Investment Watch

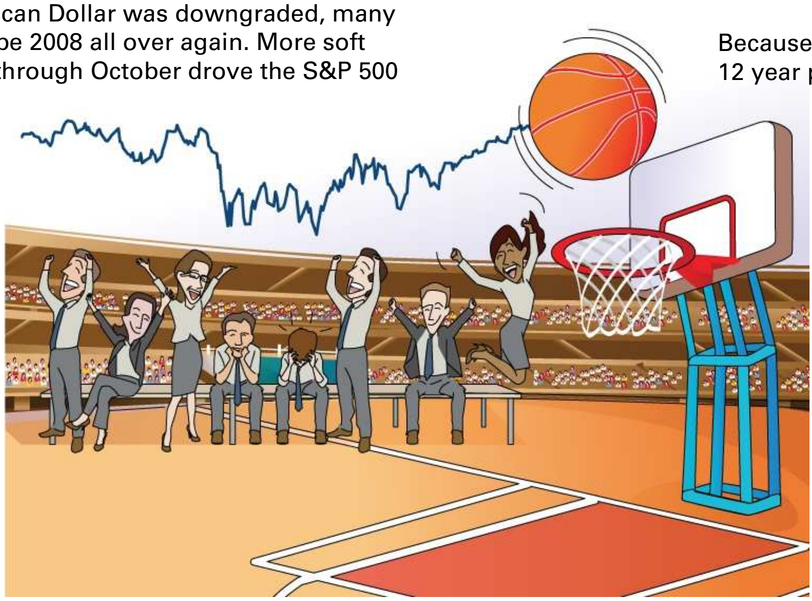
1st Quarter, 2012

Market Madness?

Just like those Cinderella underdogs surprised the favored elite in the early rounds of the NCAA tournament this year, so too did the stock market shock the pundits beginning the new year on what feels like a championship run. The stock market as measured by the S&P 500 index was up over 12% in the 1st quarter, the biggest first-quarter gain in well over a decade. Is this **Market Madness** being fueled by the faith that our economy has finally found its footing? Or will the global softness derail our run to the Final Four?

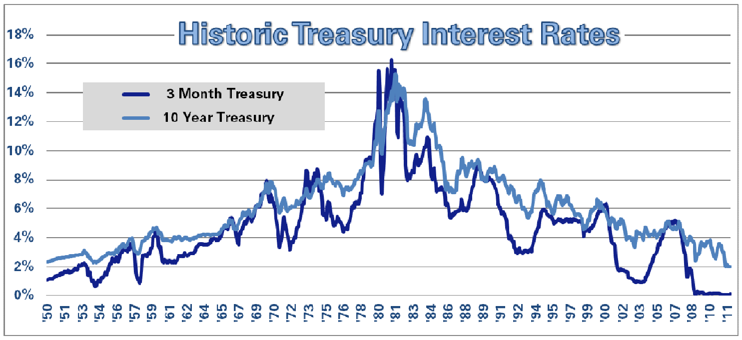
It was just over four years ago when our banking system almost collapsed and the stock market hit bottom along with our economy and our confidence. Now with this latest surge, the stock market has recovered almost all of those losses, but our economic recovery has been sluggish and unsteady. The emotional rollercoaster driven by erratic and conflicting economic news has kept us on the edge of our seats, like those basketball fans in the ebb and flow of those highly contested NCAA games.

With our spirits down and our heads in our hands last August when the American Dollar was downgraded, many felt like it was going to be 2008 all over again. More soft global economic news through October drove the S&P 500 index down to the brink of a bear market—were we going to be knocked out in the first round? Since then, we've gone on a tear with more good news than bad driving the current market rally. The Consumer Confidence Board says most Americans remain upbeat about the economy and consumer confidence and spending can add needed fuel to our nascent recovery. Now maybe the momentum has shifted and we can mount a comeback to finally get our economy back on track.



America had always been the economic top seed and the one to lead the world out of recession. After the Great Recession, the American engine stalled and it was the emerging economies with the muscle that stimulated global growth. However with the recent softness in China, the sovereign debt crisis in the European Union and the unrest in the Middle East, the US is again assuming its role as global economic leader. Unemployment, fiscal deficits and political paralysis, not only here at home but throughout the developed world, are formidable headwinds which could hold down global growth and derail our rally to the finals.

Our Federal Reserve, along with central bankers around the world, have made use of various easy money polices to



Source: US Treasury

stimulate growth. These central bankers are the referees and their near-zero interest rate polices have been letting us play. "Operation Twist" the newly coined and latest unprecedented monetary tactic employed by the Federal Reserve has depressed interest and lending rates to historic lows. Interest rates peaked in the early '80s, but since then a steady decline in rates has caused bond prices to rise resulting in a 30 year bull market in bonds - the longest run in history!

Because stocks have had such a dismal 12 year period and bond holders have received a premium due to the interest rate decline since the '80's, some fair weather fans of stocks are changing teams and touting the dominance of bonds over stocks. Yes, bonds have had a long winning streak, but now short term rates are effectively zero and the 10-year Treasury rate is around 2%. Most experts believe that they can't go much lower. For sure they can't go below zero and remember the inverse relationship of interest rates and bond prices means that if interest rates go up, bond prices will go down. All good runs must end.

The stock market rally might be **Market Madness** and the yields on bonds may be less than desirable, but as this last quarter has shown us, you must play the game to win. We can improve our odds by balancing our retirement portfolios just as a basketball team needs balance to succeed. This recovery has been a season full of ups and downs and we still have a long road ahead to make it in the *Big Dance*.

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