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capital markets review

Fall 2010

Economic Outlook

GROWTH LIKELY MODERATE WHILE AVOIDING DEFLATION

Executive Summary

The U.S. economic recovery has downshifted into a lower gear. The Great Recession was declared over, but domestic growth is trending on only a moderate growth path. Positives abound: inflation remains subdued; capital spending, manufacturing, and auto production are doing very well; and the prospect of a double dip is moderate. However, housing is only now showing signs of life, fiscal budget deficits are a continuing concern and volatility should remain high.

It's hard to tell whether we are going into a double-dip. What do you think about growth, globally?

Our base case, which calls for moderate and somewhat volatile economic conditions, appears to be playing out since spring. Moderate growth in the second quarter showed several pockets of strength, evident in manufacturing, the consumer (yes, more on that later), productivity and profits.

Selected other areas were more emblematic of weaker underlying trends. These included housing, some service sector surveys and a modest hiring pace.

We continue to see areas of good news that the market has failed to focus on. For example, personal income and personal spending are now above previous peaks, and auto sales are growing at an annual 12% pace.

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Outside the U.S., and consistent with the theme of uncertainty, the news is mixed. Europe is showing a "North-South" split. Germany is leading in nearly every measure, while the periphery (including southern members like Greece, Spain and Portugal, and others like Ireland) is facing years of adjustment in government spending and private-sector wages, as they seek to regain competitiveness. Also, the UK has formed a consensus around the biggest retrenchment in public spending and the role of the government since the Thatcher years, with some agencies facing budget cuts of over 25%. These adjustments will dampen growth in the region for the foreseeable future.

Japan is fighting deflation, mainly due to a lack

Continued on back

Matt Hamilton, CFP®
Chairman
& CEO

Tony Caxide, CFA®
Chief Investment
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Vice President
Portfolio Manager

The Interviewees

The content in this issue of *Capital Markets Review* was taken from an interview with Hamilton Capital Management Chairman & CEO Matt Hamilton, CIO Tony Caxide and Vice President & Portfolio Manager Eric Shisler shortly after the end of the third quarter of 2010.

Equity Portfolios

Through The Volatility, Equities Continue To Offer Value

Executive Summary

The equity market remains priced at a discount to levels suggested by NIA (National Income Accounts) earnings. Of course, we believe the discount gap between current price and earnings will fluctuate with changes in the level of earnings and stock prices. But investing in equities when this size of a discount exists creates a margin of safety as the market remains volatile. Further, we believe the level of interest rates will also have an impact on "fair" value, through changes in the P/E. Recent drops in the level of market interest rates, all else being equal, also tend to support stock prices.

It does not feel like it, but it appears the market did OK last quarter. True?

Although it does not yet feel great, markets did more than OK. The S&P 500 produced over 11% in total return. But it was quite the ride. A strong July was followed by a weak August and then a booming September. It can leave you breathless, but should also provide some modicum of relief, as an 11% gain in wealth in a three-month period is superb by any measure, but particularly in light of 1% inflation and 2.5% 10-year government bond annual yields.

So much for believing those simple tips like "…sell in September…." Simple is rarely the right answer with financial markets. Even more importantly, neither is frequent trading nor reacting suddenly to market volatility. Trading typically only enriches the brokerage community. And reacting to headlines also tends to lead investors to stray from their long-term plans. We always encourage our clients: if you feel you have to do something, give us a call and let's discuss recent events and confirm that your long-term "policy" portfolio is the right one for your needs. The conclusion typically is, "Yes, I do have the right long-term plan, and now I understand the market volatility a lot better, even if I still don't like it."

What are some of the fundamental, long-term drivers of value telling you?

Stocks remain one of our favorite asset classes exactly because of those fundamentals. Again, we would stress that, after the kind of significant economic storm we just went through, it's too early to say it's clear sailing from here on out. But the clouds are getting much lighter and our ship is strong.

We see hope in the kind of very strong productivity growth the U.S. economy has displayed. This has helped lift profits very close to their previous peak of 2007. It's hard to believe but it is true and not generally recognized. We also see a strong commitment from the U.S. Federal Reserve to do what it takes to manage both inflation as well as jobs. Near term this means the Fed will likely ease further if needed. But when the time comes, it may mean the Fed will tighten policy (by raising interest rates, shrinking its balance sheet, raising reserve requirements and other means) as needed to prevent runaway inflation. It seems too early to worry about that, but that day will come. And we are confident the Fed will be there when the need arises.

Lastly, we see the market still skeptical. This is healthy. As of this writing, the broad equity market is priced as a discount to its normal relationship to earnings. We are not arguing that it can't get even cheaper for some time, or that we will make up this discount suddenly. What we do argue is that earnings are the single most important factor for determining stock prices, and that the current discount provides a material margin of safety.

This leaves us with enough confidence that we have maintained our portfolio largely unchanged through all the volatility of the past quarter. That's a good thing, too, because in general our portfolios participated in the markets' strong gain and avoided a lot of needless trading costs.

What else are you thinking about?

As you know, many advisors claim to be active managers, when in fact what they mean is that the outside fund managers they select actively choose stocks. That's good, but we feel it's not enough. We also spend a lot of resources to actively manage from a top-down perspective. That means we are constantly looking for asset classes that are cheap or expensive relative to their intrinsic value. Currently we feel that both U.S. stocks and high-yield bonds are relatively cheap, so we are overweighing them in our portfolios.

Don't get us wrong – we also carefully vet the outside managers we select. We have access to the best ones. But we also have an extensive and detailed set of criteria and a sophisticated process we follow in a disciplined manner.

In Agreement

The equity markets are one of the most powerful wealth creation mechanisms in history, and the U.S. is relentlessly innovative and tenacious – I wouldn't bet against either over time.

— Ron Sloan, CIO,
Invesco U.S. Core Equity, May 2010

We continue to feel that economic growth will be modestly positive and that the U.S. economy will skirt a double-dip recession. …In such an environment, borrowing costs would be attractive and potentially help to further boost corporate profits. Also supporting the high yield market, in our opinion, will be improving credit fundamentals, declining default rates and benign inflation.

— Anne Benjamin and Thomas O'Reilly,
Portfolio Co-Managers,
Neuberger Berman High Income Bond Fund,
Manager Commentary, Third Quarter 2010.

We are confident that in the long run, stock price and intrinsic value will converge and our disciplined investment philosophy will reward shareholders accordingly.

— Thyra Zerhusen,
Chief Investment Officer, Portfolio Manager,
Optimum Investment Advisor,
Q3 2010 Portfolio Update

Fixed Income Portfolios

Bonds Post Gains As Demand Continues

Executive Summary

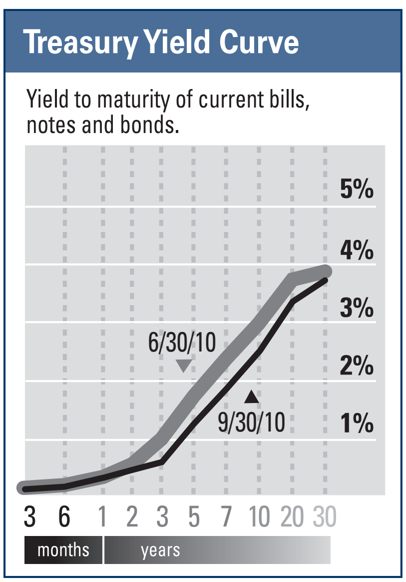
The bond market continues to be impacted by investors' concern with the worldwide economic recovery. And while many claim the bond market is priced in a bubble, our analysis suggests that is a mis-characterization. Given the current level of inflation, and monetary policy, we believe yield levels are far from extreme, even if they are at lows not seen for many years.

Although not extreme, bonds are not attractive either, in our view. We took a step this past quarter toward lower duration in an effort to reduce the impact to the portfolios should rates start to move higher as the economy continues to recover. Our greatest allocation in bond portfolios is focused on high-quality corporate bonds (or municipals, depending on the strategy) with a lesser allocation to government-backed issues. And, with an attractive risk/reward relationship, we have maintained an overweight exposure to high-yield bonds in appropriate portfolios.

What took place in the bond market last quarter?

U.S. government bond prices generally rose slightly over the quarter. These gains, however, were at a much slower rate than in the second quarter, when fears of a default in Europe sent shivers through the world markets and sent investors fleeing for the safety of Treasury bonds. As concerns of a potential European sovereign debt default faded and the worldwide economic recovery continued, investors appeared willing to pursue riskier investments in an effort to achieve potentially higher returns.

Gains in the U.S. Treasury market were primarily driven by another factor – the sense that inflation is surprising on the downside, which makes fixed-income investments more attractive.



Headlines have been alluding to a bubble in the bond market. What's Hamilton Capital's view?

First it's important to note that there are different sectors of the bond market – U.S. Treasuries, corporate bonds, mortgage-backed bonds, high-yield bonds, and municipal bonds, among others. Most of what we see in the headlines today is specific to the U.S. Treasury market, so we'll focus our comments there.

Market bubbles inherently imply that a given asset class is excessively priced relative to its intrinsic value. One example of an obvious asset bubble was the TMT (technology, media, telecom) sector of the U.S. stock market in the late nineties and early 2000s, when many companies were valued in the hundreds of millions of dollars before they generated any revenue, much less posted any profit.

We've heard and carefully assessed the rhetoric by many pundits. Their arguments typically focus on the generationally, absolute-low levels of interest rates, or the fact that the bond market must be overvalued simply because it's outperformed many major stock indexes over the past decade. We find these to be insufficient and superficial.

Why aren't those good enough reasons to call it a bubble?

We don't base our investment analysis simply on the current price or yield levels, nor on necessarily what happened to those metrics in the past. We review markets' valuations through the screen of fundamental factors and in the context of future expectations. When studying Treasury bonds and interest rates, the principal fundamental is core inflation. Hence we prefer to analyze the real yield – the yield adjusted for inflation. Current levels of rates, albeit low on a nominal basis, are not at extremes when measured after core inflation.

Another consideration for understanding relative values in the bond market is awareness of monetary policy. Given that current policy is focused on stimulating economic activity and the Federal Reserve is holding the Fed funds rate at 0%-.25%, it's not surprising that yields in general are at lower levels.

Therefore, while we believe the U.S. Treasury bond market is fully valued and other segments of the bond market offer more attractive risk/return profiles, we do not feel that government bond yields suggest a bubble.

How are you managing bond portfolios in this market?

Although we would push back on the notion of a bubble, we are not necessarily enamored with government bonds. As rates have fallen sharply, the risk/reward characteristics of the asset class have become less attractive. Treasury bonds offer less return opportunity for further gains plus greater risk that an economic recovery and higher debt issuance by the federal government could frighten investors. In other words, this asset class does not offer much of a risk cushion.

As a result, we moderately reduced the duration of the investment-grade portion of many bond portfolios by moving from 90-95% of target to 80%. By reducing duration we are lessening the negative impact increasing rates have on bond portfolios. In terms of market sectors, for accounts invested in taxable bonds we have not changed our emphasis in corporate bonds over Treasuries or agencies, and are maintaining an allocation to high-yield bonds. From the quality perspective, we are still focused on higher-quality bonds in the corporate and municipal bond areas. And, although the high-yield portion carries greater risk, we feel the relatively higher yields currently available in the sector more than compensate for this additional risk.

Economic Outlook

(Continued)

of demand. The previous 20 years show how hard it may be to get out of a deflationary trap. However, emerging signs of growth offer some promise, and we see even some tentative signs of spring on the deflation front.

Since you're on the subject, all of a sudden everyone is talking about deflation… in the U.S.! You were talking about this more than a year ago, before others. Are we facing deflation in this country?

We admit to often "leaning against the wind" of common wisdom, which often turns out to be much more common than it is wise.

Six to 12 months back, the refrain was along the lines of "…with all this spending, inflation is right around the corner…." At that time we felt (and continue to think today) that the pressures of inflation and deflation were fairly comparable, and that inflation was at risk of slowing. It's called *disinflation* (as opposed to *deflation*, which refers to a persistent *drop* in prices) and we are in it, as consumer price increases have slowed to an annual rate of just under 1%.

Now that everyone has become a "deflation" disciple, we again are tempted to lean the other way, if only modestly. The structural forces that led us to predict slowing price growth are still there – high unemployment and excess capacity globally, low wage growth, and modest pricing power by corporations. We still do not see rapidly accelerating inflation near term. However, we also feel that although close, we will skirt actual deflation or, if we do experience falling prices, it will be temporary and mild. We feel that the U.S. central bank is determined to manage this risk and will do what it takes – including engaging a second round of "quantitative easing".

However, we remain very watchful. Policy makers throughout the world have only a modest understanding of managing deflation, so the risk does require attention.

The U.S. dollar has also hit the headlines. Is it really collapsing, and what does it mean for the economy and financial markets?

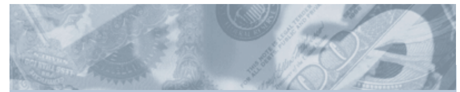
The level of the U.S. dollar is another example where a kernel of truth has been taken to an exaggerated and extreme conclusion. Albeit volatile, we do not feel that the U.S. dollar is in an overpriced bubble, and the recent headlines of weakness are focusing on too short a time frame (since early June). In trade-weighted terms, the U.S. dollar is roughly where it was a year ago, a little higher than two years ago, and comparable to levels three years back. And policy makers are not intentionally trying to weaken the U.S. currency relative to most of our trading partners (although the Chinese yuan is another story).

An additional pull-back in the U.S. dollar – so long as it is not excessive – could be just what the doctor ordered: an additional stimulus to growth from exports and help in avoiding persistently falling prices.

So, in essence, we would say – so far, so good.

We have a big mid-term election coming up. Certainly it will have an impact on the economy, won't it?

Actually, this election may merit all the attention that it is getting, but for the wrong reasons. In our view, the actual make-up of the Congress after November 2 is likely not the main event. The most important issue for financial markets may be that they see some clarification after the election – not necessarily in terms of who wins what, but rather as a function of what the presidential budget commission says about fiscal responsibility, how they say it (does a consensus emerge among its 18 members?), and, finally what the Administration and Congress then actually agree to do over the next two to three years. A gradual but believable reduction in deficits may be the best solution, and one that both ensures we do not "pull the plug" on the recovery prematurely while also setting the stage for persuasive structural fiscal reform.



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