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A Speeding Ticket

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Confidential – Proprietary

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A Speeding Ticket

Investors closed the books on 2009 with a sigh of relief – the powerful rally off the March 2009 lows went a long way in restoring both wealth and confidence. However, as is well known, markets never move in a straight line. Anyone tempted to forget what a volatile market looks like received an early New Year reminder. A correction commenced in late January, interrupting the upward trajectory of equity indices. The S&P 500 Index is now down 7% from its closing high of 1,150 on January 19th, 2010. This retreat has been accompanied by heightened volatility, as measured by VIX, the CBOE Volatility Index. Markets, it seems, were moving at a pace that warranted a speeding ticket. The advance heading into January was simply too fast and a breather appears both timely and necessary. With so many moving parts – from the shape of the economic recovery and the state of corporate profits to political uncertainty and international conflicts – the market, we believe, will need time to digest all the incoming information, get answers to some outstanding questions, and formulate future expectations based on facts rather than hopes and fears.

GLOBAL STOCK MARKETS: INDEX MOVEMENTS (IN LOCAL CURRENCY TERMS)

Index	1/29/2010 Index Value	Since High	Date of High	Performance Since 3/9/09 Low	2010 YTD Return	2009 Return
MSCI World Index	1,120	-33.5%	10/31/2007	62.6%	-4.2%	27.0%
MSCI Emerging Markets Index	934	-30.3%	10/29/2007	92.4%	-5.6%	74.5%
DJ Industrial Index	10,067	-28.9%	10/9/2007	53.8%	-3.5%	18.8%
S&P 500 Composite Index	1,074	-31.4%	10/9/2007	58.7%	-3.7%	23.5%
Nasdaq Composite Index	2,147	-24.9%	10/31/2007	69.3%	-5.4%	43.9%
Russell 2000 Index	602	-29.6%	7/13/2007	75.4%	-3.7%	25.2%
German DAX Index	5,609	-30.8%	7/16/2007	51.9%	-5.9%	23.8%
Paris CAC 40 Index	3,739	-39.4%	6/1/2007	48.4%	-5.0%	25.2%
UK FTSE 100 Index	5,189	-22.9%	6/15/2007	46.5%	-4.1%	22.1%
Dublin ISEQ Index	2,976	-70.2%	2/20/2007	55.3%	0.0%	27.0%
Swiss SPI General Index	5,570	-28.1%	6/1/2007	53.8%	-1.0%	23.2%
Nikkei 225 Index	10,198	-44.2%	7/9/2007	43.9%	-3.3%	19.0%
Hang Seng Index	20,122	-36.4%	10/30/2007	77.4%	-8.1%	52.1%
Shanghai Composite Index	2,989	-50.9%	10/16/2007	41.1%	-8.8%	80.0%
Bombay Sensex Index	16,358	-21.6%	1/8/2008	100.5%	-6.3%	80.9%
Brazilian Bovespa Index	65,402	-11.0%	5/20/2008	78.0%	-4.6%	82.7%
Russian Trading System Index	1,474	-23.8%	5/19/2010	117.8%	3.2%	134.8%

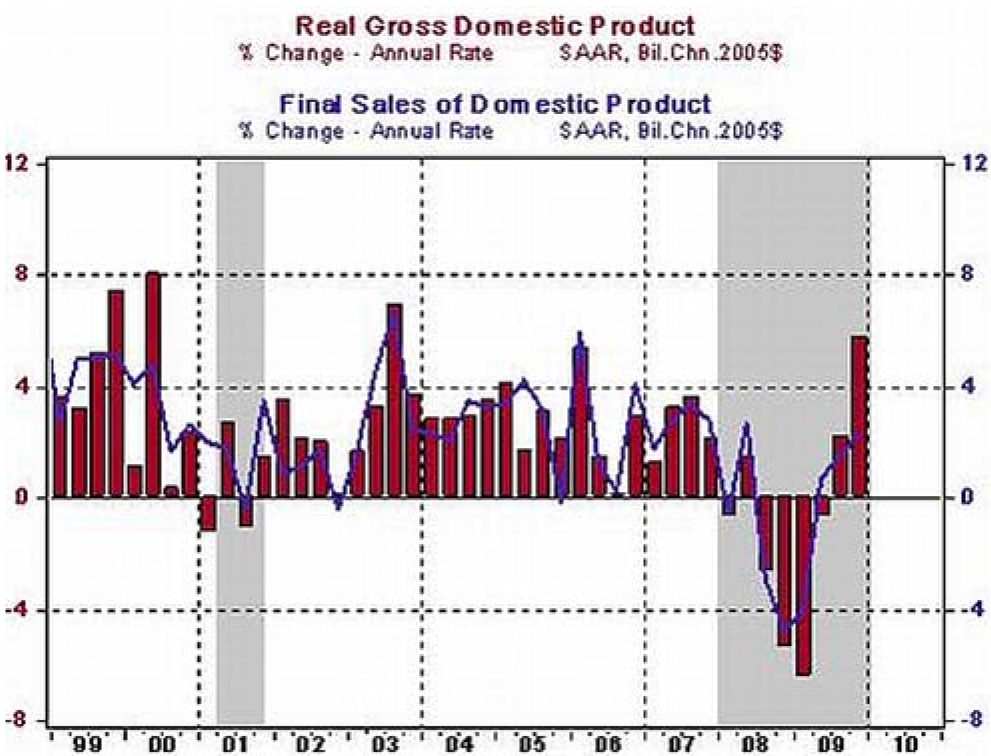
Source: Plexus Asset Management (based on data from I-Net Bridge)

There is no way to know how long the correction will last or how deep it will be. David Fuller of the Gloom, Boom, and Doom Report recently opined: *"Why might this be no more than another correction rather than the beginning of a new bear trend? Unless the modest global economic recovery is about to slide back into another slump, which I doubt, I do not see the catalysts for another stock market collapse. Instead, and despite the current uncertainty, I think this could still be an economic sweet spot for stock markets characterized by modest global GDP growth, reasonably accommodative monetary policy, and generally low inflationary pressures. Yes, there has been some overheating in emerging Asia, especially China where the PRC's monetary authorities have moved early and incrementally to contain this problem, as I have said before. In North America and Europe central banks are talking about ending quantitative easing but that is not the same as a monetary squeeze. Historically, the US stock market has usually continued to rise during the early stages of a cycle of higher short-term interest rates from the Fed, and this has yet to commence."*

There is certainly no shortage of reasons to worry –sovereign debt default risk, geopolitical tensions in the Middle East, the eventual timing of Central Banks' transition to tighter monetary policies, the possibility of a double dip, a growing federal budget deficit, uncertainty with regard to health care reform and future taxes, financial industry regulation coming down the pipe, Toyota's unexpected stumble, and so on and so forth. It is well known that "markets don't like uncertainty". Nevertheless, the fundamentals underlying the U.S. and foreign economies have undoubtedly improved in the past year, credit markets have recovered, and fiscal stimulus will continue to act as a powerful tailwind in the near future.

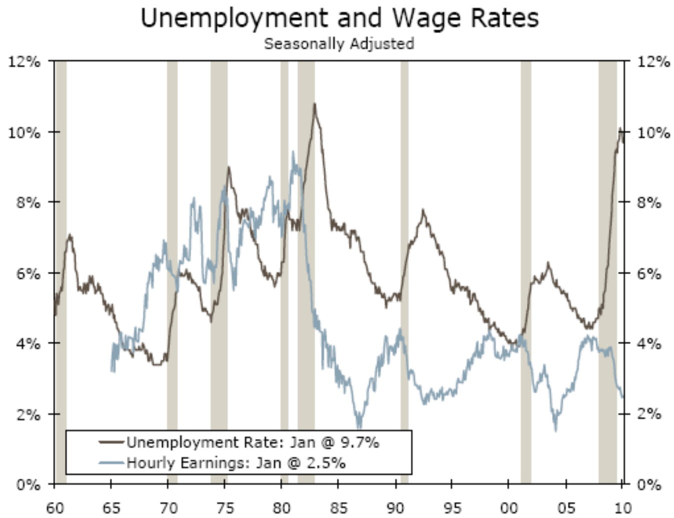
The U.S. economy emerged from the Great Recession in mid 2009*, posting annualized real GDP growth rates of 2.2% in 3Q09 and 5.7% in 4Q09 (the fastest pace in six years). For 2009 as a whole, however, GDP shrank by 2.4%, the biggest decline seen since the 10.9% drop in 1946. Much of the recent GDP bounce is attributed to inventory restocking, whereas real final demand is yet to stage a robust recovery. Continuing credit restraint and the rising personal savings rate act as headwinds that counter the strength of the normal cyclical inventory cycle. Future GDP readings will provide more clarity on the pace of demand growth, its impact on unemployment, and, ultimately, the sustainability of the recovery.

**Note: An official pronouncement of the recession's end is yet to come from NBER, the National Bureau of Economic Research.*

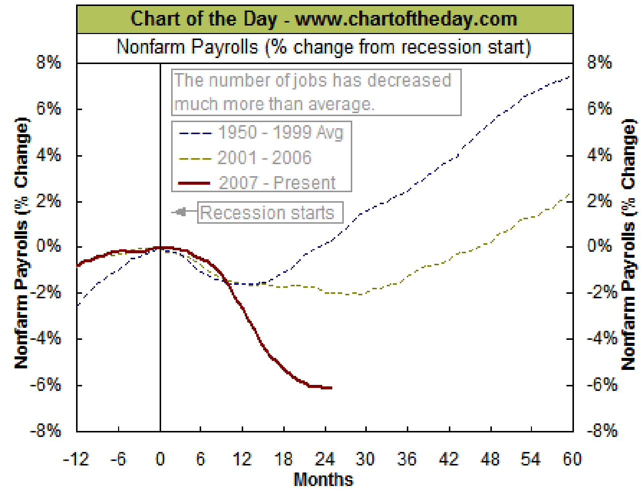


Source: Bureau of Economic analysis, Haver Analytics, Northern Trust Company

Last week's January unemployment report provided mixed signals on the state of the job market. On one hand, the unemployment rate ticked down for the first time during this cycle, falling from 10.0% to 9.7%, indicating a possible stabilization in the job market. The broader measures of unemployment, the U6 (which includes discouraged and part-time workers), fell from 17.3% in December to 16.5%, but remains elevated. In addition, job losses continued with the cumulative job loss number rising to 8.4 million since late 2007. There are signs of improving payrolls in manufacturing and services, while construction is still a laggard. On balance, the numbers point to a nascent recovery, albeit a slow one.

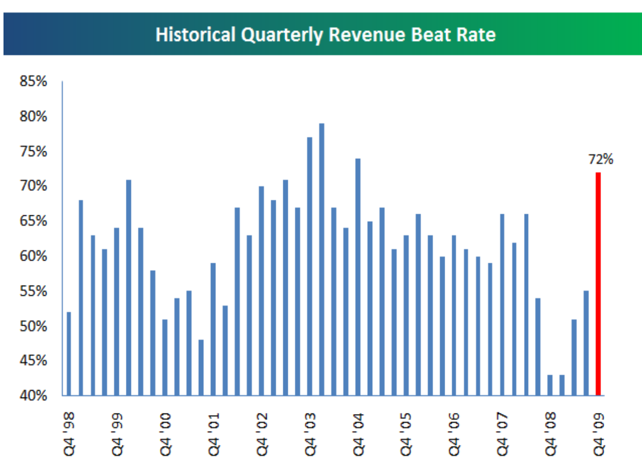


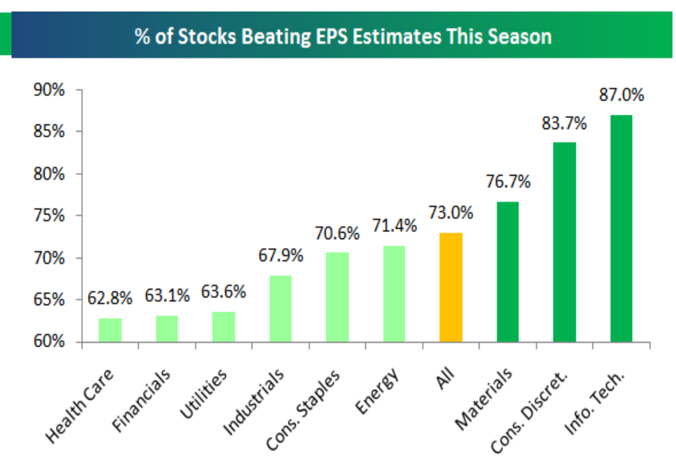
Source: U.S. Department of Labor, Wells Fargo Economics Group



Source: Chart of the Day

On the corporate profit side, the fourth quarter reporting season has so far delivered mostly good news, with both top line and bottom line results beating expectations. 73% of companies posted better-than-expected fourth quarter profits, with Information Technology, Consumer Discretionary, and Materials companies leading the pack. These positive EPS surprises (shown in the bottom right-hand chart) confirmed last quarter's trends. But, while the previously strong bottom-line results were driven primarily by cost cutting, the latest quarter suggests that sales have turned a corner as well. The current revenue "beat" rate of 72% (shown in the bottom left-hand chart) is a considerable improvement over the past few quarters and the highest level since 2004.



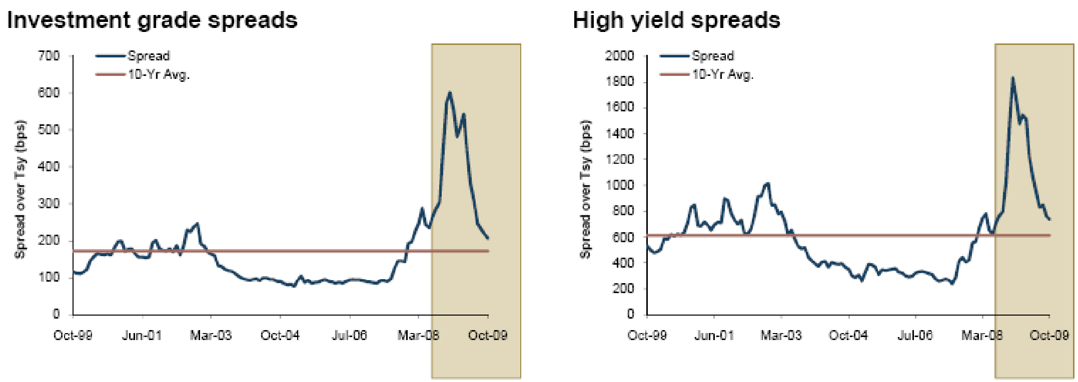


Source: Bespoke Investment Group

On the credit side, the spreads' recovery has been even more dramatic than the equity advance. After suffering their worst relative returns (in terms of excess return vs. Treasuries) in 2008, spread sectors posted record gains in 2009. High yield bonds gained 58%, emerging market debt increased 28%, and investment grade credit rose 18%. The following chart illustrates the inverted V-shape of the spread movement over the two-year period. As the credit crisis unfolded throughout 2008, spreads grew exponentially and, after peaking early in 2009, have come very quickly back down to approach pre-crisis levels. Interestingly, during the current equity pull-back, spreads have remained relatively stable, a positive sign.

Spreads have tightened significantly, approaching pre-crisis levels

- Spreads are back near long term averages and inside prior recessionary peaks
- Current levels reflects a more realistic view of upcoming defaults and recoveries
- While liquid credit spreads have narrowed, illiquid credit still trades at relatively wide levels



Source: Goldman Sachs

So where does that leave us? One investment manager we talked to summarized his views on the current situation as follows: "We are nowhere near end-of-cycle buoyancy, just the end of the beginning". Granted, most indices are down from their January highs. We believe this pull-back is more of a speeding ticket, rather than a suspended license. The ticket serves as a reminder of the potential dangers of going over the limit. After paying the fine and/or sitting through traffic school, the market is free to go back on the road and continue to its original destination. But it should proceed with a different state of mind – more cautious, thoughtful, and alert. What changes, then, is not where it is going, but how it gets there. Each investor's road trip's success will depend on making good decisions. The economic and investment environment over the near and intermediate term will bring ambiguity, presenting investors with both perils and opportunities. This type of environment generally favors those with a focus on security selection, a strong research effort, and unwavering valuation discipline. These are the managers Beacon Pointe has always recommended for client portfolios and, we believe, they will continue to make good decisions that position your portfolios well for preserving and growing capital in the future.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.