

GREEN INVESTMENT MANAGEMENT, INC.

309 W 7th Street • Suite 101 • Fort Worth, Texas 76102-6901

Toll Free (800)950-8004 • Phone (817)335-1178 • Fax (817)877-0741

Web Site: www.GIMlink.com

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Market Commentary

A Review of the Markets and a Look into the Future

Forks Ahead!

"When you come to a fork in the road, take it"

-Yogi Berra

Overview: A Look Down the Road

One quarter into 2010, we can already see plenty of “forks” awaiting us in the investing road ahead. For instance, China may choose to let its currency rise against the dollar, or continue devaluing it to help its own exporters. Each alternative could lead us into a very different environment. Yogi Berra’s advice notwithstanding, the big question for us as investors is not which fork we will choose to take. That is out of our control. The big question for us is how to best prepare ourselves and our clients for the myriad of possibilities that are coming our way.

To help answer that question, in this quarter’s Commentary we will take a look at some different upcoming forks in the road. We will consider the places where each fork might lead, and evaluate how to best prepare ourselves for the trip.

Economy: The Recovery Gains Steam

Signs still point to a slow-building but steady recovery in the economy. Even the labor front has good news to offer. March saw nonfarm payrolls increase by 162,000, the most in three years. While census-related hiring by the government provided some of the boost, most of the jobs (123,000) were generated in the private sector.

The unemployment rate remained unchanged at 9.7%. Unemployment is expected to retreat only stubbornly as the recovery continues. Many expect it may stay above 9% even into 2011. As new jobs are generated, many who left the labor force (and therefore the unemployment statistics) for school or other options will feel encouraged to re-enter, keeping the unemployment rate relatively high.

Both manufacturing and the service sector have shown strength in recent reports. Consumer confidence appears to be coming back as well, along with consumer spending and retail sales. For March, Thomson Reuters reported same store sales growth of 9.1%.

Housing and construction continue to lag. The housing market, still dealing with the overhang of the sub-prime collapse, may have bottomed out. But some regions may still require years to fully recover.

Annual GDP growth hit a robust 5.6% rate in the fourth quarter of 2009. Much of this strength came from businesses replenishing their inventories, as well as from ongoing monetary and fiscal stimulus. As this stimulus winds down over the coming months, internal economic strength will need to take over. Because of this, some expect GDP growth to moderate into the 2-3% range for the remainder of the year, what some are calling a “new normal” growth environment that could last into 2011 and beyond.

The global recovery continues as well. It is fastest in Asia, particularly China, where annual GDP growth was near 11% in the fourth quarter of 2009. We expect that the emerging nations of the BRIC (Brazil, Russia, India, China) will continue to outpace the developed world and offer excellent opportunities for portfolio diversification.

But even among the developed nations of the OECD, there are clear signs of recovery, as in figure 1 below, which shows industrial production rebounding from a precipitous fall in 2008.

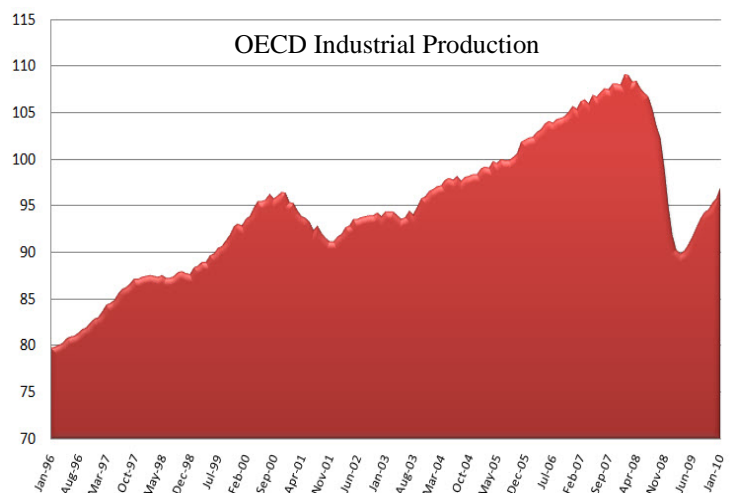


Figure 1. OECD Industrial Production Index (2005=100, source: Organization for Economic Cooperation and Development)

Fork in the Road: Chinese currency policy

Regarding the macro-economy, one of the key issues is that of China's currency policy. Tremendous global (and American) demand for Chinese goods has created upward pressure on the yuan. To keep its own goods cheap to the rest of the world, China has been keeping the yuan pegged to the dollar. If China were to remove this peg and let the yuan appreciate, the world's goods would become cheaper to Chinese consumers. With huge numbers of Chinese consumers seeing their incomes rise with economic growth, their demand for other nations' goods could become an important new driver of the global economy. On the other hand, if China continues to keep the yuan pegged artificially low, it could lead to inflation in China and continued trade imbalances and growth impediments in the U.S.

Ever protective of its exporters, the spokesman for China's Ministry of Commerce claimed that a \$7.24 billion trade DEFICIT in March (not a misprint), China's first since April 2004, was an indication that "...trade has created the conditions for the renminbi's (yuan's) exchange rate to remain basically stable."

Except that the monthly deficit figure in March was a clear outlier. Moreover, China's huge trade surplus with the U.S. remains. The deficit was primarily with Taiwan, South Korea and Japan. Much of it was driven by a surge in the price of imported commodities. This greatly weakens the Ministry's case that the trade deficit implies no need for yuan revaluation.

In fact, given the all-around benefits of yuan appreciation, we feel it is very likely to happen eventually. The questions remain of *how soon* and *by how much*. Chinese President Hu Jintao is in Washington for a nuclear safety summit as I write this. A recent softening of rhetoric appears to indicate that he and the leadership may soon accommodate calls to let the yuan rise. Nonetheless China remains culturally averse to being publicly pressured on such issues. They much prefer face-saving private negotiation. It will be interesting to see how events play out.

The worst possible outcome would be one where disagreements over the value of the yuan lead to trade sanctions or even a trade war between the U.S. and China. This scenario seems unlikely at present. In response to China's softening stance, the U.S. Treasury has delayed a report that might have labeled China a currency manipulator. In addition, as with nuclear weapons, the dire consequences a trade war would bring to both sides should act as a strong deterrent.

Stocks: Room Still Left for Bulls to Run

A strong March for equities helped the S&P 500 to a 5.4% year-to-date gain in 2010 (see Figure 2). As I write this, it is trading near 1,200 and the Dow is above 11,000. Industrial and financial issues have led the way in this year's rise, with information technology and utilities lagging.



Figure 2. The S&P 500 in 2010 (Adjusted close, source: Yahoo! Finance)

So far the economic recovery has walked a path that is advantageous for stocks. Signs of recovery have been plentiful enough to support market growth, but not strong enough to trigger worries of imminent inflation or Fed re-tightening.

While price-to-earnings ratios may appear lofty, near 20 for the S&P 500, it is important to consider the interest rate environment. The "Fed Model" compares the earnings return on equities (found by inverting the P/E ratio), to the yield on 10-year treasuries. With treasuries offering such low returns now, the earnings-to-price available in the stock market tops them. While the Fed Model is no crystal ball, this is one indication that equity indices remain undervalued.

Going forward, we expect significant volatility, but believe that the path of least resistance continues to be on the upside. Gains may be more selective than in 2009, but even an extended period of slow GDP growth in the U.S. should bring opportunities for U.S. companies that are well positioned for global growth.

In the near term, much will depend on first quarter earnings. With all of the fat companies have trimmed in the recession, gains will need to come from sales-driven earnings growth rather than cost-cutting. Improving retail sales data bodes well for such a scenario.

Fork in the Road: Healthcare Legislation

How will the new healthcare legislation affect stocks? Like everything else about the 2,300 page law, the precise impact is shrouded in mystery, complexity and a staggered implementation timeline. One big question is whether the program will truly pay for itself as advertised. If it ends up feeding the deficit, it will reinforce the slow growth environment many are anticipating for the coming years.

The new law also calls for a Medicare tax of 3.8% on investment income for high earners, to take effect in 2013. This provision helps the program in terms of paying for itself, but brings the danger of slowing growth by discouraging investment.

On the company level, stocks that could turn out to be winners are ones that would benefit from the increased demand for health care and insurance that the law will create, but that don't stand to have their profit margins squeezed. Generic drug makers and retail pharmacies are two potential winners. Potential losers could include hospitals and insurers, depending on how everything shakes out. For instance, it is uncertain whether the increased cost to insurers of bringing in the very sick will be offset by simultaneously bringing in younger and healthier people.

Bonds and Interest Rates: The Action is Still in Corporates

The high yield segment of the corporate bond market continues to *bull* out our confidence, so to speak, rising some 4.4% in the first quarter of 2010. We look for continued opportunities in this market through 2010, with Moody's expecting default rates to fall to 2.9% by year end. Even in a slow growth economic environment, high yields can achieve strong returns just by earning their coupons.

We also anticipate investment grade corporates being attractive going forward. A wave of baby boomers are at or nearing retirement age. They are likely to begin looking for stable, income-oriented investments. At this point, treasury rates do not offer an attractive alternative, so corporates could become their asset of choice.

Some selling pressure in bonds as well as stocks is possible late this year, as investors seek to log gains ahead of the likely expiration of capital gains tax cuts, at least for high income earners.

Fork in the Road: What about deficits?

Unless the economy shows more strength than we anticipate, the Federal Reserve Open Market Committee is unlikely to raise interest rates until 2011. Beyond that timeframe, deficits could play a big role in the interest rate picture. If U.S. voters demand fiscal restraint and policy makers supply it, low interest rates may continue, which should boost the long term economic outlook. On the other hand, if deficits continue to balloon, real interest rates will likely rise and cut into economic growth. If the Federal Reserve acted to offset this rise with easy monetary policy, the result would likely be serious inflation. Both of these scenarios bring significant risks to a broad spectrum of assets. Both will need to be carefully hedged, for instance with precious metals exposure in the case of inflation. The situation bears close watching.

The Dollar and Commodities: A Misleading Statistic

The U.S. dollar index, which tracks the greenback's performance against a basket of world currencies, has risen steadily in 2010. But this fact fails to tell the full story. The comparison basket is very heavily weighted (57.6%) with Euros. The Euro has been very weak thanks to problems such as the Greek debt crisis. The European Union (EU) has agreed to provide up to 30 billion euros over the next year to help shore up the situation. But in the long run similar problems may recur, as the EU seems to lack sufficient enforcement muscle to prevent individual nations from letting their balance sheets get dangerously out of sorts.

Against strong currencies like that of Australia, where monetary

tightening has already begun, the dollar has fared poorly in 2010. So far, inflation expectations remain modest due to slack in the economy. But if inflation does eventually come, it will be yet another weight around the dollar's neck. The further the dollar sinks, the better cash, metals, and the currencies of low-debt nations start to look.

Crude oil remains in the neighborhood where it ended 2009, trading in the low eighties as I write this (see Figure 3 below). As the summer driving season approaches in the U.S., a spike above \$100 per barrel or \$4 per gallon of gasoline could spell trouble for the economy. We do not expect this as Saudi Arabia appears committed to a lower price range. Gas prices above \$3 per gallon, however, are a real possibility.

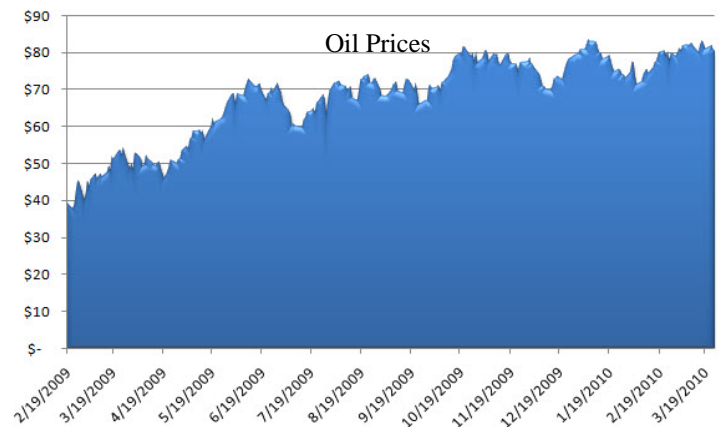


Figure 3. Crude Oil Recovers from Recession (West Texas Intermediate per barrel, source: U.S. Department of Energy)

Gold remains elevated, trading near \$1,150 an ounce currently, but down from its highs over \$1,200 in late 2009. Inflation fears, if kindled, could fire it to new records. For now, it appears to be, like inflation concerns, in a holding pattern.

The Bottom Line: Anticipate and Endure

The sayings of wise men are often misunderstood. Maybe that is the case with Coach Berra's quote above. When he advises us about forks in the road, and says to take it, maybe he is telling us that we need to be ready to endure, to *take it*, regardless of what environment we end up in. That would certainly be perfect advice for investors. Only by anticipating how the road ahead of us may fork can we take steps to hopefully protect ourselves from risk while taking advantage of opportunities. Keep this advice in mind and enjoy the ride!

These remain volatile times, and we will continue watching the situation closely in order to respond quickly to any changes in outlook. As always, we send thanks to those of you that are our clients. We value the trust you have placed in our firm and we sincerely appreciate your business. If you have any questions or concerns, please do not hesitate to give us a call. 🐎

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