

**NIXON PEABODY  
FINANCIAL ADVISORS LLC**  
A Registered Investment Advisory Firm

1<sup>st</sup> Quarter 2010 newsletter  
April, 2010

**Market Review**

Following a strong March, all domestic equity asset classes are now well into positive territory year-to-date. The large-cap S&P 500 Index was up 5.4% for the quarter, while the iShares Russell Midcap benchmark gained 8.6% and the small-cap iShares Russell 2000 gained 8.8% for the first three months. Foreign stocks also posted strong gains in March and are now in the black for the year so far, with the MSCI EAFE Index and the MSCI Emerging Market Index up 6.2% and 8.0% for the month, and 0.9% and 2.1% for the quarter, respectively.

Turning to fixed income, the Barclay's Aggregate Bond Index gave up a bit of ground (-0.1%) in March, though posted a positive 1.8% return year-to-date. Developed foreign bonds (as represented by the Citigroup World Government Bond Index) slid 1.7% in March and are down 1.3% for the year so far. Emerging-markets bonds gained an impressive 4% for the month (as measured by the JPMorgan GBI-EM Global Diversified Index), ending the quarter with a 5.4% return. High-yield bonds posted a 3.1% gain in the month, ending the quarter up 4.8%. We talk more about our current views and the investment implications in the commentary below.

**The Big Picture – Mountains of Debt**

A year ago the stock market had just started its rebound from the depths of the worst bear market in over 70 years. While the powerful rally in "risk" assets over the past year is certainly comforting, we remain concerned and our assessment of the key macro issues and risks that the global economy must deal with in coming months and years has not changed. Though the worst case of a great depression has been avoided, the global economy continues to struggle in the aftermath of massive wealth destruction and a hard stop to the decades-long trend of expanding indebtedness.

More so than in past periods, the investment climate in the years ahead will be highly influenced by how the key macro components of this environment unfold. We've seen massive growth in debt throughout society, reaching binge levels in the last decade. Think of all that debt as a form of borrowing against future consumption – now we must pay it back in the form of less spending. This suggests a sluggish economy, possibly for many years to come.

Government spending has kept the economy from falling off a cliff, but at a longer-term cost of massive deficits that will be difficult to fix without causing more damage – including the possibility that shifting gears to cut budget deficits too early could throw the economy into a significant and ugly decline. The recent economic strength stems mostly from this stimulus spending and smaller inventory drawdowns (companies are still drawing down inventories – selling more than they are producing so that inventories decline – but the drawdown has slowed). The problem is that both of these factors are temporary.

There is still a lot of government spending that will roll out this year but unless there is a new round of stimulus, which is quite possible, it will dissipate in coming quarters. Inventories will be a positive growth driver for a while as they are gradually rebuilt, but this too will pass as the year progresses. Other sectors of the economy are strengthening—manufacturing in particular has been impressive but it is still far below its prior peak and overall, the economy is on fragile footing. What we don't yet know is whether the economy will be on solid enough footing to stand on its own as government supports are withdrawn and inventories stabilize, or whether it will stumble and possibly contract again. In normal cycles the consumer is the key to sustained growth. The weakness in this critically important sector suggests to us that a sluggish recovery is the most likely outcome over the next couple of years.

There are several important variables to a strong and sustainable economic rebound, but jobs are the most important. The big question is not whether the job picture will improve, but how much it will improve and how quickly. But while the labor market remains very weak, monthly job losses likely peaked some time ago, and we appear to be entering a period of net job creation.

A strong snapback in job creation at some point would not be shocking. With over eight million jobs lost, there was probably some overreaction on the part of businesses that will be reversed. However, we also believe that businesses are adjusting to a smaller workforce in the face of continued concern about economic growth in coming years. We don't know how this will play out, but the weight of the evidence suggests to us that even with a strong temporary snapback, we shouldn't be optimistic about a return to a strong labor market for several years.

Other big problems include huge amounts of commercial real estate debt coming due, continued strains in the housing market, and possible high inflation down the road from deficit spending.

There are some positives that could contribute to a better outcome, including continued strength from emerging economies. Domestically, we could see stimulus spending, low rates, and inventory rebuilding create a virtuous circle in which businesses with strong balance sheets add jobs, and consumer and business confidence builds and feeds on itself.

### **Investment Outlook**

It would not be shocking to find bargain valuations in some asset classes when the outlook is poor—often times risk is more than fully priced into financial assets in negative environments. Unfortunately, that is not the case today—generally speaking, return potential over the next five years is not compelling. However, that does not mean that returns couldn't be decent over the near term.

**Global Stock Outlook:** We think mid-single-digit returns or worse are more likely for stocks than higher returns over the next five years. Our outlook for developed market foreign equities is similar and for emerging-markets equities is slightly higher. We believe risks are relatively high, but we can't predict timing. We can easily imagine good returns in 2010 if the economy continues to grow, low rates encourage risk taking, and there is no catalyst to cause risk aversion.

**Emerging Markets Local Currency Bonds:** Among other asset classes, emerging-markets local-currency bonds remain a compelling opportunity from a relative-return perspective versus other major asset classes. We think it can generate mid- to high-single-digit returns in our most

likely five-year scenarios—admittedly not spectacular returns but better than any other asset class. The returns are driven by the underlying bond yields plus an expectation of at least mild currency appreciation we expect given the stronger fiscal conditions in much of the developing world.

**High Yield Bonds:** High-yield has continued to do well in 2010, though the returns have been much more moderate. We no longer view the asset class as clearly superior to equities (both have low expected returns). High-yield could continue to generate decent returns in the short to intermediate term if the economy continues to gradually improve and interest rates remain low. But the increase in prices of high-yield bonds (now at or approaching par for most of the high-yield universe) means that our expectations for returns over our five-year investment horizon have fallen.

**Fixed Income Strategies:** Eighteen months ago there were many table-pounding opportunities in the fixed-income market as everything outside of the government-backed market was in the bargain bin. Since that time every fixed-income sector except for government bonds has rung up big returns. Now, however, the opportunities are not so compelling, though on a five-year basis the return potential may be higher in non-government bonds, depending on your tax bracket.

### **The Value of Our Research is the Decisions We Make With It**

Investment decisions involve determining if you are being adequately compensated for risk. The possibility that it may take years to complete the process of deleveraging is not uplifting. Skewing towards a positive view when the environment doesn't support it may feel better, but is not a path to generating better returns, so we are committed to working hard to understand the reality we live in and make decisions accordingly.

Please keep in mind the issues discussed in this letter are general in nature and describe our investment approach. While they may be reflective of your assets managed by us, they are not intended to be a specific analysis of your individual accounts that we manage. Feel free to give us a call to discuss the performance of your individual accounts.

As always, we appreciate your confidence and welcome questions.

Thomas M. Farace, Esq., CPA, CFP	585-263-1440 <a href="mailto:tfarace@npfa.com">tfarace@npfa.com</a>
Michael A. Tullio, CPA	585-263-1479 <a href="mailto:mtullio@npfa.com">mtullio@npfa.com</a>
Todd P. Mazzo	585-263-1453 <a href="mailto:tmazzo@npfa.com">tmazzo@npfa.com</a>
D. Jim Manou, CPA	585-263-1288 <a href="mailto:dmanou@npfa.com">dmanou@npfa.com</a>
Jason S. Nicholson, CPA	585-263-1563 <a href="mailto:jnicholson@npfa.com">jnicholson@npfa.com</a>
Anne B. Covert, CFP	585-263-1401 <a href="mailto:acover@npfa.com">acover@npfa.com</a>

*NOTES: This newsletter was prepared with the assistance of Advisor Intelligence, one of our strategic investment consulting sources.*

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