



The economy is unfolding along the lines of our recovery outline, first presented in our *Winter 2008* article, “Positive Returns Will Spring from Fear Factors.” See “2008 Quarter 4” under the Outlook & Research tab at www.sharpergranite.com. We have seen come to pass 1) credit market restoration, 2) stock market rally, 3) positive U.S. economic growth, and we are now seeing signs of the final step, 4) U.S. housing market recovery.

With improving first quarter economic data, the stock and bond markets continued their rally. Our “First Quarter 2010 Economy Review” below suggests continuing healthy economic growth. With such positive leading economic indicator momentum, what is now the biggest danger to the recovering U.S. economy?

Each quarter we present pertinent research from our own work or from leading academics, sharing with our clients fact-based analyses of the economy or securities markets. This quarter we review the strength of the current recovery and discuss what may be the chief economic threat over the next two years, high U.S. debt.

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Financial Markets Summary

U.S. securities markets continued their collective recovery this quarter. The S&P 500 Index has gained 71% from its nadir March 9, 2009. Powered by the best February in twelve years, the S&P 500 and Dow Jones Industrials recorded 5.4% and 4.4% gains (with dividends included) during 1Q10.^{1,2} This strong quarter for the S&P 500 followed the remarkable 26.5% gain in calendar 2009.¹



The iBoxx Liquid Investment Grade Bond Index, which Sharper ♦ Granite uses as its key bond benchmark, gained 2.0% this quarter. This followed the blockbuster 12.8% bond gain in calendar 2009.¹ Many classes of bonds now sit near relative highs and could be pressured as interest rates increase during the expansion phase of the economic cycle.

Clients may read about their individual quarterly performance in their personal reports. For 1Q10, the average investment return from all Sharper ♦ Granite portfolios was estimated to be 3.7% (net of fees) at an estimated average risk level 23% less than that of the S&P 500.³

The quarterly performance of the S&P 500 Index (with dividends) and zero-risk 3-month treasury bills may be used to estimate fair market return at specific risk levels in a Security Market Line (SML) analysis.³ The fair-market, risk-adjusted return for the average of all Sharper ♦ Granite portfolios using this analysis is estimated to be 4.8%, slightly better than the Dow and just below the S&P 500 this quarter when adjusted to the same risk level.³

The Coiled Spring Fires Back Upward ⁴

Average S&P 500 gain in the first five months of the 13 bull markets since 1940	22.6%
S&P 500 gain in the first five months of the current bull market	49.4%

The Strength of the Recovery and the Danger of High U.S. Debt

The stock market recovery has been strong, and many economic indicators are rocketing upward. While in the depths of the recession, few pundits predicted a strong “V-shaped” recovery. But that is exactly what we are experiencing.

Key indexes for earnings, manufacturing, GDP (Gross Domestic Product), consumer sentiment, and housing have all formed sharp “V-shaped recovery

patterns. Even the leading indicators for job growth, typically the last component to recover from a recession, are smartly rebounding. These measures include temporary help services, unemployment claims and non-farm payrolls.

This recovery has, in many ways, been typical when the data is reviewed alongside past recoveries. We believe the improvement will continue, perhaps with some corrections as the market has risen so far so quickly. So then, what is the biggest danger over the next couple years? Many factors are in the news: corporate real estate, the Fed’s pending monetary tightening, inflation in China and India, protectionism, the high unemployment rate, and oil prices. But the most worrisome issue over the next two years should be sovereign debt levels, in particular the rising U.S. Federal budget.

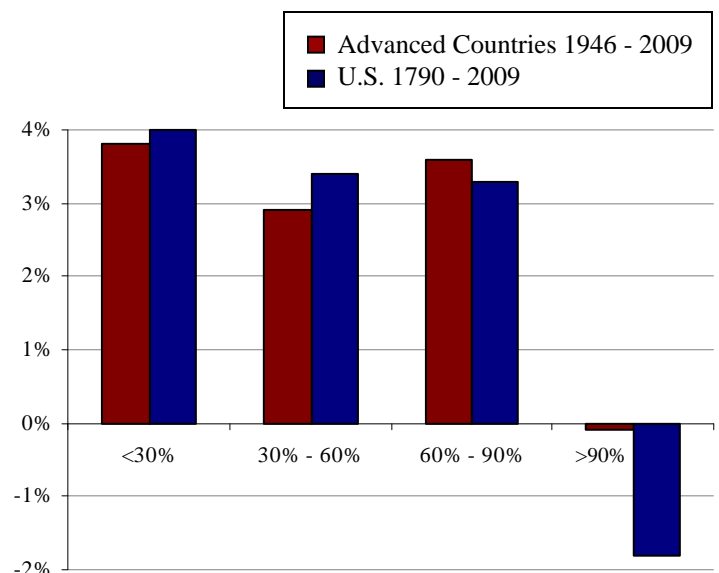
Some of the most fascinating recent research has come from Kenneth Rogoff at Harvard and Carmen Reinhart at Maryland. This quarter we reviewed their January draft analysis of the relationship between sovereign debt level and annual GDP growth.⁵ GDP is the official measure of the national economies, tallying all goods and services produced by a given country. GDP tells us the overall health of a nation’s economy and whether it is in recession.

Their research presents an interesting finding – the key government debt level above which nations are no longer able to sustain healthy economic growth. This magic number is Debt/GDP of 90%.⁵ That is, when the amount a country borrows exceeds 90% of what it produces annually, its economic growth is critically hindered – no matter whether the country is advanced or emerging. Below that key debt level, there is little correlation between debt and GDP growth, at least in advanced countries.⁵

U.S. debt is currently 84% of GDP and rising.⁵ The Fed, our *monetary-control* arm of government, has recently urged more discipline from Congress, the *fiscal-control* arm of government. This new data supports that thesis and gives quantitative guidance. Rogoff and Reinhart have a strong reputation for thorough, accurate research, and have gained the ear of many politicians. However, history shows that “tough medicine” changes are especially challenging in election years. As always, we hope that sound research will take precedent over political incentives.



Government Debt vs. GDP Growth ⁵



First Quarter 2010 Economy Review

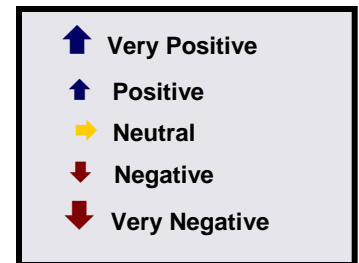
The overall trend for the economy remains encouraging as the economic data reports of 4Q09 were generally strong. Our leading indicators below now primarily flash positive.

The Conference Board's Leading Economic Index agrees. As of March it shows a 9% gain over the previous year with nine of its ten index components stable or improving.⁶ The Federal Reserve district-specific leading indicators are also trending upward. In particular, the key Philadelphia Fed district index of leading indicators, which we watch, has trended upward through the last two quarters.⁷



Leading Economic Indicator Summary

- **Calendar Cycle:** The second quarter of each year historically averages an annualized return of 10.9% with April tending to be the strongest month.⁸
- ⬆️ **Interest Rate Stimulus:** Interest rate direction is one of the most significant short-term influence on stock prices.⁸ Market returns from 1955 - 2006 averaged only 7.2% in years following rate increases compared to 18.5% in years following rate decreases.⁸ Both long and short interest rates continue to sit at extremely low values by historical standards. Low inflation will keep short-term rates near zero for at least another quarter. Low treasury yields are helpful to stocks in that they provide little competition for investment dollars.



Ned Davis Research (NDR) builds a “policy index” which interprets how stimulative government policy is. It includes not only interest rates but other monetary factors such as U.S. dollar value and money supply, as well as fiscal policy indicators such as real federal expenditures. This indicator has been quite high and into the range where the stock market performs its best. This indicator is still in the bullish zone but coming down fast now as the Fed begins reeling in the money supplied to the U.S. economy.⁹

- ⬇️ **Political Cycle:** We are in the second year of President Barack Obama's term. Traditionally, the second year in the presidential cycle is the weakest for the stock market, averaging 7% returns under Democratic presidents and 8% returns overall since 1888.⁸

In addition to the macro-political cycle, the recent health care bill and other fiscal spending has created challenges that Washington will need to address with higher taxes or other economically restrictive measures. Tax and estate planning should consider the certainty of pending tax increases. Protectionist legislation also looms as a threat to free trade and thus U.S. and global economic growth.

- ⬆️ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy. 4Q09 GDP rose a very hot 5.9% as compared with the poor 4Q08 quarter a year ago.¹⁰

JP Morgan and Macro Advisors have been among the most accurate estimators of GDP. They currently project 1Q10 GDP at 2.5% and 2.9% respectively.¹¹ This would be a solid GDP growth rate, and near the “sweet spot” for stock market performance. Stocks actually perform better in weak GDP growth periods than in strong ones.¹² This may be due to the high interest rates that accompany periods of hot growth. In those times high bond yields prove worthy competition for investor money.

- ↑ **Employment Momentum:** Employment conditions continue to dominate much of the conversation in the media and in Washington. The most frequently mentioned metric, the unemployment rate, is a lagging indicator, typically improving six months or so after recessions end.¹²

While backward-looking job indicators such as the unemployment rate are dismal, the *forward-looking* job indicators are strong. They include the non-farm payroll and initial unemployment claims, which are showing momentum. March saw a 162,000 *gain* in non-farm payrolls from the previous month.¹³ This was the most significant jobs increase since the recession began in December, 2007, and is a healthy beginning to the claw back of 8 million jobs lost since then. Initial unemployment claims have decreased sharply to 469,000 (four-week average).¹³

Charles Schwab's analysis of the last nine recessions since 1950 indicates that perhaps companies cut jobs deeper during the last recession than was warranted due to fears of a depression. Recessionary declines in non-farm payroll are closely correlated with the GDP decline. Based on the GDP decline of our last recession, they estimate that a normal payroll decline should have been 4.0%, when in fact we saw a 5.2% decline. That equates to 30% more job cuts than this particular recession warranted and implies that a hiring boom could come.¹⁴

- ↑ **Home Price Trends:** The Standard & Poor's/Case-Shiller Index now signals price increases in many metropolitan markets. San Francisco, where many of our clients reside, is leading the recovery, rocketing to a 9% price increase in January from a year earlier with tremendous upward momentum. The Los Angeles metropolitan area is also now showing positive year-over-year price changes for the first time, with a 4% gain in January.¹⁵

While the rest of the country recovers, Las Vegas continues to suffer. Once home to soaring prices during the boom, Las Vegas dropped 17% in January from the previous year and has now declined for three straight years.¹⁵

- ↑ **Stock Market:** Of all economic forward-looking indicators, the stock market is one of the best. In the short-term (days and weeks) the stock market moves unpredictably. Over several months and years, its purposeful trends are revealed. The S&P 500 Index made a low on March 9th and as of the end of 1Q10 has rallied 71% (including dividends).¹⁶

- ↑ **Purchasing and Manufacturing:** The Purchasing and Manufacturing Index (PMI) from the Institute of Supply Management (ISM) is the key economic manufacturing indicator. The PMI improved again this quarter over the previous quarter and is now showing strong expansion in the manufacturing sector.¹⁷ The manufacturing index is one of the most stable and telling of all the economic indicators discussed here.

One discouraging point in the February PMI report was that the important "new orders" component fell 6.8%, albeit from a previously high reading.¹⁷

- ↑ **Inflation Control:** The most widely accepted measurement of inflation is the Consumer Price Index (CPI). The CPI and most other inflation indicators remain tame. As of February, the CPI was running at 2.1% year-over-year.¹⁸

The more-stable Core CPI, which excludes the volatile food and energy components, is currently reading 1.3%, its lowest level since 2004 and well below the Fed's stated tolerable level of 2%.¹⁸

The inflation rate is currently in the sweet spot. Inflation rates of between 2% – 3% result in the highest valuations for the stock market, averaging a P/E (price-to-earnings ratio) of 20.6.¹⁹ We continue to see little threat of inflation during 2010.

Looking out a decade, our key predictor of 10-year average inflation is the 10-year TIP-Treasury spread, the difference in yield between the 10-year Treasury and the 10-year Inflation-protected Treasury. This spread is now 2.25%, indicating that the market is betting on only 2.25% average annual inflation average over the next 10 years.²⁰ The Philadelphia Federal Reserve's data shows a similar result, 2.39% expected 10-year average inflation rate.²¹

↓ **Oil Price Control:** Oil closed the quarter near \$80/barrel. We continue to watch the price of oil carefully and consider it one the most significant threats to the recovery. After rebounding 33% in 2Q09, oil price volatility has calmed, climbing a modest 9% over the last nine months.¹ Oil prices and the U.S. stock market are currently moving together; that is, they are positively correlated.¹¹

↑ **Consumer Spending:** Consumer spending rose at a 2% annualized pace in the second half of 2009 and is now on track to rise 3% to 4% in 1Q10.²² This is a healthy growth rate.

The momentum in the improving consumer sentiment trajectory paused this quarter.²³ We use two gauges to review consumer sentiment, the University of Michigan's sentiment index and the Conference Board's confidence index. The Conference Board polls a larger number of consumers, has more questions about the labor market, and is more volatile. Both measures have existed more than 40 years.

The surveys are often better forecasters of recessions than recoveries. Consumers' attitudes typically do not brighten until the jobs picture improves. Because job growth tends to begin well after the official recession ends (businesses want to be sure the economy is improving before hiring again), consumer confidence often lags in the recovery as it did during the last two recessions.²⁴

↑ **Business Capital Spending:** The Business Roundtable's CEO Economic Outlook Survey Index, which surveys 160 companies, made a "V-shaped" recovery, rising back to the pre-crash levels of early 2008. Two-thirds of corporate executives surveyed expect their company's sales to increase in the next six months.²⁵ Businesses also added to the hours of existing employees and added more temp workers, actions which usually precede permanent hiring.²⁶

↑ **Investor Sentiment:** The major sentiment indicators that we track were in the optimistic zone in 4Q09 and early this quarter before falling sharply to pessimism, at least for the moment. We prefer to see sentiment in this pessimistic zone as this implies that investors have available cash which they have not yet pushed into the markets. Ned Davis Research's Crowd Sentiment Poll currently shows a reading of near 54, which tends to be bullish for stocks as the chart below shows.²⁷

On a negative note, American Association of Individual Investors' research shows cash levels decreasing as investors move heavily into bonds. Investor bond allocation is currently near record high levels for the 1987 – 2010 period.²⁸

↑ **Corporate Earnings:** Companies in 1Q10 did not disappoint with their earnings announcements. Additionally, analysts continue to increase their S&P 500 company earnings projections.²⁹ As with GDP, the markets prefer environments where corporate earnings are positive, but not too hot.²⁹ Projections are currently hot enough to imply a Fed rate increase later in the year, which could drag on the stock market.

Optimism vs. Stocks Past 15 Years ²⁷

NDR Crowd Sentiment Poll	S&P 500 Index Annualized Gain
> 62	-1.1%
56 – 62	+6.3%
< 56	+8.6%

- ↓ **Insider Trading:** This continues to be one of our weakest economic indicators. Significant insider selling implies that executives have negative information about their respective company outlooks. Insider buying remained weak, below \$10 million/day throughout all of 1Q10.³⁰
- ↑ **Merger and Acquisition Activity:** Available cash and ready lending are igniting IPO's (initial public offerings) and M&A (merger and acquisition) deals, which is a boon to the stock market. "The IPO window is open," declared Bill Hurley of Benchmark Capital in November.³¹ Globally, deal-making is recovering. The pace of announced M&A deals is now almost double the lows from last summer.³²

Notes and Acknowledgements:

1. Index data is as of March 31, 2010, and includes the S&P 500 Index, State Street's Dow Jones Industrial ETF (DIA), and BlackRock's Goldman Sachs Oil Index ETF (OIL)
2. Investor's Intelligence, March 2, 2010
3. Global Investment Performance Standard's (GIPS) Original Dietz Method is used to calculate returns. Arithmetic average used for return measurement. Performance is net of fees and may include assets tracked for clients that lie outside Sharper ♦ Granite direct management. Such assets total less than 4% of total assets. All client portfolios are weighted equally in calculation of average client performance. A few Sharper ♦ Granite have multiple portfolios. S&P 500 Index returns include dividends. Past performance does not guarantee future results. Normalization to similar risk as S&P 500 uses weighted average beta of all assets for a given client portfolio, then normalizes to beta = 1.0 (S&P 500 Index β) using the Securities Market Line (SML). The SML is constructed as a line on the beta-return chart between two points, A and B: A is the point representing "risk free" at $\beta = 0$, and return = 3 month return of the 90-day Treasury Bill rate on the last day of the quarter. B is the point representing the "market return" at $\beta = 1$, return = 3 month total return (including dividends) of the S&P 500 Index. β (asset) = covariance (asset monthly price % Δ vs. S&P 500 Index monthly price change) / variance (asset monthly price % Δ) using Yahoo! Finance historical price data. "Risk" as used here means market β risk. Sharper ♦ Granite makes all efforts to compute these internal statistics accurately and consistently uses this SML process but recognizes that many performance measuring methods exist and that errors are possible. These values are presented only as guidance, and Sharper ♦ Granite should not be held liable for errors in computation.
4. InvesTech Market Analysis, August, 2009
5. "Growth in a Time of Debt," Carmen Reinhart, University of Maryland and the National Bureau of Economic Research (NBER), and Kenneth Rogoff, University of Harvard and (NBER) January 7, 2010. Chart is for advanced economies 1946 - 2009
6. The Conference Board and National Bureau of Economic Research (NBER), March, 2010
7. The Third District Leading Index, Federal Reserve Bank of Philadelphia research department, March 19, 2010
8. *Stocks for the Long Run*, Jeremy J. Siegel, Ph.D., Professor of Finance, Wharton School of Business at Penn University
9. Ned Davis Research data, January 31, 2010
10. The Commerce Department, Bureau of Economic Analysis, February 26, 2010
11. Research from Jeremy Siegel, Ph.D., Professor of Finance, Wharton School of Business, December 11 and 23, 2009; March 8 and 22, 2010
12. Schwab Center for Financial Research: data from March 31, 1960 to December 31, 2009
13. U.S. Dept. of Labor: Jobless Claims Report, April 2, 2010; Non-farm Payroll Report, March 5, 2010
14. Schwab Center for Financial Research interpreting regression analysis of data from 1050 – 2009 from the Bureau of Economic Analysis, FactSet, and the Department of Labor
15. Standard & Poor's/Case-Shiller Index of Home Prices through December, 2009
16. S&P 500 Index adjusted for dividends closed at 683.38 on March 9, 2009, and 1169.43 on March 31, 2010, a 71% change
17. Institute of Supply Management, March 1, 2010
18. U.S. Dept. of Labor, Bureau of Economic Analysis Report, March 18, 2010
19. Charles Schwab interpreting January 1946 – January, 2010 CPI and P/E data from the Department of Labor and The Leuthold Group
20. Bloomberg data, March 25, 2010. The difference between the 10-Yr Treasury = 3.625% and 10-Yr TIP = 1.375% = 2.25% implied average 10-Yr inflation rate.
21. Federal Reserve Bank of Philadelphia, First Quarter 2010 Survey of Professional Forecasters, February 12, 2010
22. U.S. Commerce Department, March 26, 2010
23. University of Michigan sentiment index and Conference Board confidence index, December 26, 2010
24. "Consumers Say They Are Down, Are They?," *Wall Street Journal*, March 26, 2010
25. Business Roundtable's CEO Economic Outlook Survey Index, December 21, 2009
26. Manpower, the world's second largest provider of temp workers; U.S. Department of Labor, December 21, 2009
27. Ned Davis Research Crowd Sentiment Poll, Data is from December 1, 1995 to January 5, 2010
28. American Association of Individual Investors' Asset Allocation Survey, 1987 – January, 2010
29. Ned Davis Research, FactSet, Standard and Poor's, Charles Schwab, December 31, 2009
30. Insidercow, through March 24, 2010
31. Bill Gurley of Benchmark Capital in a CNBC interview, November, 2009
32. "Unmistakable Signs of Life in Worldwide M&A," *BusinessWeek*, December 7, 2009