



# investment update

**Sunil Swami**

President and Chief Investment Officer  
Alerus Investment Advisors

**Alerus**<sup>™</sup>  
FINANCIAL

spring 2010

## stocks roll on

As the U.S. and global economies continued to recover from the worst recession since World War II, the stock market extended its rally in the first quarter of 2010 with the Dow Jones Industrial Average up 4.1%. With financial stocks outperforming, up nearly 11% in the first quarter, the broad Standard and Poor's 500-stock index was up even more—4.9%. Smaller and lower-quality stocks of companies most dependent upon a cyclical economic recovery did the best. The Russell 2000 rose 8.5% in the first quarter of 2010.

International stock markets did not do as well as the U.S. The Dow Jones World ex. U.S. Index rose only 1.4% during the first quarter. Greece's debt problems and potential spillover into other countries such as Spain, Italy, and Portugal, hurt European stocks. Germany's DAX was up 3.3% and France's CAC only 1%. However, an improving U.S. economy strengthened the U.S. dollar relative to the Yen, helping Japanese exporters. And, despite Toyota's problems in the U.S., the Nikkei index was one of the world's best performers, up 5.2% for the first quarter.

Emerging markets, the star performers of 2009, cooled off during the first quarter of 2010. A double-digit inflation rate caused the Reserve Bank of India to raise interest rates. Mumbai's Sensex was flat for the first quarter. The Chinese government increased bank reserve requirements to reduce consumer lending. And as the Federal Reserve began pulling back some of its emergency liquidity facilities, investors reduced their exposures to the world's riskiest stock markets. China's Shanghai Index fell 5.1% and the Hang Seng fell 2.9%.

## retail investors love bonds

Despite the huge rally in stocks since March 2009, individual investors have shunned stocks. They have moved money from money market funds and bank deposits and poured it into bond mutual funds. Consumers in the U.S. are de-leveraging and increasing savings to help them retire. With cash rates close to 0% and the memory of the recent stock market debacle

fresh in their minds, retail investors have made bonds their asset class of choice.

As a result of the influx of money into bond funds, the Barclay's Aggregate Index delivered a total return of 1.8%. Corporate bonds did better—up 2.3% for the first quarter of 2010. Like stocks, low quality “junk” bonds of the most speculative companies did the best. Risk premiums for investment-grade corporate bonds fell below 2% for the first time in two years. Investors now believe that Berkshire Hathaway, an investment company run by Warren Buffet, is more credit worthy than U.S. Treasuries. High-yield spreads also narrowed to below 6%. Credit markets appeared to be functioning smoothly as high-yield issuance reached almost \$68 billion compared to just \$11 billion in the first quarter of 2009.

## commodities hit by headwinds

The combination of a strong dollar, the Chinese government reigning in demand, and an excess supply of natural gas in the United States hurt commodities. The Dow Jones-UBS Commodity index fell 5% in the first quarter of 2010. Natural gas prices fell by over 30% in the first quarter, while a better-than-expected supply hit sugar prices, which were down 38%. Global economic growth, tensions with Iran, and excess liquidity helped oil prices end the quarter at over \$83/barrel—up over 5.5%. Gold was up 2% and demand for steel in China drove nickel prices up 35%.

Going forward, we expect the macro headwinds to continue for commodities. The Federal Reserve is draining excess liquidity and should begin raising interest rates later in the year—thus supporting of the dollar and hurting commodity prices. Meanwhile, the Chinese government is expected to continue to control inflation by reducing demand for commodities.

## dollar—more room to run

As the financial markets focused on debt problems in Greece and the potential for similar problems in Spain, Italy, and Portugal, the Euro fell 6% in the first quarter

of 2010 and the dollar gained over 4% against major currencies. We expect this trend to continue as many European governments will be forced to cut spending and the European Central Bank will need to keep rates low to support growth. The Japanese economy also needs a weaker Yen to support its export-driven corporations; their government is expected to do just that.

### **2010 outlook: overweight U.S. risk assets**

A self-sustaining recovery appears to be underway and should build momentum into the second half of 2010. The Federal Reserve is draining liquidity and is preparing to raise interest rates later in the year. These actions will be supportive of the U.S. dollar. On the other hand, low growth and high debt levels will hamper several European countries and Japan. We believe the dollar will continue to strengthen against the Euro, the Pound, and the Yen. A strengthening dollar will be supportive of U.S. assets.

With interest rates at historically low levels and housing prices down 30-35% from their peak, we believe 2010 will be an excellent time to buy a new home or trade up to a more expensive home. In many parts of the country, housing prices have stabilized and many homes are selling below their replacement costs. We also like U.S. equities—particularly large, high quality multinationals with strong balance sheets, cash flows, and significant exposure to high growth emerging markets, (i.e., IBM, McDonalds, Colgate, Abbott Laboratories, and United Technologies). Many financial companies such as Bank of America, Wells Fargo, and State Street are also attractively priced at a discount to their normalized earnings. With interest rates set to rise we recommend that investors underweight bonds—particularly government debt such as Treasuries, Agencies and Mortgage-backed securities. For bond investors we recommend corporate debt and sovereign debt of emerging market countries.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs