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Market Insight
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Market Sustainability Requires Real Solutions for Main Street

"If you look at overvalued, overbought, overbullish, hostile yield conditions of the past, you'll find that the most likely market outcome, in terms of raw probability, is a continued tendency to achieve marginal new highs...but significant damage often follows abruptly and unpredictably." –John P. Hussman, Ph.D.

Equity markets fell shy of last quarter's 8.1% advance in the Dow, tacking on marginal highs to the tune of 4.82% for the first three months of the year ending March 2010. Consumer discretionary and small-cap value categories led the way, surging 11.31% and 9.45% respectively under the prevalent assessment that the "gears of recovery" were in motion. Investor appetite for equity risk was also evident in the S&P 500 (+5.39%) and NASDAQ (+5.91%), fueling the major indices toward new 52-week highs. Meanwhile, the international EAFE Index (Europe, Australia and the Far East) and emerging markets underperformed their U.S. counterparts gaining 1.27% and 2.94%, respectively.

Investment grade corporate bonds, as represented by the Barclays Aggregate Bond Index, managed to hold ground following a pullback in late March, gaining 1.61%. Such returns were dwarfed by the high-yield "junk" bond category which rewarded investors with equity-like gains of 4.25%. Risk-averse investors were content to protect their principal while garnering only a 0.16% return for U.S. Treasury bills. The longer duration 10-year Treasury yield actually declined fractionally to 3.84%, reflecting muted inflation concerns. As a result, principal values were modestly boosted, lifting the average return on long-term Treasury bond funds +0.72% for the period.

After losing eight million jobs since the recession began in December of '07, monthly payroll changes pushed into positive territory for the first time in March. Reports indicated that 162,000 new payroll positions were added, with the gain lauded as the largest one-month increase in three years. However, enthusiasm was somewhat restrained by the fact that 48,000 of these jobs came from the hiring of temporary workers by the Census Bureau.

Despite these gains, the unemployment rate continued to linger near 10% due to the fact that the economy must add at least 125,000 jobs per month just to absorb new entrants into the labor market. A more comprehensive analysis of the employment figures remains worrisome as continuing claims rose from 4.6M to 4.65M, consistent with the U.S. Department of Labor's broader U-6 measure of unemployment (those who are unemployed, underemployed, and not currently looking), which rose from 16.5% to 16.9% during the quarter.

Stubbornly elevated unemployment numbers combined with the prospect of higher taxes and rising interest rates are hardly an attractive environment for improving consumer demand. Homeowners "running on fumes" have already faced difficult choices. As the *Financial Times* recently reported, six million American households have ceased paying their mortgage and are temporarily living rent free in their homes. Some portion of the resulting $100 billion dollars in "strategic defaults" has been redirected into consumer spending which will also inevitably come to an end.

In an environment where federal and state tax revenues continue to slide and deficits have already surged to 10%-12% of GDP, Congress will undeniably be called upon yet again to extend unemployment benefits and plug other economic gaps. Government officials face the challenging task of simultaneously administering to the pain of Main Street without adding to the already exploding budget deficits. Investor optimism will only carry the market so far without concrete solutions to these issues.