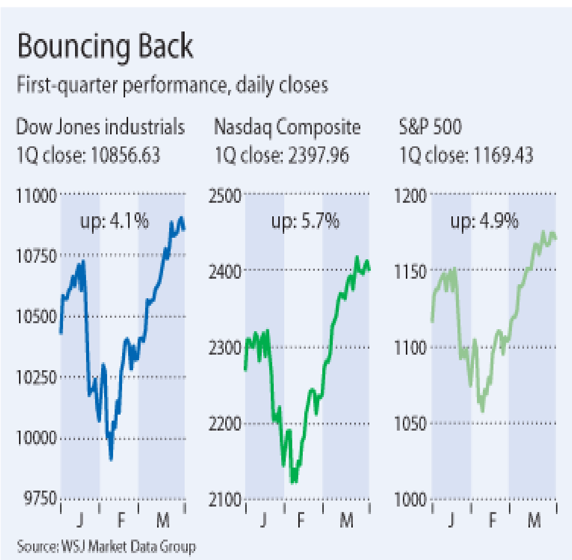
Quarterly Economic Update

First Quarter 2010

Wow —another roller coaster quarter—a rebound, but with many little corrections, including a pullback in January.

The Dow Jones Industrial Average ended up the 1st Quarter of 2010 with a total return of 4.1%. This marks the Dow's 4th consecutive quarterly gain and its best first-quarter performance since 1999. The Dow closed above 11,000 on Monday, April 12th, something it hasn't achieved since the financial system started deteriorating 19 months ago.



Just over a year ago the Dow hit bottom. It has now rallied more than 70%. The NASDAQ Composite index was up 5.7%. (Source: WSJ, 4/1/2010)

A big question is how much of the market's rebound was driven by improving economic fundamentals (such as optimism about corporate profits and the latest debt release plan for Greece) and how much by government stimulus.

This revival of our economy is very similar to past recoveries, with consumer spending leading the way, followed by industrial production and, much later, employment and capital spending. The market still looks poised to gain a lot more ground in 2010. However, investment returns are still likely to be volatile and unpredictable.

Global Overview

The global recovery has been driven by growth in China. In 2009, the U.S. economy **shrank** by 2.4% to $14.5 trillion in size, while China's economy **grew** by 8.7% to $4.9 trillion in size. Chinese revitalization of Asian capitalism remains one of the most important positive events in the world in the last 30 years. However, instead of treating China like the indispensable capitalist partner it has become, the U.S. treats China as an adversary because it defies us on global warming, dollar devaluation and internet policy.

Emerging Markets

It has become an investing truism lately: If you want stocks with high-octane potential, you are wise to invest in the fast-growing economies of the emerging markets. The result has been frenzied demand for such stocks and sky-rocketing valuations. The MSCI Emerging Markets index has risen 76% in the last year and China's main stock index now trades at a price/earnings ratio of 31, more than 50% higher than that of the S&P 500. Many larger companies are experiencing their fastest growth from places like China, Brazil, and India, which makes it possible to buy shares of companies in established economies that provide significant exposure to emerging markets.

Emerging markets could suffer reversals, but their long-term outlook is robust, according to many economists. Many emerging markets are exiting the global recession on stronger footing than many developed markets, and widespread shifts in growth and consumption suggest there is significant opportunity in global markets for patient, long-term investors. (Source: Barron's, 4/12/2010) Please also remember that international investing can involve special risks including greater economic and political instability, as well as currency fluctuation risks, which may be even greater in emerging markets.

U.S. Budget Deficit

According to the latest Administration projections for fiscal year 2011 (October 1st, 2010 to September 30, 2011), the U.S. debt has reached record highs for peace time—$1.6 trillion (10.6% of GDP). While some of that reflects the downturn in the business cycle, which cuts into tax revenue while boosting unemployment compensation, bank bailouts and other spending, it is not temporary. The budget office projects a deficit as high as $752 billion in 2015 despite some rosy economic assumptions. And this doesn't even include the multi-billion dollar deficits facing most states. (Source: Time Magazine, February 15th, 2010)

When the President signed into law a 2-year stimulus package worth about $787 billion, the White House predicted that unemployment would peak at about 8%. Instead, unemployment rose to 10% in 2009. This unexpected bad performance means the President must focus on the weak labor market just when he ought to start switching his attention towards deficit reduction. (Source: The Economist, 2/6/2010)

Federal Reserve Chairman Ben Bernanke warned about the two giant fiscal waves headed for the federal government—the big deficit caused by the economic downturn, followed by the ballooning costs of baby-boomer retirees drawing Social Security and Medicare funds. He worries that our huge deficit threatens the nation's long-term economic health and should be addressed soon. (Source: WSJ, 4/8/2010)

Mr. Bernanke also stated that there are 2 ways to reduce the deficit—cut spending or increase taxes. Many political battles during the next few years will pit taxpayers against the beneficiaries of public spending, as well as workers against retirees. (Source: The Economist, 3/6/2010)

To understand how hard it is to cut Federal spending, consider the breakdown in public spending:

- 57.3% - direct payments to individuals (or on their behalf) by healthcare and housing providers, for example
- 19.6% - military operations and hardware
- 16.0% - transportation, education, homeland security, law enforcement and disaster relief, just to name a few (none of which gets even 3% of the budget and many are well under 1%) (Source: Kiplinger's Personal Finance, 4/20/2010)

Our tax revenues are adequate to cover just 4 budget items: military spending, health spending, Social Security, and interest on the national debt. Every other program has to be covered with borrowed funds, including unemployment compensation, support for state and local governments, etc. (Source: World Report, 4/2010)

Therefore, President Obama has proposed a number of different tax increases in order to help reduce this deficit, but these are not easy to swallow and may not be enough.

Some investors aren't too concerned about the deficit. When we hear the media saying, "Oh, a trillion here, a trillion there," almost daily, do we become immune to the seriousness of this amount of money? **Here is what a trillion dollars looks like: $1,000,000,000,000. That's a lot of zeros, and a trillion dollars is a lot of MONEY!**

Social Security Changes

With all the baby boomers retiring, many taxpayers have wondered how long it would be until Social Security would start paying out more than what it took in. Well, you don't have to wait any longer – it just happened!

The Congressional Budget Office (CBO), which did not expect this to happen until at least 2016, stated that this would have no affect on benefits in 2010 and retirees would keep receiving their checks as usual. Unfortunately, payments rose more than expected during the downturn because jobs disappeared and people applied for benefits sooner than planned. Revenue also fell sharply because of the high unemployment.

At least a bit of good news—the latest projections state the program will not exhaust its funds until about 2037. Let's hope that this projection is more accurate. (Source: NYT, 3/24/2010)

National Health Plan

On March 23, 2010, President Obama signed healthcare reform legislation. The bill is massive – nearly $1 trillion in spending and $400 billion in new taxes over the next decade. Did I mention it came in at over 2,000 pages?

A Little Perspective:

- The Lord's Prayer: 66 words
- The Ten Commandments: 179 words
- The Gettysburg Address: 286 words
- The Declaration of Independence: 1,300 words
- U.S. governmental regulations on the sale of cabbage: **26,911 words** (source: *Game Over* by Stephen Leeb)

This legislation is the biggest change in America's welfare state since the 1960s. It will extend coverage to 32 million uninsured by expanding Medicaid rules, establishing new health-insurance changes to provide more competitive rates, and providing subsidies for middle class families to buy into private plans.

This healthcare legislation carries with it important tax implications including:

- An additional 0.9% Medicare Health Tax (from the current 1.45% to 2.35%) on earned income above $200,000 for individuals and $250,000 for joint filers

- A Medicare tax of 3.8% on investment income (e.g., dividends and interest) for individuals with Adjusted Gross Income (AGI) above $200,000 ($250,000 for joint filers)

The new tax laws do not take effect until 2013, and a lot can happen between now and then.

Tax Planning Strategies

Let's look at a tiny sliver of taxpayers for a minute—the top 1% of taxpayers. In 1980, they paid 19.1% of all federal income tax while the bottom 50% of taxpayers paid 7.1%. In 2007, they paid 40.4% of all federal income tax while the bottom 50% of taxpayers paid only 2.9%. Thus, since 1980 the top 1% of taxpayers has gone from paying nearly three times the federal income tax of the bottom 50% of taxpayers to nearly fourteen times as much! (Source: Tax Foundation, By The Numbers, 2/15/10)

Projections from the Urban-Brookings Tax Policy Center show that 38% of Americans were expected to have zero or negative federal individual income tax liability in 2009 before the stimulus package was enacted. After the stimulus and other tax changes, this proportion will increase to nearly 46%! Today, according to the Tax Foundation, 50% of Americans consume more in government services than they pay in taxes. (Source: WSJ, 4/14/2010)

The tax law changes from this health care plan is one of many different tax increases that will affect many taxpayers. For example, taxpayers at all income levels could be affected by new limits on medical flexible spending accounts and medical deductions. The 3.8% Medicare tax, combined with the expected expiration of the Bush tax cuts for high income taxpayers on January 1, 2011, would produce a top federal income tax rate of 23.8% on long-term capital gains from the sale of investments in 2013, up from 15% today. The top income tax rate on interest and other types of "passive" income would increase to 43.4% from 35% today.

Dividend income is expected to be affected the most, and if Congress doesn't act, the top income tax rate on dividends will zoom from 15% in 2010 up to 44.6% in 2013.

There are a number of tax law changes that we will cover later this year. These changes can offer tax strategies that you would possibly be able to use. We will review the details of this with you later this year.

The Bond Market

There is now more than $9 trillion sitting on the sidelines in various low-yielding bank instruments. (Source: Investment News, 2/6 /2010)

The average interest rate was less than 0.1% on Treasury Bills, as of April 9, 2010. The interest rates on bonds are affected by the demand for loan-able funds, and during a recession, the demand for loans is usually low and interest rates tend to decline. Current interest rates are at historical lows, but can't stay this low forever. When they eventually start getting higher, what can investors expect?

Although the bond market has historically been less volatile than the stock market, bonds also fluctuate in price, some significantly. When yields for new bonds fall, existing bonds with higher yields become more valuable and can demand a higher price, and vice versa. If history serves as a guide (which is no guarantee), bond investors will suffer when interest rates start to move upward.

Conclusion

The severe global sell-off that erupted in 2008 coincided with the global recession that affected developed and developing markets alike. One year later, the outlook is much different. Most stock markets have recorded extraordinary gains, boosted by government and Central Bank interventions. Stronger-than-expected corporate profits are a sign of stability and recovery in economies throughout the world.

Despite the strong rebound in global stock markets, financial and economic difficulties persist in many countries, particularly the United States. However, remember that the problems facing equity markets today (inflation, unemployment, regulatory uncertainty) have been experienced—and conquered—before.

Don't fall prey to all the negativity in financial journalism! Journalism's goal is to keep your focus as short-term as possible (ideally minute to minute) so you won't dare turn off that television. *Our* goal is to help you think, plan, and invest for the long term.

P.S. Some good news: The government bailout of various financial companies is starting to look far less expensive than once feared. The government estimate has now dropped from the original $250 billion to approximately $89 billion, which includes the Troubled Assets Relief Program, capital injections into Fannie Mae and Freddie Mac, and various other courses of action it has taken over the last couple of years.(Source: WSJ, 4/12/2010)

Sources: Wall Street Journal (April 1st, 2010, C1; April 8th, 2010; April 12th, C1), New York Times (March 24th, 2010), Barron's (April 12, 2010), Kiplinger's Personal Finance (April 20th, 2010), The Economist (February 6th, 2010, page 31; March 6, 2010, pg 95), World Report (April 2010, page 72), Stephen Leeb, Game Over, page 58, Tax Foundation, By the Numbers (2/15/10), Wall Street Journal (April 14, 2010) Contents provided by MDP, Inc.

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Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs or expenses. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss in periods of declining values. International investing involves special risks not present with U.S. investments due to factors such as increased volatility, currency fluctuation, and differences in auditing and other financial standards. These risks can be accentuated in emerging markets.

There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. Rebalancing investments may cause investors to incur transaction costs and, when rebalancing a non-retirement account, taxable events will be created that may increase your tax liability.

This optimism about the future does not minimize the fact that we have gone through one of the worst economic periods in market history. Remember that equity markets are volatile and an investor may lose money and there is no guarantee that securities will appreciate.

In general, the bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that investments in; lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

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