

INVESTMENT OUTLOOK

1st Quarter 2010

Like many Baby Boomers, I am a product and devotee of pop culture. That's why current events often remind me of situations, songs and TV shows of our past. I recently heard the lyrics to the 1980's song, *The Heat is On*. I flashed back to the song as the sound track to the movie, *Beverly Hills Cop*, and *presto*, I found the theme for this quarter's *Investment Outlook*.

The song was written by Glenn Frey and the first verse is:

*The heat is on, on the street
Inside your head, on every beat
And the beat's so loud, deep inside
The pressure's high, just to stay alive
'Cause the heat is on*

It's no leap of linguistic faith to say, "The heat is on the Fed." Global sounds of higher interest rates are beating to this driving rhythm. The Reserve Bank of Australia just raised its "cash rate" (the equivalent of our Federal Funds rate) by 25 basis points. China, the 800 pound gorilla Americans love to hate, is reveling in its economic growth. It has already begun its program of internal growth rather than relying on exports to whining, left-leaning countries like America, to keep its economy lubricated. Just imagine a China that concentrates on internal middle class growth. If successful, its days of an open checkbook for buying hundreds of billions of US Treasuries for us to finance our trillions of deficits may be closing. Scary thought.

We Americans need to "get it". We need to force our representatives to live within our means. Borrowing more to paper over deficits won't work like the old days. For those of us who have saved, we know the miracle of compounding. For our country, states and cities that have borrowed in the credit markets to fund deficit spending they couldn't afford--the nightmare of negative compounding is now haunting them.

Our local and national debt clocks are ticking. That's why the heat is on the Fed. The US owes approximately \$12.66 trillion--a difficult number for anyone to comprehend. Let's make it easy. This \$12.66 trillion is roughly \$115,425 for every US taxpayer.

The ten-year bell weather US Treasury bond ticked up to 4% in the first week of April and there it hovers. Look at this chart going back to 1980.



If this were a stock chart, your response would be:

- A. Wow...this is one sick-looking company
- B. Is this the stock chart of General Motors?
- C. Is this a trick question?

Actually, this is the yield chart of the ten-year US Treasury bond beginning in 1980 through the excruciating 1981 bond bear market; then through the Great Recession we just survived. There's no doubt about it--yields are rising. The bond vigilantes, global bond investors who consider our monetary and fiscal policies inflationary, are back selling bonds. These vigilantes see our massive debt, artificially low rates and our lack of fiscal

restraint as a Molotov cocktail.

The "Heat is On" the Fed and on us. For those of you with new accounts, we are investing in the front part of the yield curve--seven years and shorter. For all existing clients, we are replacing maturing bonds and bonds that are called with callables and bonds at the yield curve's front end. We want to be opportunistic in a rising rate environment.

At this point in the economic and interest rate cycles, we are more concerned with interest rate risk than with credit risk in the corporate bond space. In the municipal bond sector, we are concerned about both.

The real miracle of this Great Recession is that rates stayed so low for so long in spite of the throbbing, bulging and ballooning deficits--deficits on all levels.

Patience now will be rewarded with higher yields later. The fix is in and "The Heat is On."

We welcome your questions and comments. A special thanks to those of you who have thoughtfully referred your family and friends to us. We graciously appreciate your confidence and your referrals. Have a wonderful Spring!