

The first quarter continues a near perfect scenario for equities as corporate earnings continue to surge as most companies took advantage of the recession to wring excess costs out of their businesses. Bond markets also performed well as the Fed continues to forecast low rates of inflation, allowing a continuation of loose monetary and fiscal policies. The near perfect investment conditions are beginning to create a false sense of comfort as memories of the market free fall during late 2008 are receding. Regarding equities, we continue to like the U.S. over foreign developed markets and continue to keep a small weighting to emerging markets. As we discussed in our last quarterly letter, we remain fully invested but spend most of our time thinking about what could go wrong, playing defense.

Our main concerns center on the financial health of many countries in the developed world, both in North America and Western Europe. At this writing Greece is in a vicious cycle that we saw with equity markets in 2008, that is fear of default is causing a stampede to sell Greek debt, which in turn raises cost of debt to Greece, making the potential for default all the more real. Greece has let their national debt grow to roughly 125% of GDP, more on this in a moment. European countries that have managed their finances more prudently (think Germany) are reluctant to bail out EU countries that have lacked spending discipline. We are concerned the phrase "PIIGS" which refers to debt of Portugal, Ireland, Italy, Greece and Spain will become much more familiar to bond investors. Normally, bond investors always had the safety of U.S. debt obligations to fall back on as our budget deficits were controlled, inflation pressures were quiet and the U.S. dollar was strong. As discussed in our last quarterly letter, we are very concerned about fiscal trends in the U.S. and have substantially decreased client exposure to U.S. debt.

At this writing U.S. debt represents roughly 90% of GDP and current budget deficits continue to increase the deficit to GDP ratio at an alarming rate. We remain quite concerned that as the baby boomers age, the cost of entitlement programs (social security and health care) will continue to crowd out funds for all other government expenditures. Further, there seems to be little political will on the left or the right to get serious about bringing current deficit spending down to a more manageable level. We continue to avoid U.S. bills, notes and bonds, with a small allocation to TIP's, although these securities are also quite fully priced today. We see investment grade bonds as fairly valued; however, we have moved our allocations to the intermediate part of the yield curve.

Finally, we see municipal bonds as the one area of the market that offers good value. While there certainly is headline risk if a state or municipality defaults, the reality is the probability for any individual municipality defaulting is low. Moody's said it best in their March 2010 U.S. Public Finance bulletin "we anticipate...higher credit stress for smaller and weaker municipalities, although defaults are expected to be idiosyncratic and rare". (I must admit I enjoyed using the word idiosyncratic in a bond discussion). We continue to overweight municipal bond holdings, with an emphasis on national pools that avoid a concentration in any one state. An added benefit of municipal bonds is in a rates up scenario, prices drop more slowly than taxable debt, as the tax benefit helps limit losses.