# First Quarter 2011 Market Review

We continue to see mixed signals as to sustained market direction. While the U.S. economy shows continued improvement, political concerns both here and abroad, coupled with FED action, create an air of uncertainty. Let's quickly review some key 1st quarter activity:

**Federal Reserve**

The FED kept its aggressive action of keeping short term rates near zero in an effort to stimulate growth. At the same time, reduced its quantitative easing (QE) and announced its ending in June. True, this never tried before program improved the economy & created jobs, but nowhere near expectations.

**Political**

On the home front, the house republicans began an ambitious plan to tighten government spending. The Dodd-Frank Act rules on Qualified Residential Mortgages when into effect, which should have a profound impact on Fannie and Freddie. And, if history repeats itself, debate on the final outcome of both these issues will continue for sometime.

Overseas, Japan and the Middle East are in the news. Both crises will have an impact on our economy since 70% of our GDP is tied to consumer spending. Rising oil prices caused by the Middle East and reduction in imports from Japan.

Europe continues its woes with bailout for troubled countries.

**Corporate America**

If you isolated the activity in corporate America, one would believe all is well. But the backdrop to large number of refinancing debt to lower yields stems from the QE program. And with the new strict bank loan requirements, the large cash positions held by corporation may continue for sometime. Top line growth, though improving, has not been the catalyst for corporate profits.

**Bond Market**

We saw improvement in the bond market during the quarter with high yield debt leading the way. Rates artificially remained low by aggressive FED action. We saw some movement in Treasuries during the quarter, but at quarter end only a slight increase from 12/31. (5 year: 2.006% to 2.277% & the ten year 3.294% to 3.470%)

**OUTLOOK**

In addition to continued fallout from the crisis in Japan, disruption in the Middle East, and bailouts in Europe, we see a key inflection point in June when the FED discontinues their QE program. One would expect to see rates return to their pre-QE values. This would put the 10 year at the mid 4% level. With respect to deficits and its impact on the economy, the math is simple, the solution is difficult. The U.S. takes in $2 trillion a year and has outstanding debt of $14 trillion+ and rising. And, if you consider Fannie & Freddie, Medicare, and Social Security, the debt level is significantly higher.  Congress will continue to debate spending cuts and will hopefully have some resolution.

We continue to believe inflation could be with us during the second half of the year.  As a result, we continue buying low leveraged short maturities and low extension risk GNMA product to maintain short duration portfolios.