O'Brien Management Quarterly Review

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Economic Overview

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The economy appears to be nearing the point of self-sustaining recovery. Recent data indicates improvements in profits alongside new job creation and fewer jobs lost. These positive developments have contributed to the continued rally in the stock market. There will be some choppiness in the economy and the markets this year, however, because it will take years to return to full employment and questions are currently being raised as to whether the surging stock market is reflecting unrealistic profit and growth expectations. Longer-term interest rates have risen, reflecting the improvements in economic data. During the quarter, O'Brien Management positioned its clients for this possibility of increased rates.

EMPLOYMENT

The March employment report provided evidence that a moderate economic recovery has begun to take hold. Non-farm payrolls increased by 162,000 and the unemployment rate held at 9.7%. Approximately 50,000 of these job gains were Census hires, and those jobs will eventually go away. The permanent jobs that were added were broad-based and represented most segments of the economy. In addition to job gains, there have been fewer job losses. Initial jobless claims still remain at a concerning level but they have declined markedly from a year ago, as the current four-week moving average is at its lowest level since September 2008. However, there is still much work to be done. Of the 15 million people unemployed in March, almost half of them, or 6.5 million, had been unemployed for over 27 weeks. It will take several years for the U.S. to return to a state of full employment.

A lingering concern is employment by U.S. small businesses. At his December Congressional testimony, Mark Zandi of Moody's Economy.com noted that small businesses are vital to U.S. job growth. He testified that companies with fewer than 100 employees accounted for nearly half of the net jobs lost during the Great Recession. And, as we highlighted in our last quarterly letter, small businesses are important because, according to the Commerce Department, they have provided more than half of U.S. net new jobs over the past ten years. The most recent February survey conducted by the National Federated Independent Business (NFIB) still showed signs of stress for small business owners. Sales remain weak due to price weakness, capital spending has been shelved, credit is difficult to obtain, and there is little demand for capital or labor. Perhaps the March NFIB survey will show improvements that dovetail with the recent improvements in U.S. economic data and show small business improvements in profits, sales and investment that will lead to more hiring. And perhaps these small business concerns will be alleviated through future possible government efforts to support these businesses. But for now, it is a segment of the economy to monitor.

PROFITS

Improved large company profits are one of the key reasons we are finally seeing job gains. In each of the past three quarters, the majority of public companies have soundly beaten Wall Street analysts' projected earnings expectations. As companies see their profits, profit margins, and productivity improve, they are more willing to add staff and invest capital in new projects. Margins and profits can improve from cost cutting, an improvement in sales volumes, increased prices, or some combination of these factors. Over the past six months, profits have improved primarily because of company cost cutting and lowered labor costs. Until the most recent quarter, sales gains have been mostly non-existent during the Great Recession. But sales projections have begun to increase, and realizing these projections will help increase profits further. Companies have recognized the improvements in profits and the upcoming improvements in sales, and they have begun hiring in response to the improved business conditions.

The improvement in profits is also why we have witnessed the stock market's parabolic rebound since the March 9th 2009 lows. The velocity of this 77% rebound is historically unprecedented. Granted, the stock market is still 23% below its October 2007 highs, but does this market really deserve to rally back to those levels so soon? After all, a significant contributor to the stock market's run up to its 2007 highs was the leverage in the system. Consumers were levered, boosting spending, housing prices, GDP and stock prices. That leverage no longer exists to the extent that it once did. The financial industry was also highly levered and profitable, boosting its 2006 contribution to the S&P 500's market value to 22%, where it was the S&P's largest segment. Today, financials represent 17% of the S&P 500 and they are not nearly as profitable as they once were.

The stock market is a forward-looking mechanism. It does not only reflect today's state, but it also reflects future expectations. The numbers that analysts are projecting for S&P earnings in the second half of 2010 and in 2011 are close to the earnings figures registered in 2006 and 2007. The question is whether the analysts' robust earnings projections are too rosy, and hence, that the stock market is reflecting unrealistic expectations. Analysts' expectations seem to have diverged from economists' more modest economic growth expectations.

INTEREST RATES

The level of intermediate and longer-term interest rates will typically reflect real economic growth and inflation expectations. Based on the improved economic data, economists are calling for 2010 real GDP growth of close to 3%. Inflation expectations, based on the breakeven inflation expectations priced into Treasury inflation protected notes, are close to 2.3%. Thus, the level of interest rates on intermediate and longer-term interest rates should be approximately 5%. Indeed, the ten-year Treasury recently touched 4% and thirty-year Treasuries are above 4.7%. In January, when ten year Treasuries yielded 3.6%, we felt that intermediate to long-term interest rates were destined to rise over time. The economy was improving. Inflation remained subdued, influenced by weakness in wages and rents. We felt that interest rates should be closer to 4% than 3.6%, and were further convinced of this due to the amount of upcoming Treasury supply that would be needed to finance the deficit. Thus, we reduced our clients' exposure to the more interest rate sensitive bond funds that we owned in favor of less interest rate sensitive funds. The trade was made not so much to make money, as we made quite a bit of money in the bond market in 2009, but to guard against losing money. We maintained some exposure to the more interest rate sensitive bond funds to hedge against the prospect of deflation or a "double dip" recession. Both of these risks would cause intermediate to long-term interest rates to decline, benefiting the more interest rate sensitive bond funds.

This quarter's economic data has laid the groundwork for the nascent recovery to turn into a self-sustaining recovery. Employment and profits are improving and this bolsters confidence. Confidence is what encourages employers to invest in their businesses, and thus, we should see further improvements in employment and profits as businesses rehire and begin to see top line sales growth.

Market Update

By: Allison S. Gates
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The rally that began on March 9th 2009 just won't quit. Since then, through March 31st 2010, the S&P 500 Index grew almost 77%. Even so, the S&P is still about 23% below its 2007 peak, reminding us that the uptick in stock prices requires even more staying power to recoup investors' losses.

In the stock market, as well as in our clients' portfolios, all domestic capitalizations and styles outperformed their international counterparts. In the U.S. stock market, small and mid-sized value stocks led the way, with small and mid-sized growth stocks next in line, and large cap stocks finishing last. But The MSCI EAFE Index, which tracks stocks from developed countries, plagued by sovereign debt fears mainly focused on Greece, was barely in the black for the quarter, gaining just less than 1%. The MSCI Emerging Markets Index didn't fare much better, returning 2.4% on the quarter. The U.S. bond market performed well, with the Barclays Aggregate Index returning 1.8% over the three-month period.

Over the past quarter, one market recovery theme continued and another was reversed. First, low-quality assets have continued to outperform high-quality assets. This trend began with the bull market rally last year when investors warmed to riskier assets on evidence that financial markets would avoid Armageddon. In the stock market, this means that stocks of companies with shaky financial footing, comparatively high debt levels, and that lack sustainable competitive advantages have gained more quickly than their higher quality counterparts. In the bond market, the increase in risk-taking is reflected in investor interest in high-yield bonds. According to data from Cambridge-based EPFR Global, high-yield bond fund inflows set a weekly record for the week ending March 10th 2010, bringing in over $1 billion. Furthermore, in the first quarter there was $60 billion of new high-yield bond issuance, which is a record according to Fitch Ratings, the global rating agency. What may be more telling is that a high percentage of these new issuances are unsecured by assets, making them inherently more risky. According to Fitch, 80% of new high-yield issuances in March were unsecured. In contrast, after the worst of the 2008 credit crisis, 60% of new high-yield bond issuances were unsecured by assets. This increase in risk appetite in both the stock and bond market has been fueling the persistent market rally.

A trend that reversed itself over the last quarter is that of emerging market stocks outperforming domestic stocks. This is the first quarter in the post-March 9th rally in which domestic stocks have outperformed their emerging market counterparts. The S&P 500 gained 5.4% over the past quarter while the MSCI Emerging Markets Index was up only 2.4%. This is not entirely a surprise given the emerging markets' 81% gain since March 31st 2009 – this exuberance could not be sustained. However, there are more substantial factors that have also contributed to this trend reversal. Investors are worried about emerging market stock prices in the near-term due to country-specific issues.

The major Chinese and Indian market indices serve as stark examples of this trend reversal. Since their respective bear market lows*, China's Shanghai Composite Index has returned 95% and India's Sensex Index has gained 115%. From its March 9th 2009 low and throughout the rest of 2009 the S&P 500 grew 68%. However, during the first quarter of 2010, the Shanghai Composite returned -5 % and the Sensex added 0.4%, while the S&P 500 returned over 5%.

Though we believe that long-term prospects for emerging market stocks are robust, there are certain issues that may hamper their near-term performance, namely the tightening of monetary policy, and possible looming asset bubbles. Last quarter, China and India both tightened monetary policy. The People's Bank of China raised reserve requirements. The Reserve Bank of India both raised reserve requirements and increased short-term lending and borrowing rates by 0.25%. Further fears that the Chinese government will reduce its generous spending have caused ripples in other markets that depend on China's robust demand for their products. For example, Brazil relies heavily on China's demand for iron ore and soybeans and those markets would suffer if China's spending decreased. Brazil is facing near-term challenges of its own, however, with prospects for rising interest rates and the possibility that a less market-friendly president will be elected as President Luiz Inacio Lula da Silva's term comes to an end this year.

There is also the fear of looming asset bubbles, one of which is the Chinese real estate market. According to Chinese government statistics, a record $560 billion in real estate was sold in China last year, representing an 80% increase from 2008. Furthermore, house prices have risen 150% since 2003 in Shanghai, which is considered to be the center of the Chinese housing boom.

While near term prospects for certain large emerging markets look to be dampened by tightening monetary policy and potential asset bubbles, individual stock selection becomes increasingly important. Our approved emerging markets fund, Lazard Emerging Markets, outpaced the index last quarter by nearly 4%, experiencing just over a 6% return. We expect the investment management team to continue finding stable companies at excellent values even during this challenging near-term landscape. In the long-term, we expect the strong macroeconomic prospects for the emerging markets to drive robust returns.

As we pass over the peak in unemployment and business hiring increases, prospects for the 2010 stock market look good. However, returns will most likely be a bit more muted than we have grown accustomed to in the last year. In the coming months we will continue to evaluate our individual mutual fund holdings and broader asset allocations to best position our clients' portfolios to reach their objectives.

*China's Shanghai Composite Index Low: 11/4/2008
India's Sensex Index Low: 3/9/2009

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