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Where Do We Go From Here?

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As of the date of this writing, several market factors are becoming clear. First, the Federal Reserve has chosen to continue a very accommodative monetary policy by keeping interest rates at historically low levels. While concerns over longer term inflation continue to be discussed, the Fed has recognized that the current (and maybe debatable) recovery is far too fragile to withstand any immediate rate hikes.

Another factor that has become evident is the investor's appetite for risk has returned. This is supported by the one-year bounce of equity markets since the market lows on March 9, 2009. Large cap stocks, as measured by the Russell 1000 Index, are up 72.9%, the Russell Midcap Index is up 94.2% and the Russell 2000 (Small Cap) Index is up 92.1%. In addition, we recently saw the Dow Jones Industrial Average hit the 11,000 level for the first time since September, 2008.

Another clear indicator of an improving appetite for risk has been the significant (and somewhat expected) decrease in the yield spreads for corporate bonds from their peak in early 2009. At their peak, 10 year "A" rated corporate bonds were trading near a 650 bps spread to the 10 year Treasury, almost 5% above the "normal" spread associated with "A" rated corporate bonds. In our April, 2009 Market Perspective, we suggested that the narrowing of these yield spreads would be a leading indicator of an improving stock market as investors once again were willing to assume risk. That narrowing did indeed lead to a substantial rise in both bond and stock prices over the past several quarters.

So, where do we go from here? While fragile, most economic indicators point to a broad based global recovery. This should be good news for corporate earnings as many companies have "trimmed the fat" and are positioned to see significant profits if and when they see top line revenue growth. The expectation is that this growth will lead to additional jobs as the unemployment rate continues to be a major concern to investors.

While most developed countries are experiencing slow growth and an alarming rise in their debt, many emerging markets are seeing just the opposite. As a result, approximately 50% of emerging market debt is now rated as investment grade. This is a significant shift from previous years and provides investors with additional opportunities.

Inflation and interest rates should remain relatively stable throughout the rest of 2010, suggesting an expected bond return similar to the coupons on the bonds. We believe the Fed will continue to keep rates low until they see clear evidence of job growth and an economy that can sustain higher rates – even at the risk of future inflation. Some inflation may actually be a relief to the Fed as it would most likely indicate a recovery is well underway and may be a catalyst to support higher real estate values.