# Market Watch
# 1st Quarter 2010



## Summary

- 2010's first quarter continued 2009's momentum. Asset classes rose across the board.
- The S&P 500 was up 5.7% for the quarter and that index ended the quarter up 76.8% from its March 2009 lows.
- Unemployment continues to improve, as temporary hiring paves the way. The unemployment rate now stands at 9.7%.
- Inflation, which was low and steady last year, continued that trend in the first quarter inching up only 0.55%
- Bonds generally performed well. High-yield bonds were the best performing class of bonds returning 4.6%. Inflation-protected bonds were generally the weakest bond performer
- International equities performed comparably to domestic equities, but due to the strengthening dollar returned just 0.9%.
- Overall, alternatives were flat but positive.

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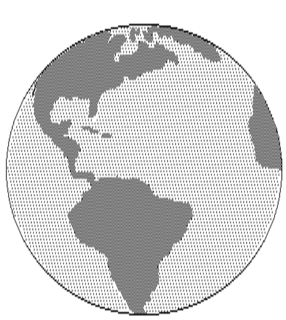


The first quarter continued the financial market's momentum from 2009 as the S&P 500 finished up 5.7% for the quarter. The Dow Jones Industrial Average and NASDAQ also rose during the quarter, gaining 5.3% and 5.6%, respectively. Since the market low on March 9th 2009, the S&P 500 has now gained 76.8%. For the quarter, domestic markets slightly outperformed their foreign counterparts and stocks of small companies outperformed those of larger ones.

Continued economic healing has fueled optimism in the financial markets and is the primary reason for improved asset prices. There were some bumps in the road, such as Greece's budgetary problems and the uncertainty involving health care reform's passage, but general optimism seems to have replaced the pessimism that was so pervasive a year ago.

Nearly all economic metrics show the economy getting stronger. While still unofficial, most economists are now in agreement that the "Great Recession" is behind us. We have also seen confirmation of economic improvement in a more official capacity; the Treasury has begun to withdraw its support from certain segments of the economy.

*Source: Standard & Poor's*


The market is now only 20.9% below its October 2007 high.

### An Overview of the Economy

*Unemployment*

Employment growth has been slow during this recovery, earning the label of "jobless recovery." The unemployment rate has ticked down to 9.7% from its high of 10.1% in October of 2009.

In March, the economy added 162,000 jobs. However, much of new hiring has been in temporary jobs, including February's hiring of 48,000 Census jobs. Since September of 2009, the economy has added just 343,000 jobs (we need something north of 100,000 new jobs a month just to keep up with population growth).

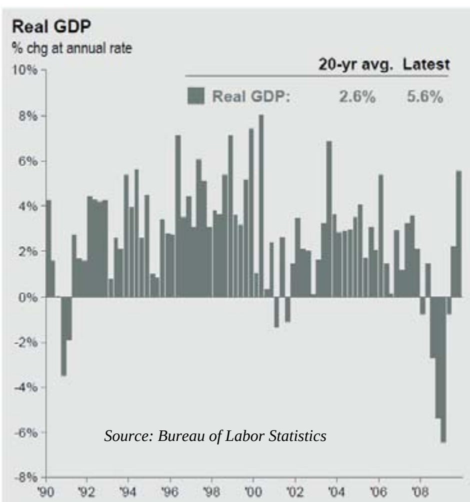
Headline numbers get most of the public attention but some other numbers may be more important and relevant. The broadest measure of unemployment is U-6 (which tracks the unemployed as well as those forced into part time work and those no longer looking for work because they are too discouraged by their failure to find a job). The U-6 unemployment rate finished the quarter at 16.9%. While this was below

October's rate of 17.4%, it has risen 0.4% since January. The average duration of unemployed has steadily increased with time. In March of 2009, the median duration was 13.1 weeks. At the end of March of 2010, it had increased to 21.6 weeks. The longer workers remain unemployed the more difficult it becomes to find new employment.

An interesting side effect of this recession has been increased productivity. The Bureau of Labor Statistics reported that productivity (i.e., economic output divided by hours worked) rose at 6.2% last year as companies were forced to try to maintain production with fewer employees.

*The Overall Economy*

Economic growth, as measured by the Gross Domestic Product, declined by 2.4% in 2009, even including the fourth quarter's growth of 5.6% (annualized). The strong fourth quarter growth was primarily driven by businesses adding to their inventories and by renewed consumer spending.




Consumer confidence is still weak, but it appears to have stabilized and is substantially better than a year earlier.

Foreign economies helped the US in the prior quarter as US exports increased by 22.8%. Imports also increased leaving the US with a trade deficit of $378.6 billion for 2009. This is a dramatic improvement from 2008, when our trade deficit reached $695.9 billion. While improved, the size of the US trade deficit is still reason for concern. The United States can run a trade deficit for a long period of time by selling assets or borrowing money but eventually the US must reconcile its imbalance. While a weaker dollar would likely improve our trade balances, oil would then become more expensive creating additional economic pressures (a weaker dollar would, however, make non-U.S. investments in your portfolio relatively more attractive.)

Over the last decade the Chinese have become an increasingly important trade partner with the US. They have enabled the US to run its trade deficit up -- China sells the US goods and in exchange purchases US treasuries. However of late, the Chinese have been pressured by the US Congress and Treasury Department for their alleged currency manipulation. If the Renminbi were allowed to appreciate, it would almost certainly help the US improve its trade balance.

Corporate profits have begun to return to more normal levels, increasing by $108.7 billion in the fourth quarter from the prior quarter. Larger profits will result in growing tax payments, helping our budget deficits and encouraging more hiring, which would also help boost tax receipts.

*Real Estate*

Housing prices have slowly begun to rebound. Investors and home buyers are finding attractive opportunities resulting from low prices, government-offered tax incentives to home buyers, and from continuing low mortgage rates. According to the Case-Shiller Housing Index, national housing prices are now where they were in 2003.

To provide further help to the housing market, the Treasury has been purchasing mortgage back securities (MBS), which lowers the relevant interest rates. However, the Treasury began to phase out this program at the end of the first quarter and as a result, mortgage rates have recently risen to 9 month highs (though still near historical lows).

Commercial real estate is more closely tied to the economy than is residential real estate. As the economy has slowed, more business have folded, leaving properties vacant. This depresses commercial property values. Additionally, commercial property owners still have difficulty getting loans to either acquire new properties or refinance existing loans. This is preventing traction in the commercial real estate market. The National Council of Real Estate Investment Fiduciaries (NCREIF), which tracks the investment performance of large pools of individual commercial real estate properties acquired in the private market, has experienced six consecutive negative quarters. The NCREIF Western Region was down 19.1% in 2009.

Despite the commercial real estate troubles, publicly traded real estate investment trusts (REITs) were one of the best performing sectors in 2009. REITs maintained their momentum in the first quarter returning 5.78%. While REITs fell 40.9% in 2008 (as measured by the Cohen and Steers Realty Majors Index), the NCREIF was down just 6.85%. The public markets are forward-looking while private owners (the NCREIF) can refuse to sell in hopes that prices will eventually rebound. Taking the bigger hit as soon as the problems were recognized in 2008 put REITs in a position to rise in anticipation of eventual recovery while private owners may have simply delayed having to confront the problem.

*Inflation and the Dollar*

Inflation has been consistently low since the beginning of 2009. After oil prices fell in mid 2008, commodity prices have remained relatively stable and the weak job market has prevented many employees from seeking raises. Commodity price and wage increases are traditionally thought of as the two main drivers of inflation. Inflation was unchanged from January to February (at this writing, March numbers are not available).

Commodity prices have been held in check by the strengthening dollar. Commodity prices are set globally for the most part, so the strength of the dollar affects the price. For example, the price of oil, always denominated in dollars, quickly appreciated when the dollar weakened against most currencies last year.

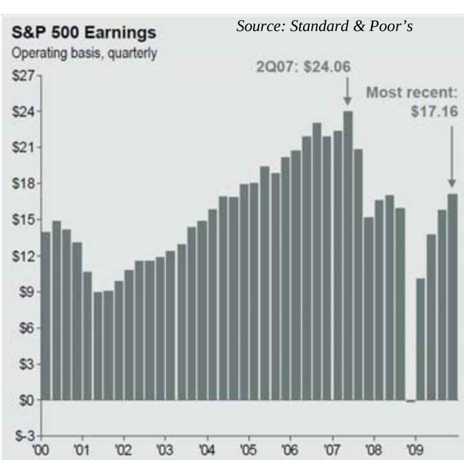
Emerging market currencies continued to appreciate as their economies continued to display strong growth. Emerging markets are increasingly growing in importance to the global economy.

*Bankrupt countries*

The last few months have seen real threats to the fiscal integrity of several countries—among them Greece, Dubai, and Ireland. Greece's fiscal problems and questions regarding who would bailout Greece put pressure on the Euro, causing it to lose 6% against the dollar.

Dubai, which finally received a $9.5 billion bailout from Abu Dhabi to restructure its debt, is another reminder that nations have been stretched to continue their levels of services while tax receipts shrink. These bailouts should be a reminder to many of the world's most developed countries that fiscal conservatism remains a tenant of monetary strength.

Unlike Greece and Dubai, Ireland took the course of solving its fiscal problems internally, cutting programs and services, improving its ability to service its debt. Might this be a model for the US?




**Investments – Domestic Equities**

Value stocks gained more than growth stocks during the quarter and small company stocks outperformed large company stocks. Historically, over longer periods value has outperformed growth while experiencing similar volatility. Value stocks tend to include the "cheap" companies, while growth stocks generally include companies with high earnings growth rates.

Among the best performing sectors in the first quarter were financial company stocks, which enjoyed returns of 11.1%. Financial stocks have now risen 160.5% from their March lows. Telecom company stocks were the worst performing sector during the first quarter, losing 4.3%.

According to JP Morgan statistics, shown in the table below, value stocks of all sizes now appear to be fairly priced (comparing their current average Price/Earnings ratio—using current stock price and earnings over the prior twelve months—to the respective 20-year average ratio) while growth stocks may be under valued, especially among larger company stocks.

That said, there are a number of ways to estimate the fair

**Current P/E as % of 20-year average P/E**

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 99.6% | 89.9% | 77.4% |
| Mid | 105.8% | 100.1% | 84.6% |
| Small | 102.7% | 100.2% | 95.6% |

value of stocks, and the relationship of current price to the prior period's earnings is only one way to do it. Markets are forward looking and therefore many prefer to use analysts' forecasts of future earnings. Making the questionable assumption that such forecasts are reasonably accurate, the S&P 500 is now priced at 14.1 time forecasted earnings. This would imply significant room for appreciation, especially if earnings continue to improve. Price to book, another valuation tool, also deems stocks to be historically cheap.

**Investments – International Equities**

The MSCI EAFE Index represents stocks domiciled in developed non-US countries. The returns of the underlying stocks (in local currency) was 4.4%; however, due to the strengthening of the dollar the index returned only 0.9% to US investors. Within international indexes growth stocks outperformed value and small outperformed large. Growth outperformed Value by 2.66% as the MSCI EAFE Growth Index returned 2.49% during the quarter. The MSCI EAFE Small Cap Index returned 4.8% in the first quarter.

Emerging markets, after a strong 2009 (+79.0%), grew 2.5% during the first quarter. Changes in relative currency


valuations helped US investors. Developing nation economies have been growing rapidly, for example the latest economic numbers (4th quarter) show the GDP of China, Brazil, Mexico and Russia grew 10.2%, 8.4%, 8.4%, and 8.1%, respectively.

**Investments – Fixed Income**

To finance our debt, the US government has had to issue an enormous amount of bonds. Typically, the cost of these loans to the government—the interest rate—rises as the term of the bond increases. The steepness of this "yield curve" has gone from relatively flat a year ago (short term and long term rates were about the same) to much steeper recently. The rate for a 3 month treasury bill is now 0.16% whereas the 10 year yield is 3.89%. At the beginning of 2009, the 3 month treasury yield was 0.27% compared to a 10 year yield of 2.25%. Higher rates reflect greater uncertainty and risk. This steeper yield curve is likely to make it increasingly expensive to service US government debt

The bond market, as measured by the Barclays Aggregate Bond Index, returned 1.8% over the quarter. Other solid sectors included high yield (4.6%) and corporate bonds (2.3%). The worst performing bond asset class was Treasury Inflation Protected Securities (TIPS), which returned 0.6%, because inflation remains low.

**Investments – Alternative investments**

After a spectacular 2009, commodity returns slowed in the first quarter. The DJ-UBS Commodity Index lost 5.1%. Inflation has stayed low and the weakness of the economy has lowered demand, leading to commodity price declines.

In most portfolios we hold an exposure to timber through Plum Creek Timber. Plum Creek returned 4.2% in the first quarter, outpacing broader commodity returns.

We recently added the Alerian Master Limited Partnerships ETN to many client accounts. Its return is tied to an index of companies that are structured as Master Limited Partnerships. These partnerships are regulated similar to utilities and distribute a significant portion of their income to shareholders without being taxed at the corporate level. As a result, income investors often like them. Alerian closed the quarter up 6.82%.

PowerShares DB G10 Currency Harvest and PIMCo Developing Local Markets each had relatively flat returns in the first quarter, 0.3% and 2.7%, respectively. These securities tend to do well when the dollar weakens, so they had spectacular returns of greater than 20% last year.

Emerging market bonds (held as part of our alternatives) continued their strong run from 2009, returning 4.6% in the quarter.

The Merger Fund finished the quarter up 1.7%.

The Managed Futures Fund lost 3.7%.

The PowerShares S&P 500 BuyWrite fund, which writes covered calls, finished up 0.8%.

**Summary**

The first quarter of 2010 was a moderate continuation of 2009's impressive recovery. Economic metrics suggest the financial environment is healing. The resulting growth in confidence has helped boost investment values.

| 1Q10 | 10-yrs '00 - '09 |
|---|---|
| Real Estate 10.0% | Real Estate 174.5% |
| Russell 2000 8.9% | MSCI EME 162.0% |
| S&P 500 5.4% | Barclays Agg 84.8% |
| MSCI EME 2.5% | DJ UBS Cmdty 50.9% |
| Barclays Agg 1.8% | Russell 2000 41.3% |
| MSCI EAFE 0.9% | MSCI EAFE 17.0% |
| DJ UBS Cmdty -5.1% | S&P 500 -9.1% |

After extensive discussion and research, we at Mosaic came to the conclusion that increasing exposure to alternative investments generally helps reduce portfolio volatility. By now, you should have seen our recommendations for your portfolio; if you haven't yet heard from us on this issue, we'll want to discuss this with you in our next meeting.

Based on historical experience, our hope is that the alternatives will act as additional diversifiers, helping buoy the portfolio when times are more uncertain and less traditional sources of returns are needed. Lessening downturns in your portfolio will help you sleep better at night and will actually increase the probability of you reaching your long term goals. As Warren Buffett says, "You only find out who is swimming naked when the tide goes out." We want to help you keep your suit on.

Your Mosaic Team

Sources: Morningstar, JP Morgan, Deutsche Bank, Bureau of Labor Statistics, Ibbotson, The Federal Reserve, Reuters, Forbes, Bloomberg, Standard & Poor's