HAMILTON CAPITAL MANAGEMENT
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capital markets review

Spring 2011

Economic Outlook

Consensus View Shifts To "Sustainable" Recovery, Even With Inflation Worries

Executive Summary

The roots of the U.S. economic recovery continue to gradually expand their reach, and investor perceptions are becoming more uniformly positive. This is remarkable given the significant events across the Arab world, Japan and peripheral European countries like Portugal. New jobs are suddenly approaching "peak" average levels from the two previous recoveries, the consumer continues to quench strong pent-up demand with robust spending, and manufacturing is re-accelerating. Housing remains weak, but few expect much from this sector for the time being.

The most recent investor concern is inflation, and appropriately so. But so far it has had limited repercussions on markets. Inflation is indeed rising on strong commodity prices and should remain a concern for some time. But several forces are expected to constrain its increase.

Last quarter you spoke of downside and upside risks. The latter seemed optimistic then, but now it appears that many are coming to believe in a stronger growth scenario. Do you agree?

It feels a little like the spring of 2010 – just when people are starting to believe in a recovery, we are hit by crises. Back then it was Greece and the whole question of whether some peripheral nations in Europe could repay their large debts and be competitive. Now, that issue remains – most recently with Portugal requesting assistance from the EU and IMF – but we also have people's revolutions across the Arab world, a natural disaster in Japan (with associated, not-so-natural nuclear fears) and commodity prices rising sharply. And still earnings are strong and GDP rises.

When we ask ourselves whose inflationary problem we would rather have, typically the answer turns out to be the U.S.'s.

And this strength is coming from where?

In many ways and sectors, this recovery remains gradual, and slower than what might be labeled "average". But expectations had become so shaken that even that is positive. If there is a surprise in

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The Interviewees

Matt Hamilton, CFP®
Chairman
& CEO

Tony Caxide, CFA®
Chief Investment
Officer

Eric Shisler, CFA®
Vice President
Portfolio Manager

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 first quarter of 2011.

Equity Portfolios

Confidence In Equities Rising

Executive Summary

In spite of a number of geo-political concerns and significant natural events, U.S. corporate profits reached record levels in the fourth quarter of 2010, driven by the financial sector, and confidence in stocks rose. Inflation will likely increase and interest rates are sure to follow. But we feel that these increases will be constrained and, in terms of their impact on stock prices, are likely to be offset by the benefits of moderate inflation on corporate pricing power.

Once again it feels that the world is filled with problems and yet markets are performing pretty well. How?

You're right on both counts.

We continue to hold the view that, given the severity of the economic and financial market events of the last few years, it's probably going to be an awkward recovery, with improvement often masked by numerous difficult symptoms of the previous excesses – be they political gridlock on reducing deficits, painful cuts to retirement and health benefits previously awarded during flusher times, a more sober approach to consumer spending, and even the disclosure of insider trading, Ponzi schemes and similar criminal events so often associated with uninterrupted prosperity.

However, markets look ahead, and the equity and high-yield bond markets in particular are saying that, if fundamentals deteriorated in the last cycle, prices had corrected even further, and appear to still offer value in spite of all the uncertainty.

At the risk of belaboring the issue of things to worry about, please talk about the impact of inflation, which seems to be a key risk.

In an environment where many fundamentals remain largely supportive, inflation is certainly one of the key risks to worry about. As part of our top-down assessment of relative value from one asset class to another, the future direction of inflation can play a key role in our assessment of future returns. Thus, we monitor the various components of inflation regularly and reflect it in our strategy where changes are warranted.

We feel that rising prices at both the headline and core level (see Economic Outlook for more detail) could put some pressure on interest rates. Certainly it should eventually contribute to the Fed's shift away from aggressive stimulus toward a more neutral monetary stance.

In the context of our investment horizon of 12-24 months, we currently feel that fundamental building blocks remain constructive for the inflation outlook (the output gap remains very large, unemployment high, capacity utilization relatively low and wage growth still below productivity growth). Unlike emerging economies, which are heavily impacted by commodity prices, the U.S. economy is more heavily dependent on labor costs. A recent study by Wharton indicated that the generation of $1 of U.S. GDP now requires half as much energy input as it did during the 1970s energy crisis.

From an equity perspective, our view for the next 12-18 months is that any negative impact that would accrue from rising interest rates (provided they are constrained, as we feel they will be) will likely be offset by the positive impact on earnings. It's often not well understood that stocks perform well in environments of moderate inflation as they tend to benefit from pricing power. In fact, some feel that this asset class is the primary beneficiary of moderate inflation.

Nevertheless, we continue to use scenario analysis to monitor and anticipate the rate of inflation, which we believe will remain constrained. We feel this depends somewhat on three "high-wire" acts:

- Effective and timely removal of monetary stimulus/excess liquidity in the U.S.
- Agreement on establishing a credible glide-path toward gradual decrease in fiscal deficits (on this measure, the recent "watch negative" rating of the U.S. as a creditor by S&P brings some welcome pressure to this political process).
- Resolution of both the Middle East revolts and Japan's supply chain problems without unduly long or strong impact.

Given your outlook, do you anticipate significant changes to your portfolio strategy?

There is an alleged old Chinese curse, masquerading as a deceptively mild proverb: "May you live in interesting times." We've used this over our many years in the investment business, often to lighten the mood in a difficult stretch in financial markets, but it certainly took on a different flavor in the last three years. And, no, we don't blame the Chinese for it.

We have effectively had a fully invested portfolio for all of the last year and continue to feel that remains appropriate, although we have made modest changes over the last few quarters as valuations have shifted. Our most recent update of expected market returns effectively confirms that our current stance remains largely appropriate. Thus we anticipate that changes over the next quarter or so will remain moderate and evolutionary, unless we see a significant shift in market valuations that create an opportunity for us.

In Agreement

Even after last year's gains, high-quality large-cap stocks still look attractive, especially in contrast to more speculative issues.

— Todd C. Ahlsten, Portfolio Manager,
Parnassus Equity Income Fund,
Annual Report, December 31, 2010

We have never attempted to maximize short-term results, as we do not believe that our investors would be adequately compensated for the level of risk that we would assume.

— Andy Pilara, *et. al.*, co-portfolio managers,
RS Value Fund, First Quarter 2011
Mutual Fund Commentary

Getting the U.S. financial house in order is absolutely essential. … [h]owever, this country has run federal deficits almost continuously in the last half century, and while experiencing great volatility in inflation, interest rates, and stock prices, America has generated spectacular economic growth, job creation, and wealth. So, worry some over deficits, but don't "over-worry"!

— James Paulson, Ph.D.,
Chief Investment Strategist,
Wells Capital Management,
Don't "Over-Worry" the Deficit, April 18, 2011

Fixed Income Portfolios

Positioning For Higher Rates, But Expecting Increases To Be Constrained

Executive Summary

Strong growth and higher inflation pressures are leading markets to anticipate the Federal Reserve's removal of its aggressive stimulus and, consequently, somewhat higher interest rates. However, bonds can and should play a role in many portfolios for income and risk-mitigation reasons. We also continue to find value in high-yield bonds for select portfolios. These fixed-income instruments are more driven by their credit characteristics and, in fact, tend to have shorter durations, which reduce their exposure to rising interest-rate risk.

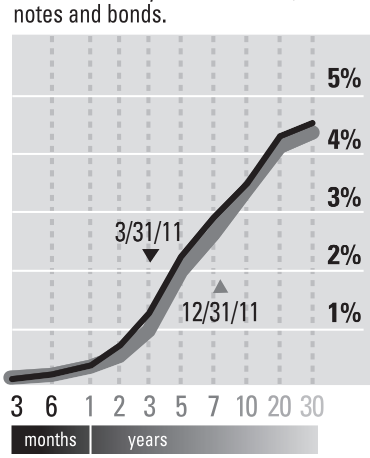
Municipal bonds, recently the focus of many concerns, have not melted down as many anticipated. Risks remain abundant, however, but are somewhat mitigated by our strategy.

Interest rates have increased over the past two quarters. Do you expect them to continue to move higher?

We do expect interest rates to move somewhat higher for a couple of reasons. First, the U.S. economy continues to recover, which will likely prompt the Fed to start removing its stimulus policy actions over the next few quarters. As the market begins to anticipate this eventuality, we expect interest rates will start to move higher. But this increase may not be linear and we could see periods of increase followed by periods of reversal as the market tries to understand the trade-off between quantitative tightening (QT, as we just christened it) and higher rates.

Treasury Yield Curve

Yield to maturity of current bills, notes and bonds.



The second reason stems from the rapid inflation rates that emerging markets have been experiencing. Many young economies have experienced strong economic growth, leading to rising pressure on basic commodities like food (wheat, rice, corn) and energy (oil). In order to prevent this new global demand from pushing prices too much higher, we expect these countries will continue to increase interest rates in an effort to slow growth as it nears overheating levels and head-off high inflation.

So if you expect interest rates to increase from here, should we avoid all bonds?

Even in difficult bond markets, fixed-income instruments retain many of the valuable characteristics that made them an appropriate part of a portfolio in the first place. These include steady income generation through the ups and downs of various market cycles and historically lower volatility than stock prices – both of which suggest bonds can be suitable stores of capital and can mitigate portfolio risk in many market conditions.

Nevertheless, rather than blindly holding a predefined bond allocation, the current environment does require purposeful and active management of the fixed portfolio. As we allocate assets from one asset class to another, we carefully develop a base case for the macro-economic environment (including growth and inflation) and a number of alternative scenarios. Then we translate these into a portfolio design that seeks to capture both our base case view as well as a strong understanding of likely alternative paths for the economy.

So how is Hamilton Capital managing bond portfolios in the current market?

Among other characteristics, we're implementing a bias toward higher rates of income generation. In markets where rates are likely to increase, investing in bonds that distribute cash flows relatively quickly means greater amounts of capital are being reinvested at higher interest rates. This has the potential to lessen the impact of increasing interest rates. This, combined with a bias toward price stability, means that we are buying bonds with shorter durations (or maturities) than our neutral or normal stance.

Additionally, our fixed income portfolios continue to favor high-yield bonds on a relative basis. Although they carry higher levels of credit risk, they tend to carry less interest-rate risk as they are often of shorter maturities, and a greater portion of their return is driven by the large coupon payments they generate. In the current environment, we also feel this asset class will benefit from our constructive outlook on the general financial strength of corporate America and earnings patterns, which supports high yield issuers' ability to pay their debts. Lastly, high-yield bonds appear to still be attractively valued based on historical valuations in spite of very strong past performance.

Given the headlines from a few months ago, which pointed to severe municipal bond market pressures, can you give us a market update?

To date we have not seen the wide-scale meltdown that was forecast. That doesn't mean we're clear of all risks at this point, as budget negotiations on every level of government continue to take place. But those who anticipated a collapse appear more focused on an issuer's liabilities than many municipalities' fiscal resources, like their ability to raise revenues and cut expenses.

We continue to monitor the marketplace closely and are looking for areas that may turn troublesome. Our focus remains on solid credits that represent general obligations of the issuer, are backed by essential purpose revenues (like sewer or water), or represent other obligations of issuers outside the direct municipal government realm, like universities or bonds backed by electric revenues.

Economic Outlook

(Continued)

the area of growth it probably lies with manufacturing, which is displaying reaccelerating growth, with hiring and production surveys that exceed previous peaks.

Many curmudgeons (and we know a few) have mournfully described the alleged collapse of the U.S. manufacturing sector. However, we have long believed that this is a normal part of economic evolution that is occurring in most developed economies, including Germany, which is widely seen as a manufacturing powerhouse. The U.S.'s manufacturing efforts are increasingly focused on high-valued-added activities, which serve to supplement our service sector, where the U.S. also has a strong competitive advantage.

Another source of strength is job additions, which suddenly are perceived as robust and sufficient enough for unemployment to fall. We would observe that additions to payrolls are now broadly on a par with average peak levels in recent recoveries – probably a surprise to many.

Maybe we fall into the curmudgeon category but we're worried about inflation. Isn't it really rising, and if so, won't it spell doom?

Inflation is indeed rising, and it's appropriate to be very watchful. But we don't feel that the nature of the increase spells disaster.

As we previously noted, we look at a large number of measures of inflation so we can form a complete picture. Focusing on a single series or fixating on a single facet is inadequate in our view. Currently, the focus is on rising food and energy prices. The prices of these inputs can be very volatile and they are causing the "all-items" measure of inflation to begin to rise. However, while these rising prices are grabbing headlines, other inputs are serving to temper inflation. Two notable examples are a lack of upward pressure on labor costs (a large portion of corporate America's cost structure) and excess global manufacturing capacity.

With that said, we do expect that both "all-items" as well as "core" (ex-food and energy) measures of inflation will continue to rise. The former could easily approach 3.5-4%, while we anticipate core inflation (the series most closely watched by the Fed) will stabilize in the range of 2-2.5% (within the Fed's comfort zone). The latter increase will actually be a "good" thing. Although it's not widely understood, we just had a close brush with something quite dangerous – deflation (a persistent drop in general prices) at the core level. We feel that policy makers have steered us away from that precipice – an important victory for our central bankers.

Isn't the U.S. dollar weak and doesn't that spell inflation problems?

All else being equal, a weaker currency can lead to rising inflationary pressures, and the dollar has indeed pulled back on a trade-weighted basis (our favorite way to analyze it). And yet, in the current environment, the weaker dollar seems to be having a positive impact on exports (also a normal outcome of a lower currency) without an uncontrolled, negative impact on U.S. inflation.

To better assess this, it's important to look at U.S. inflation in the context of other countries, particularly since our portfolio strategies choose among the most attractive global asset classes based upon relative value. Currently much of the world is experiencing materially higher inflation rates than the U.S. despite our stimulative monetary and fiscal policies, a weaker currency and the perceived risk of large fiscal deficits.

Emerging markets like Brazil and some commodity-dependent economies have a significant inflation problem, even with rising and/or strong currencies. In the developed world, the UK is experiencing a pace of inflation between 5 and 6%. Europe's inflationary pace also may be marginally higher than ours, despite a strong currency that some judge to be 20% overvalued relative to fundamentals.

So, net of all this, we continue to monitor developments, but when we ask ourselves whose inflationary problem we would rather have, typically the answer turns out to be the U.S.'s.

THE HCM ADVANTAGE

The largest investors often have the benefit of sophisticated internal investment departments led by a qualified Chief Investment Officer to design and manage their investment portfolios.

Unfortunately, most investors can't maintain an internal team of that caliber. But if having an external investment team of that sophistication is something you could gain from, then we're here to serve.

We function in a fiduciary capacity as an external Chief Investment Officer for our clients. Our structure is similar to the investment departments of large, sophisticated institutional investors, and our team has extensive global investment experience. In fact, several of our team members have received national recognition for their abilities and accomplishments.

Each day, we diligently apply our disciplined investment process to the design and continuous, forward-looking supervision of your portfolio. Our goal: To build a complete investment solution for you.

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