MV Capital Management Thought Leadership

First Quarter Flowers, Future Showers?

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The first quarter of 2012 will come to a close in just three days, and unless something completely unforeseen crops up between now and then (always a possibility, mind you), major market indexes will finish in positive low-to-mid teens territory. The Russell 3000 index currently stands just above 13% while EAFE continues to weather the Eurostorm with a 12% showing and the MSCI Emerging Markets index perches atop 15%. In the DC metro area an unseasonably – in fact historically – warm winter and spring has provided resplendent floral hues to be seen and enjoyed in the area's garden beds and parks and highway median strips. Good vibes are in the air – but can the good times last?

It's hard to make sense of this rally in terms of traditional asset class relationships. For much of 2011 the way of things basically boiled down to the notion that when stock prices rise, so do bond yields (i.e. bond prices fall), and vice versa. When risk assets started to crumble in the middle of last summer, the yield on the 10-year Treasury note plummeted from 3.2% - a level it still maintained in early July – to a 65-year low of 1.75% by late September. Risk on, risk off – that was the dominant paradigm.

As of now, however,10-year rates remain nowhere near their 3%-plus levels of last year even as the S&P 500 and the Dow are a handful of percentage points away from regaining their all-time highs of late 2007.The 10-year is currently at 2.2%. By contrast, it was over 5% when the stock indexes reached their peaks in 2007, and it was over 6.5% when the previous records were set at the height of the technology bubble in early 2000. What's changed? Well, first and foremost, during those earlier bull market runs the central banks of the world were very different places than they were today, The main reason for rates continuing to be so low even as asset prices soar is that the US Fed Chairman has reliably lived up to his *nom de guerre* of Helicopter Ben – either actually dropping money out of helicopters or promising to drop money out of helicopters when the need arises.

Just this week we were treated to another "Bernanke Bounce" – an assessment by the chairman that economic conditions are still weak enough to merit consideration of another dose of quantitative easing, He didn't come out and announce a new program, of course. But with economic data points generally showing better-than-expected results across a range of macroeconomic measures since the beginning of the year, Bernanke's words were a sweet balm to investors who might have been concerned that a return to economic strength would lead to monetary tightening sooner than expected. Stocks rose, rates stayed flat. That's been the story of the year so far.

The question, as always, is how long this can go on. There are a variety of cases being made that span the range of outlooks from doomsday to Garden of Eden. The optimists note that the recovery in the US appears to be on its firmest ground since the nadir of the 2008-09 collapse. One of the indicators held up as most promising by this crowd is housing. A series of recent data points in new starts, prices and existing home sales offers a plausible argument that the severe downturn in this sector has bottomed out. Were that the case then household balance sheets could start improving and earnings outlooks for the many industry sectors closely correlated with the housing market could turn more positive. That having been said, we are not seeing many clear signs of improvement in average household income levels – and for the housing sector to really get into gear incomes have to be moving in the same direction. After all, one of the traditionally most important benchmarks for housing prices has been the ratio of average home price to average annual income. When that number started to go off the rails in the mid-00s too few people paid attention, citing "this time it's different". It wasn't, and it's worth paying attention to it now.

The pessimists ask a simple question: What's changed? Greece is still on life support, other peripheral countries are a 200 basis point spike in bond yields away from being back on the edge of the abyss, Europe itself is in recession while China is trying to finesse its policymaking through an emerging era of

lower growth expectations. Oil prices are back in the territory where they can throw a wet blanket on nascent growth, with major geopolitical risks in the Middle East threatening to become the major X-factor of mid-spring. Political leadership is in short supply throughout the world. Even Japan, traditionally one of the world's most impressive strongholds of high public trust, has suffered in the wake of botched government and corporate responses to last year's natural disasters, to the point where the level of public trust today is barely above that of the eternally cynical and distrusting Russians towards their rapacious kleptocracy of a government.

Where do we stand? We believe there is a reasonable case to make that the near-term market environment will remain generally firm, though we also think that with the substantial gains already reaped in the first quarter, the pace will more likely be subdued. The rally has – as is often the case when the bull is in full snort – disproportionately benefited lesser-quality stocks (though not exclusively – witness the torrid pace of Apple, the five-diamond quality stock that seems impervious to any and all market forces that rail against it). We see a plausible case for a reversion to the high quality, high dividend names that are popular when the midpoint sentiment could be best described as "cautiously optimistic". In fact that is a reasonably accurate and succinct way to describe our outlook over at least the next couple quarters. In the larger picture, though, we think there is still a road to travel in the macro gap market we have been stuck in since 2000. That gap will be over when the Dow surpasses 14,000 and never looks back. We see some significant speed bumps in the way before that finally happens.

With warm regards,

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