

Prepared Comments from 4/15/2010 Conference Call

My last conference call was on January 15th. US stocks have since risen 6.7%—much of that gain is from the past six weeks. The 1st quarter brought another rising stock market. Unemployment is no longer rising, and jobs are being created. Revenues at companies have been rising, and profits are starting to look healthy again. **Investors have been losing their fear of the ‘double dip recession.’**

The US economy is recovering, and leading indicators show that it should continue, albeit at a slower rate. The Fed continues to maintain overnight interest rates at near-zero levels, and has indicated that they plan to continue this for a few more months, to help assure that the economy is better able to recover.

Where is the consumer? The Consumer Confidence ‘expectations index’ rose 12% in March. After peaking at about 4% last year, the personal savings rate so far is running at 3.2%, higher than 2005, 06, 07, or 08. This is a mixed blessing, however I consider it a net positive.

Late last week I prepared the quarterly Market Review and Outlook, which is posted on our website www.mallardadvisors.com, under **Client Resources** and then under **Newsletters and Articles**.

The Economy

Economic Highlights

- Majority (60%) of stimulus remains unspent, and is being spent NOW—this is a BIG positive impact to economy in coming quarters
- Fed is expected by many to hold Fed rates at current low for several more months
- GDP growth is improving, leading indicators are improving (11 straight months, per the Conference Board), and earnings growth is improving (expected to rise 50% for the S&P 500 in the next year)
- Inflation pressures are low due to excess capacity (low demand) and high unemployment (which should last several years), +1.1% in past year (ex-food, energy, or +2.3% all-in), per www.bls.gov

- Housing affordability has crested, but remains 53% more affordable than three years ago (www.realtor.org), due to combination, price decline and low mortgage rates
- **Banks are beginning to loosen up—commercial/industrial loans are getting easier to obtain, and consumer loan standards are no longer rising**

Economic Dangers

- Residential mortgage delinquencies remain at 10%, and foreclosures, after slowing last year, are ramping up, on pace for 1 million bank repossessions this year
- Many states are in the red (California at the top of the dollar-ordered list, Nevada & Arizona in percentage terms)
- Future economic growth is expected to be restrained, due to high unemployment, and a much more careful consumer (rising tax rates), and less accommodating lending environment (PIMCO's New Normal)
- Still no evidence of fiscal responsibility at the federal level (bipartisan commission, ala BRAC may be necessary)
- Commodity prices have moved sideways for six months, as low demand from developed nations is balanced by growing demand from emerging economies.
- Absence of fiscal stimulus will burden GDP growth in 2011

Bonds and Stocks

INVESTMENTS

Flow of funds

- Three times as much money added to bond funds as stock funds in first two months of 2010
- Money markets continue to see steady outflows
- Stock market recovery thus far is NOT driven by stock mutual fund flows

Bonds

- Government—supply expected to steadily increase, demand likely to fall as investors seek higher yielding alternatives, also potential reversal of ‘rush to safety’ once Greece situation is resolved—AVOID (both TIPS and normal government bonds)
- Mortgage backed bonds (FNMA, GNMA)—imminent sales by Fed will hurt returns—REDUCE
- Corporate—better than government (higher yielding, smaller risk of loss right now, strong and strengthening balance sheets), avoid long-term, keep short and short-intermediate
- Muni bonds—fiscal stability is could be stabilizing and supply could be stable as Build American Bonds redirects supply (both neutral), income tax rates are rising (positive)
- High Yield bonds, up 26% in past year, keep these, but not at ‘opportunistic levels’
- Floating Rate bonds (via ‘bank loan’ funds), require strengthening economy and good corporate balance sheets (check), largely eliminate risk from rising rates
- Global—good for some, for diversification, short-term bounce (due to Greece), expect ongoing dollar weakness

Stocks

- P/E level analysis is highly dependent on whether trailing or leading, and earnings after a recession jump, compared with trough levels
- Up, but not that far—while up 42% in the past year, the S&P 500 is still 23% below its October 2007 peak
- Cash on Sidelines—equals 31% of US stock market capitalization, well down from near 60% peak in early 2009, but above prior peak, from early 2003
- Sectors—
 - Technology—keep at ‘normal’ levels, likely to benefit from corporate strength
 - Real Estate—challenges remain, keep a modest position (2-3%?)
 - Health Care—likely good to build up—health care bill likely solidifies future demand, while stocks remain depressed
- Valuations—they seem reasonable, more positives than negatives, good growth expected for two years in US, stronger growth in Asia, most emerging markets, more modest growth in Europe

- Names—top three stocks, all currently held by clients—pharmaceutical Abbott Labs (ABT), using cash for purchase of Belgium company, 3.3% yield, tech firm Hewlett Packard (computers, printers, service (EDS)), earnings growth in mid/high teens, retailer Walmart (WMT), likely to continue to thrive in environment of cautious consumers. Three different industries (US based but all operating globally).

Closing Thoughts

The positives continue to outweigh the negatives. This is good. When no negatives can be seen, be very worried (you are missing something). US companies are lean and mean, and are able to grow to meet demand.

Cash at US companies is quite positive. They can purchase other companies, they can boost their dividends, they can buy back their stock, they can hire more employees, they can purchase additional goods/services/plant/equipment. There is a chicken:egg challenge here. Hopefully, the government's stimulus will get enough consumers to spend enough to drive companies to spend enough (and so on) so no one misses the government's stimulus when it stops.

Inflation is not a concern for a few years (except perhaps for commodities in high demand in emerging economies), and while interest rates are very low, they should move up over time for most types of bonds.

Stocks appear very reasonable at this time. I especially like foreign stocks (for the moment). Rebuild your US stocks close to your long-term target levels, and considering bringing foreign stocks above long-term targets. Exercise caution for your bonds, avoiding treasuries and long-term bonds. If you have been enjoying gains in high yield bonds, consider cutting them back, and consider adding bank loan/floating rate bonds.

We appear to be in the second or third inning of the recovery. Don't go home yet.