

### **Economic Conditions & Market Outlook**

*'A Bear Market Lurks as Dow Nears 10,000'* was the ominous headline from a Wall Street Journal article in late September 2009 after the Dow Jones Industrial Average climbed back from its low earlier in the year. Many analysts were convinced that a major downturn in the equities markets was both inevitable and imminent on the heels of the impressive rally that had raised stocks from their March 2009 bottom when the DJIA hit a low of 6,547. Nor did most analysts project this anticipated decline in stocks to merely be a quick correction; rather that economic uncertainty and market pressures would soon force the bulls into full retreat and allow the bears to regain the upper hand in determining the market's direction, i.e. downward.

We were not in that camp then and are not now. Despite spring weather long since thawing winter's chill, it appears that this is one bear that has no intention of clawing its way out of hibernation anytime soon. Ongoing economic indicators and the latest round of corporate earnings results provide positive signs of a sustainable recovery and continuing market improvement. While there certainly will be stumbles along the way, there are more factors than not pointing to the continuation of this upward trend in the near term.

One of these is the utter lack of excitement accompanying the market's current climb. Other than a steep but temporary sell-off in February, daily price volatility has been rather muted and appreciation has been mostly paced. While this 'grind-it-out' market movement may seem rather boring and uneventful, the bottom line is that more and more stocks continue to reach new 52 week highs. Additionally, this gradual progress upward tends to create price appreciation with more staying power since the market has the opportunity to digest the impact of one price move as it evaluates where valuations may go next. While some adrenaline-addled traders may miss the gut-wrenching 'thrill' of daily 300 point lurches in the Dow, most serious investors do not.

Other than February's hiccup, investor sentiment and market momentum has remained remarkably consistent since the beginning of the year. The result being that the DJIA reached a 19-month high on Friday, April 23<sup>rd</sup>, while posting a 7.44% year-to-date gain for 2010. The S&P 500 followed suit with a positive move of 9.16% and the Nasdaq was up 11.50%, with mid/small cap sectors seeing even more robust returns for the period. The last trading day of the month ended on a down note but April's net result was still positive for the markets.

While these numbers are pretty impressive, they are indeed past tense and provide little insight as to what may happen in the markets moving forward. More prescient of near term market leanings is that investors have remained relatively nonplused by recent events that easily could have roiled the markets. Both unresolved sovereign debt issues in Europe, ignominiously led by Greece but with the other little PIIGS (Portugal, Italy, Ireland, Greece, and Spain) not too far behind, and the Securities and Exchange Commission's high-profile fraud accusations leveled at Goldman Sachs had the potential to send investors running for cover.

On Friday, federal prosecutors upped the ante by launching a criminal probe of Goldman's mortgage trading activities and the markets finally did flinch. Whether this signaled a sea change in overall investor attitude or was merely caution combined with profit taking is yet to be determined. At present, we suspect it's the latter.

The current consistency of investor sentiment and market momentum is not being driven by euphoric optimism. It is instead being buoyed by improving fundamentals on several fronts. First, the latest round of corporate earnings reports continue to show improved bottom-line performance that often exceeds previously projected results. As of April 23<sup>rd</sup>, 172 of the S&P 500 companies had reported earnings for the first quarter and 83% beat Wall Street's consensus per share estimate. The amount of upside earnings surprise was also rather surprising, with the companies that exceeded expectations doing so by an average of 21%. These averages may fall slightly as the remaining companies report their quarterly numbers in the weeks ahead but the overall results are clearly stronger than had been expected by most.

This trend of improving corporate profits started in late 2009 but at that time was fueled by bare bones budgeting, lowered overhead, and spending austerity. However, expense cuts can only go so far and what makes this round of earnings results notably different is that it is enhanced top-line performance in the form of better revenues and increased sales that is propelling the profitability improvement. The fact that upward earnings growth is occurring throughout a broad base of industry and market sectors is indicative that this healthy trend should be sustainable into the months ahead.

Another factor pointing to the sustainability of the market's progress is that the economy continues to improve as well. U.S. gross domestic product (GDP) rose at a 3.2% annual rate for the first quarter of 2010 based on the Commerce Department's estimate for the period and we would not be surprised to see this result ratcheted upward in subsequent revisions. While this initial aggregate number was slightly less than expected (3.3%), the data was viewed as quite positive due to the surprising strength of the consumer spending component in the GDP result. The consensus view of economists in April's Wall Street Journal Economic Forecasting Survey is that this level of quarterly GDP growth can be expected throughout the remainder of 2010 as well.

Consumer spending comprises almost 70% of total GDP and that category's measure of 3.6% during first quarter 2010 was significantly higher than the 1.6% result pegged in fourth quarter of 2009. Total housing sales continue to look lackluster but more consumers than expected demonstrated confidence that their personal financial sky was not falling by gradually opening their pocketbooks for large ticket purchases, as well as brand-name and luxury items. While we do not expect, nor want, consumer spending to be the primary driver of the recovery's forward momentum this time, a revived consumer is critical to lasting sustainability.

Net employment measures will continue to remain suppressed, but U.S. employers did add jobs during the month of March at the fastest pace in three years. As we have noted continuously, reported unemployment is a lagging indicator of an economic recovery and will be one of the last to turn positive as the economy improves.

Business spending also rose 4.1% for the first three months of 2010, as companies restocked depleted inventories to meet cautiously revived consumer demands and reposition their organizations for better times ahead. While logging a smaller percentage increase than the prior quarter, corporate spending on business equipment and software still rose at a noteworthy 13.4% rate for the period. Despite periodic political posturing suggesting a dearth of lending to needy businesses, credit worthy companies have had access to relatively inexpensive capital and many large corporations are flush with cash; both bode well for continued business spending to fuel ongoing growth.

Inflation also remained muted for the period, with the oft-referenced core inflation rate rising a mere 0.6% in the first quarter. This particular metric excludes the impact of food and energy prices and is less indicative of inflation's true impact on the consumer than the 'price index for personal consumption expenditures' or 'gross domestic purchase prices'; indexes that rose by 1.5% and 1.7% respectively. Regardless of the measure, all indications are that inflation will remain relatively benign near term, allowing the Federal Reserve to be patient in eventually reigning in its currently accommodative stance via raising interest rates. To date, Mr. Bernanke and the Fed have been effective in nurturing a nascent recovery while remaining ready to apply the stimulus brakes. However, the Fed chair has already cautioned Congress that it must dutifully exercise the political will needed to stop stimulative spending when required; an admonition that is unfortunately unlikely to be heeded.

This lack of discipline in government spending is a major concern for the economy in the years ahead. Federal debt has continued to balloon; standing at nearly \$12,750,000,000,000 as of the end of March and growing by approximately \$4,000,000,000 *per day*. It is difficult to put such large numbers into perspective but one way of doing so is observing that given current population, every U.S. citizen's individual share of that obligation equates to about \$42,000. That's right, the amount *per person* needed to simply pay off current federal debt. A sobering statistic which higher taxes alone will obviously not resolve.

Despite this, government at all levels seems unwilling or unable to address the critical spending issues that propel this problem forward. The benefits and drawbacks of federal health care reform are matters for healthy political debate; suggesting that the endeavor as structured will somehow cut government spending is absurd. Meanwhile, the 800 pound entitlement spending gorillas of Social Security and Medicare remain unaddressed.

Unbridled and unaccountable government spending is not the exclusive domain of any one particular party. Too many elected officials of all political affiliations have viewed the public coffers as an endless supply of resources to be tapped without regard to the long-term consequences and future obligations passed on to taxpayers. Significant state and municipal spending control is often kicked down the road while new revenue generating endeavors typically over-promise and under-deliver. Ultimately, the mindset and expectations that created this gross imbalance will need to be seriously addressed by voters and elected officials alike. We need only look to some of our neighbors in Europe to see the consequences of unchecked governmental spending.

Despite the importance of confronting this issue, current economic circumstances and market conditions continue to improve and appear rather favorable near-term. Growth in the economy and investment markets has been paced and sustainable thus far. Sentiment has improved and should continue to do so. Taxes will increase and interest rates will eventually rise but that does not necessarily imply oppressive inflation will follow. Given where things were in the not-too-distant past, it is appropriate to be cautiously optimistic.

### **Our Tactical Investment Stance**

Roof Advisory Group's disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return. Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance.

While every client situation is unique, outlined below are a few of the tactics being used in the current market:

- The ***overall target level*** for portfolio allocations today is at or near ***maximum equity*** based on each client's individual investment policy range. This target level was previously moved to ***one step below maximum equity*** in September 2009. A ***temporary tactical*** move very ***briefly reduced equity exposure in February*** but a ***return to strategic target levels*** occurred shortly thereafter. At present, we see the ***relative risk/return*** potential in the ***equities asset class*** as being ***more attractive*** than either bonds or cash. The firm's ***active asset allocation*** strategy and ***disciplined portfolio rebalancing*** methodologies continue to ***add significant value***.

- Despite allocation levels remaining at or near the top end of the policy range, ***portfolio composition*** has been ***consistently modified*** throughout the period to ***capture opportunity and reduce risk***. ***Ongoing appreciation continued*** in several individual issues and/or funds held to where, even after ***profits being taken***, it was deemed advantageous to ***selectively increase exposure*** in that security. Similarly, securities with ***limited further appreciation*** or with ***diminished risk/return*** characteristics were ***actively pared*** via the firm's ongoing active sell discipline.

***Diversification is always a priority*** but ***unique opportunities*** in asset classes and sector weightings will continue to be utilized to ***capture near term market appreciation***. Portfolio exposure in ***mid-cap equities*** was ***significantly expanded*** throughout the first quarter to benefit from the ***notable growth*** in that asset class during the period. Conversely, ***foreign equity exposure was pared*** and remains so today in light of the ***uncertainty*** surrounding several overseas economies.

- ***Short-term fixed income*** investment levels remain ***significantly below the norm*** due to low yields. ***Cash positions*** have been ***shifted*** into fixed income alternatives that provide ***slightly better returns*** but still allow the liquidity needed to ***recapture rising interest rates*** when that change begins. Although the availability of ***quality individual bonds*** meeting our selection criteria remains ***more limited*** than the norm, our diligent ***fixed income management process*** has allowed us to purchase sufficiently attractive bonds ***without sacrificing quality***. The ***average duration*** of our bond portfolios ***remains relatively short*** because of the inevitable increase in interest rates in the relatively near term but opportunities to ***capture yield in slightly longer maturities*** are also utilized to ***enhance overall fixed income returns***.

**E. Jeffrey Roof**