

INVESTMENT STRATEGY NOTES

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Sovereign Risk

The term sounds almost innocuous, but, of course, it is not. Pundits in the press use it so often that we become numb as observers. Financial markets learned lessons about sovereign risk in recent decades when emerging markets suffered extreme volatility. Most recently, the southern tier of Europe, as well as Iceland and Ireland, have faced challenges of their own. Today, we see the Arab Middle East shaken by events, especially in Egypt.

Markets in the U.S., at the end of last week, reopened in familiar fashion. Caution was expressed by selling pressure in equities and by safe haven buying in U.S. Treasuries. This past week, however, the big surprise has been an unexpected rebound in domestic equities and selling in Treasuries. How can we explain this?

Just as the mantra in politics is “all politics is local”, so we must look inside our economy for a possible answer to recent market action. As we close January, we are almost through the regular cycle of corporations reporting their earnings. With few exceptions, the results have been strong indeed. Corporations, having trimmed employment and expenses during the recent recession, are now benefitting from operating leverage as their businesses recover.

Reported U.S. economic data has also provided a strong backdrop for investors. Economists boasted their growth estimates for the U.S. economy after evaluating the effects of legislation passed in December. Numbers reported for GDP in the 4th quarter were quite positive, as were those for the Index of Leading Indicators. Consumer sentiment has recorded a solid uptick, and measures from the Institute of Supply Management (ISM) have rebounded as well.

With the stock market having recorded solid gains for 2010 as well as January of this year, there is always the risk of a correction. We find it impressive, at the moment, that a crisis overseas has so far failed to dislodge faith in the recovery in the United States.

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This recovery has been reflected in the fixed income market. Yields on 2 year U.S. Treasury Notes at 0.70% and 10 year Notes at 3.50% represent the upper end of yields over the past few months. We believe bond investors' angst is growing with regard to the policy of the Federal Reserve to anchor short term interest rates near zero. As we go through the year, the bond market will signal its perceptions of future Federal Reserve Policy well in advance of the Fed's overt action.

Municipal Bonds

The municipal bond market has been under intense scrutiny recently. There has been widespread media attention to the challenges that state, county and local governments are facing in trying to balance their budgets. Much like the Federal budget deficit, pension and health care related expenses are part of the equation. As we have noted before, states have a constitutional obligation to balance their budgets, whereas the Federal government does not. Fears generated by the media provoked concerns for widespread municipal defaults. We think that is unlikely. Budgets must and will be adjusted. Some municipalities will be sorely challenged; some states, like California and Illinois, to name a few, have significant hurdles to overcome.

These factors have led to a broad repricing of the municipal market and yields of top quality credits have risen along with the weaker ones. This is the type of market development that breeds opportunity. In this case, a taxable investor has an excellent opportunity to enter the municipal market to take advantage of historically wide yield spreads of municipals relative to U.S. Treasuries of comparable maturity. The key is to select pristine municipal bond credits that will not be subject to financial stress going forward.

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Year-to-Date Total Returns January 31, 2011			
Stock Market Indices		Bond Market Indices	
S&P 500	2.31%	Barclays Intermediate Government	0.28%
Dow Jones	2.96%	Barclays Intermediate Government Credit	0.39%
Russell Growth	2.76%	Barclays Government Credit	0.08%
S&P Mid-Cap	1.99%	Barclays Aggregate	0.12%
EAFE	2.37%	Barclays Quality Intermediate Municipal	-0.27%

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