

INVESTMENT PARTNERS, LTD

March 2010 Market Recap

Submitted by Investment Partners, LTD

A Strong Quarter to Start the Year

Even though the market was down on the last day of March, the first quarter ended without much fanfare and markets showed resiliency. Equity markets pushed higher over the quarter, with the Dow Jones Industrial Average (the Dow) returning 4.82 percent and the S&P 500 Index (S&P 500) returning 5.39 percent.

It was the strongest first quarter for the Dow since 1999 and the strongest for the S&P 500 since 1998. Leading the way were industrials, up 12.98 percent, and financials, up 11.50 percent, as both sectors were buoyed by an improving economy and better than expected earnings. International markets were also higher, though they failed to keep up with U.S. markets, due in part to the strength in the U.S. dollar. The MSCI EAFE Index gained 0.87 percent for the quarter, while the more risky MSCI Emerging Markets Index advanced 2.11 percent.

Fixed income markets continued to show signs of strength, now almost fully recovered from the credit difficulties of the past two years. The broad market, as measured by the Barclays Capital Aggregate Bond Index, gained 1.78 percent. The Barclays Capital U.S. Corporate High Yield Index pushed 2.68 percent higher, as lower-quality credits continued to benefit from the improving economic environment. Investors in these more risky bonds still realized an attractive yield, but a significant portion of their upside had already been achieved off the historically depressed prices this time last year. The quarter was also favorable for tax-conscious investors, as municipal bonds gained 1.25 percent, according to the Barclays Capital Municipal Bond Index.

The health care bill becomes law: What about the price tag?

Stealing much of the spotlight for the quarter, however, were not the financial markets, but the historic passage of the \$940 billion Health Care Reform Act. The bill passed by a legislative technicality known as reconciliation, given that both houses lacked the votes to approve it by the normally required majorities. There has been much skepticism among politicians and individuals alike concerning the details, and final poll numbers show a country divided over acceptance of the new law.

(continued on next page)

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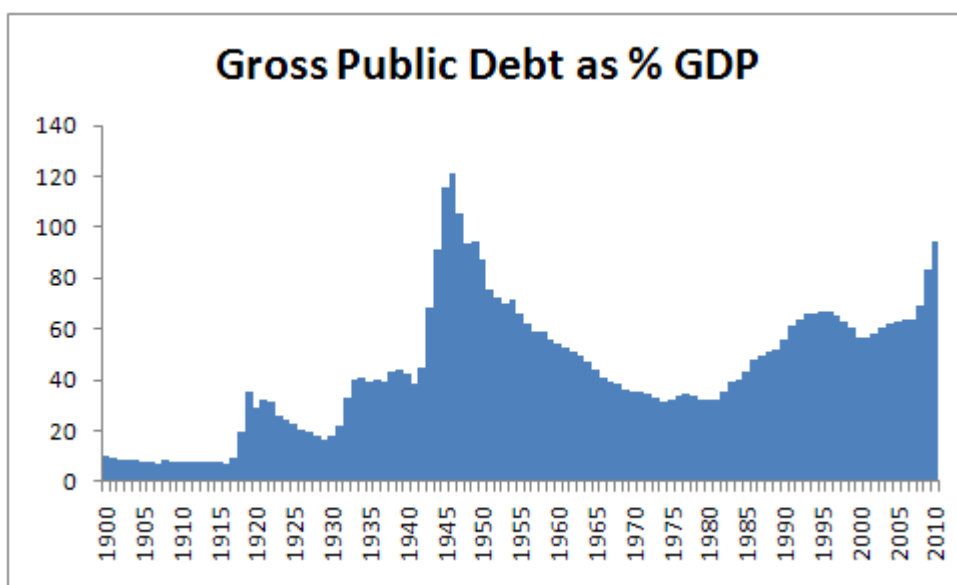
MARKET COMMENTARY (CONT.)

Markets are paying particular attention to the bill because of its massive price tag and the potential impact of the front-loaded spending on an already bloated deficit. After passage of the bill, the bond markets sold off and the yield on the 10-year Treasury increased by 25 basis points in two trading days. Some of this increase was also a result of a large supply of new issuance from the Treasury, but tepid market response to the issuance subsequently drove bond prices down. This is significant, as we believe it could begin to shape the interest rate outlook moving forward, given the massive amount of debt that the government must bring to market to satisfy budget needs.

The massive debt situation

The U.S. has now entered a phase of historical deficit spending, accruing some of the largest deficits on record. The fiscal 2010 budget deficit is projected at \$1.75 trillion dollars, which amounts to more than 10 percent of the total federal budget of \$14.6 trillion. This is a staggering number in and of itself, not to mention that it is piled on top of a national debt of \$12.6 trillion. Although the government is used to talking in trillions, many Americans, as shown in the polls, are worried that the excessive debt burden will hurt the economy moving forward.

In addition, similar to individuals who owe outstanding amounts on their home mortgages, the government needs to finance all of its deficit spending—and its financing needs are substantial. But the current low interest rates have been extremely beneficial to government efforts to refinance the outstanding debt and future deficit spending.



Source: United States government data

As we look at the yield curve or, more simply put, the various interest rates that correspond to the length of the borrowing period, we have historically seen huge advantages at the short end. For short-term, cash-like borrowing, interest rates are pegged by the Federal Reserve (the Fed) at 0.0 percent–0.25 percent, as denoted by the federal funds rate, which the Fed controls and which many market participants believe the Fed will begin to raise later in the year or in 2011. Longer-dated maturities, however, are generally controlled by market pressures, such as inflationary expectations and supply and demand.

MARKET COMMENTARY (CONT.)

In other words, if the Fed raises the short-term rates, this may or may not have a corresponding impact on the longer-term interest rates that affect corporate borrowing or investors' bond fund values. The issue of supply and demand has been critical for determining future interest rate levels, and the supply that hits the market each period is substantial, given the current deficits. Some see this supply, in the form of government debt issuance, to be a driver that will lower bond prices on reduced demand, pushing interest rates higher in the future.

No magic formula for predicting interest rates

There is no magic formula for predicting future interest rates, but outlining the situation can help put the problem in context. Therefore, as we build and evaluate portfolios, it may make sense to keep a sharp focus on interest rate risk, looking more to the shorter maturities, where interest rate changes typically have had much less of an impact on the underlying bonds. It seems likely that, moving from historically lower interest rates, there could be a push higher, particularly if inflationary pressures appear.

But these concerns are not immediate; moreover, they should be reviewed as the rate environment evolves throughout the year. Also, be mindful of diversification, particularly as retail investors have been shunning stocks and fund flows have almost exclusively gone into fixed income mutual funds. Other income-oriented investments, such as income-producing stocks, can help diversify portfolio risk.*

Economic scorecard

A key variable in the interest rate discussion is inflation, and this is highly dependent on the economy. As we negotiate the remainder of the year, we can take a quick pulse of the economy now and see where we are in the cycle.

First, to us, it is fairly evident from the numbers that we have seen an improvement in the economy. One of the clearest measures is gross domestic product (GDP), which has been positive for the past two quarters and revised to show a 5.6-percent annualized growth rate as of Q409; five of the previous six quarters had shown a negative growth rate.

The second key variable is the jobs outlook, including the unemployment rate. The economy has been shedding fewer jobs, as the weekly reports of unemployment claims have shown that fewer people have been joining the ranks of the unemployed. The challenge, however, has been job creation—the unemployment rate still was 9.7 percent, as of the end of March. But the jobs report released on April 2, just after the end of the quarter, showed gains of 162,000 new jobs, which was definitely a step in the right direction. The bottom line is that it is critical to improve the employment outlook, so that consumers can continue to help spur economic growth.

The third key component is to stabilize the housing market. The government has been aggressively trying to stabilize housing prices, and, during March, for the first time in more than a year, housing prices remained the same. But after the host of government programs and tax rebates disappear, we are concerned that further erosion may occur.

MARKET COMMENTARY (CONT.)

Existing home sales had fallen for the previous three months, to a level of 5.02 million units in February. Approximately 6.54 million units were sold last November, with buyers scrambling to take advantage of the \$8,000 tax incentive for home purchases. Any decline in the housing market could indeed put renewed pressure on the economy.

So, in short, we are in the midst of an improving economic environment, but it has not been a strong recovery thus far. Government stimulus has been a key factor in leading to the improvements, and, as the stimulus winds down, we believe it is likely we will see some erosion in the economic growth outlook. To us, this continues to suggest that investors will remain focused on risk, as the economic picture becomes clearer and they hunker down for what could be a slow slog higher in economic activity. In the meantime, we think many investors will look to yield-oriented investments to help cushion potential volatility in the financial markets.

**Diversification does not assure a profit or protect against a loss in declining markets.*

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The Barclays Capital U.S. Credit Index is comprised of the U.S. Corporate Index and the non-native currency sub-component of the U.S. Government-Related Index. It includes publicly issued U.S. corporate, specified foreign debenture, and secured notes denominated in USD. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital Municipal Bond Index includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than \$50 million.*

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