April 2012

Monthly Investment Commentary

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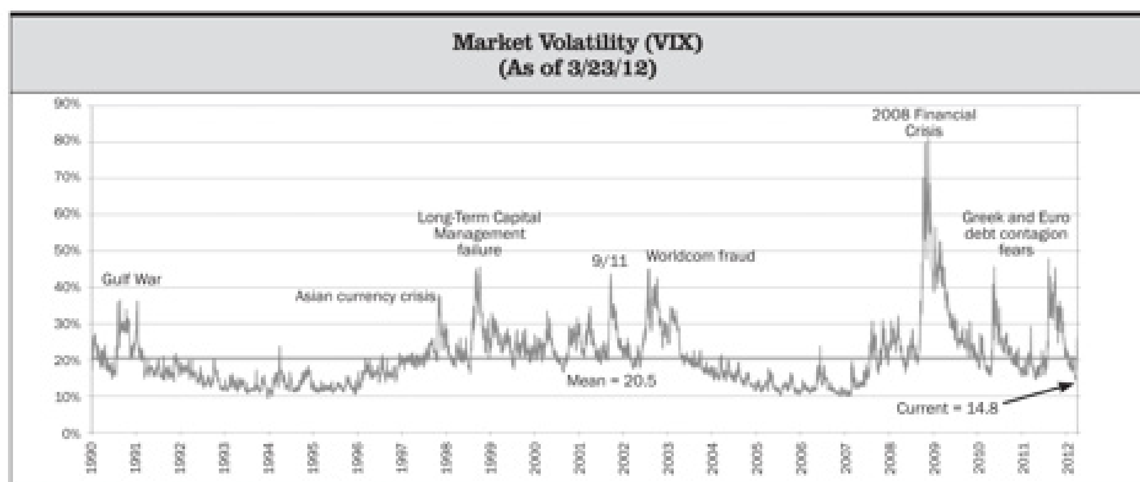
Stocks and other risk assets surged in the first quarter of 2012, continuing the strong run that began in the fourth quarter of last year. In each of the past two quarters, domestic stocks gained about 12%, marking one of the strongest runs over the October–March span going back to the 1920s. Developed foreign stocks increased nearly 12% in the first quarter, emerging-markets stocks gained 14%, small-cap U.S. stocks were up 12%, high-yield bonds rose 5%, and emerging-markets local-currency bonds added 8%.

In contrast, the core investment-grade bond index is flat on the year, as Treasury bond prices have declined and yields have increased. After bouncing around below the 2% level for much of the first quarter, the yield on the benchmark 10-year Treasury popped higher in mid-March, closing at 2.39% on March 19, 2012, its highest level since late October 2011. By the end of the month the yield had drifted down to 2.22%. But that is still up from a 1.9% yield at the end of 2011.

As a result, pure Treasury bond indexes and funds have lost anywhere from low single digits to low double digits this year, depending on the duration. (All else equal, the longer a bond or bond fund's duration, the more sensitive its price is to changes in interest rates. Rising yields imply lower bond prices, and with yields as low as they are today, it doesn't take much of a price decline to more than offset the interest income generated by the bond or fund.). We are pleased that our core bond strategies and outside bond managers that we utilize are adding value relative to their respective benchmarks this year.

Coinciding with the recent stock market rally, and after an extremely turbulent 2011, stock market volatility has subsided (although we would note that in the first quarter of 2011 volatility was similarly quiescent prior to spiking to new highs in the next two quarters). The Chicago Board Options Exchange Volatility Index, or VIX, is a commonly used indicator of market volatility. Often referred to as the "fear index" it is a measure of investors' expectations of S&P 500 volatility over the near term. The lower the VIX the less fear or risk-aversion there is in the market. As of March 23, 2012, the VIX stood at its lowest level since July 2007, and was well below its long-term average reading as well (see VIX chart below). As an aside, when the VIX reaches extreme levels it is often a good contrary market indicator, particularly when volatility is very high. That is, very high levels of volatility (fear) suggest the market may be nearing a bottom and vice versa. The VIX hit its recent peak right at the October 2011 stock market low, creating a good entry point for stock purchases.



Based on VIX Index Prices. Source: Yahoo! Finance.

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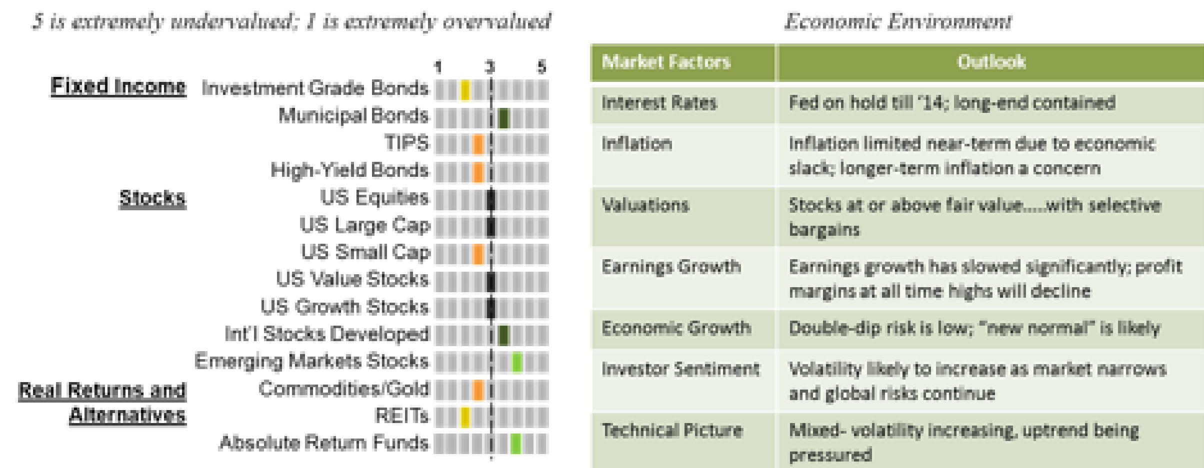
Other drivers of the rally in risk assets have been the receding fear of a European financial crisis (at least in the first quarter); positive U.S. economic data points, particularly with respect to employment; encouraging results from the Federal Reserve's latest banking stress tests; and a slowdown in the rate of inflation in China, which will allow the country's rulers to take additional measures to support growth.

We are encouraged by these positive developments, but do not believe it signals an "all clear" on the macro front by any means, we remain skeptical that the Eurozone's fundamental structural problems have been resolved and expect it will continue to be the most serious economic and financial market risk out there. Below is a summary of our outlook for the major asset classes we follow:

Asset Class Valuation Summary

Our asset class valuation and ranking methodology is based on a long-term, focused, disciplined analysis of which asset classes are over- or undervalued. We consider an asset class that is rated a "5" on our scale to be a "Fat-Pitch".



Economic Environment

Market Factors	Outlook
Interest Rates	Fed on hold till '14; long-end contained
Inflation	Inflation limited near-term due to economic slack; longer-term inflation a concern
Valuations	Stocks at or above fair value.....with selective bargains
Earnings Growth	Earnings growth has slowed significantly; profit margins at all time highs will decline
Economic Growth	Double-dip risk is low; "new normal" is likely
Investor Sentiment	Volatility likely to increase as market narrows and global risks continue
Technical Picture	Mixed- volatility increasing, uptrend being pressured

– CB&T Investment Team

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