings than at any time in the past 30 years. Critics point out that in recent years central banks have enabled excessive borrowing by keeping interest rates too low as they wrongly focus on consumer-price inflation rather than asset-price inflation. These same critics are worried that authorities may be repeating the same mistake in their eagerness to bring the credit crunch to an end.

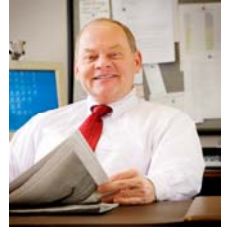
Low rates have certainly caused investors to move money out of cash. In 2009, billions were withdrawn from money market funds to invest in higher yielding securities. Equity markets rebounded strongly: the Brazilian, Chinese, and Indonesian stock exchanges more than doubled last year, resulting in a boost to economic sentiment and an end to the

downward spiral of 2008. Low-interest rates have been a critical supporting factor in emerging market expansion as well as the markets of America, Australia, and Britain.

Optimists consider the markets to be in a sweet spot these days due to a recovering global economy, with most developed countries working their way out of recession. Governments, concerned about the fragile recovery, will continue to keep interest rates artificially low. Will this policy approach create another set of bubbles? Strategists such as Jeremy Grantham of GMO, a fund-management group, disagree that bubbles can only be recognized after the fact. He theorizes that a surge in prices and valuations to levels way above previous trends is a harbinger of bubble creation.

According to some economists, the following chain of events describe the typical life-cycle of a bubble. Initially there

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Gold Consolidating as Market Looks for Direction

by Stebbins Hubbard



Many market commentators argue that investing in gold is a waste of time, especially since it does not pay interest or dividends and remains inert. This statement is very misleading. No one has ever invested in gold in order to receive interest. While gold is a precious metal as well as being a form

of global currency, it is also a commodity. The reason investors buy commodities is not for an annual dividend payment, but for a return on their investment that occurs as the price of the commodity appreciates.

It should also be noted that gold is unique as an asset class as its value is influenced by many factors. And, like other asset classes, the price does not go up in a straight line. When gold goes through periods of consolidation, certain analysts immediately denigrate it as an investment. There are going to be times when other forms of investments will out perform gold, but as the major trend in gold still remains firmly upward, we must not allow these short-term periods to cloud our long-term judgment.

Like central banks that hold a portion of their

reserves in gold, individual investors should consider doing the same and allocate a portion of their funds to this precious metal. In fact, all developed countries hold gold in their reserves while most of the developing countries also have holdings of the yellow metal.

According to the World Gold Council, *central banks added the most gold to their reserves since 1964* last year amid the longest rally in bullion prices in at least nine decades. Combined holdings rose 425 metric tons to 30,117 tons, an increase worth over \$13 billion at last year's average price. The expansion was the first since 1988. Central banks, holding about 18 percent of all gold ever mined, are expanding their holdings for the first time in a generation as investors in exchange-traded funds (ETF) amass bullion as an alternative to currencies. Holdings in the SPDR Gold Trust (GLD), the biggest ETF backed by the metal, are at 1,116 tons, more than the holdings of Switzerland.

While the primary uptrend for gold remains strongly intact, the current period of consolidation between \$1,140/oz. and \$1,100/oz. is frustrating investors. Even if gold dips below the \$1,000 level, it is important to be patient. This could be a great buying opportunity.

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Cheap Money is Driving Up Asset Prices (continued)

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is a shock to the financial system, often in the form of new technology such as the automobile and the internet. The shock provides a story that persuades investors to jump on the bandwagon, believing that asset prices can reach new heights.

This is followed by a rapid growth in credit, which inflates the bubble. Buying is now based on rising prices while asset fundamentals are ignored. Investors borrow to buy more assets, driving prices and valuations further up. Prices will continue to rise until there are fewer and fewer new buyers to fuel the bubble, similar to a Ponzi scheme gone awry. The surging prices lend credence to the increasingly higher prices until the bubble finally peaks and subsequently collapses. The collapse of a bubble brings about a slump in prices as investors unload assets, often at fire-sale prices, to cover debt.

Cheap money is often a forerunner to another round of bubbles. However, there has been no sign of the private-sector credit growth that signals bubble activity. However, current indicators reflect that current valuations are pretty high by historical standards, even though they have not reached the extreme levels of the 2000 peak. One estimate is that current valuations are nearly 50% above their long-term averages.

When assessing the future, emerging markets are believable candidates for bubble status. But, emerging markets have distinct advantages over the financial markets of developed

nations. These advantages include higher potential rates of economic growth and stronger fiscal positions than their Western counterparts. Emerging economies are the creditors financing the American budget deficit. Housing just experienced a burst bubble and is not likely to repeat anytime soon. Looking elsewhere, gold is another area where a bubble could develop. Since gold is used as a hedge when investors worry about inflation or financial chaos, it hardly seems likely to be a source of investor euphoria. However, gold has seen speculative price levels in the past, most notably in 1980 when its price reached a notable new peak, before beginning a 20-year decline that eroded two-thirds of its value.

It is feasible that if developed countries keep interest rates low for a long time that bubbles will emerge somewhere. Central bankers tend to see higher asset prices as a validation of their policies (see earlier discussion of bubble chain of events), leading to a reluctance on their part to second-guess the markets. Ben Bernanke, the Fed's chairman, recently argued that better regulation, rather than tight monetary policies, would have pricked the American housing bubble in the past decade. Plans for preventing future bubbles are most likely dependent on controlling the banks, rather than setting a general level of interest-rates. Current low interest rates leave little wiggle room to respond to a market relapse.