First Quarter | April, *2010*

Constellation Quarterly

Money for Nothing, Risk for Free

In Review

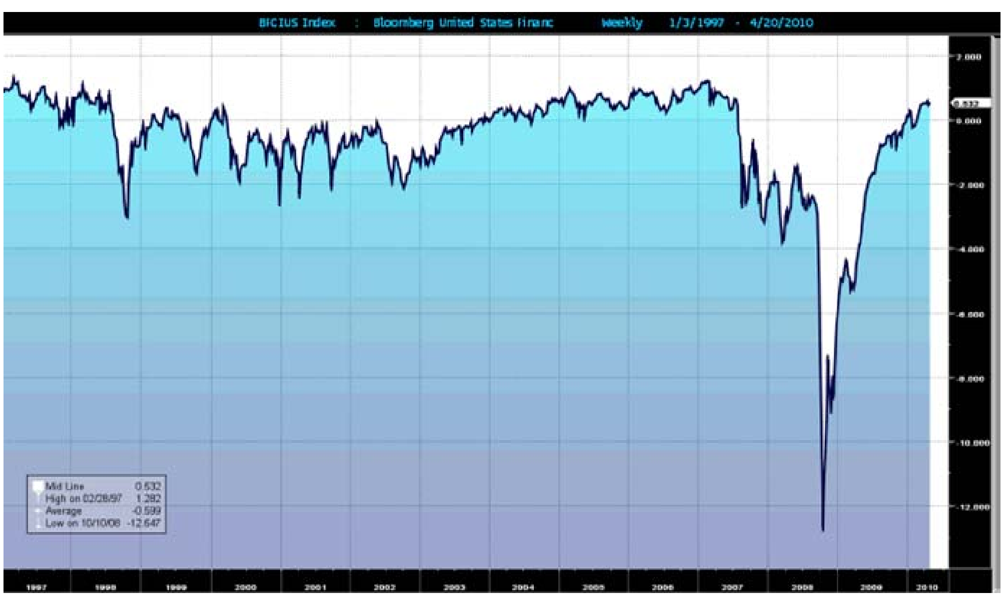
The following chart displays the returns of the various indices for the first quarter:

Benchmark Performance
Data as of March 31, 2010

	YTD	1 Year	3 Year	5 Year	7 Year
Barclays 5 Year Muni	0.80%	6.03%	6.10%	4.91%	4.15%
Barclays Aggregate	1.76%	7.65%	6.12%	5.44%	4.81%
S&P 500	5.39%	49.77%	-4.17%	1.92%	6.80%
Russell 1000	5.70%	51.60%	-3.98%	2.31%	7.31%
Russell 2000	8.85%	62.76%	-3.99%	3.36%	10.70%
iShares MSCI EAFE	0.74%	53.82%	-7.08%	3.63%	11.57%
iShares MSCI Emerging Markets	1.06%	73.16%	4.61%	14.94%	n/a

Source: PSN Informa

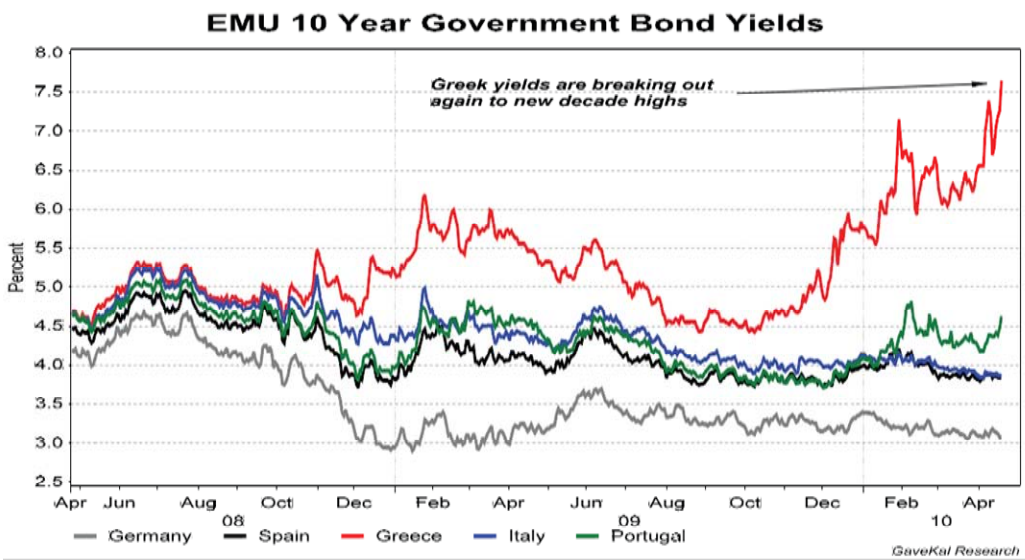
We are now over one year removed from the trough in the S&P, and 18 months from the Lehman bankruptcy, and in that time period, financial conditions, as measured by the Bloomberg Financial Conditions Index, have fully normalized. This data series, which we have shown previously, combines yield spreads, money markets, as well as equity and bond market indices into a normalized index that measures the standard deviations above or below the 1992 to June of 2008 average (the current reading is in positive territory):



Source: Bloomberg

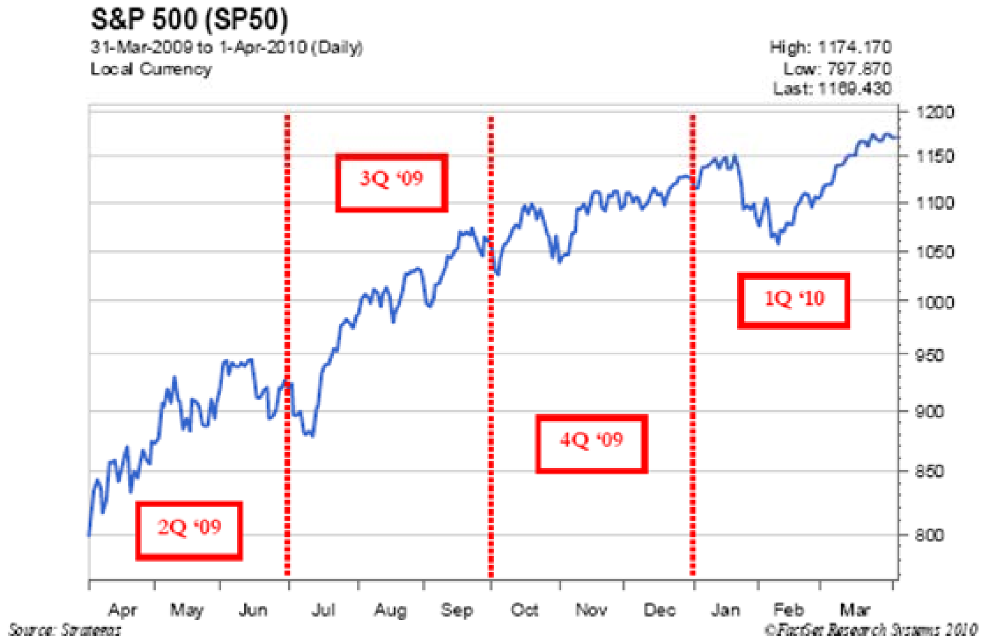
It should be noted that at the trough, the index showed financial conditions twelve standard deviations below the measurement period.

For equities, the rally continued with another positive performance across relevant categories despite a February correction caused by the sovereign debt issues surrounding Greece; a subject we discussed generally in our last quarterly letter. The chart below shows the divergence of the yield on Greek bonds (in red) from some of the other European countries, indicating that investors are demanding significantly higher yields to risk lending to the Greek government:

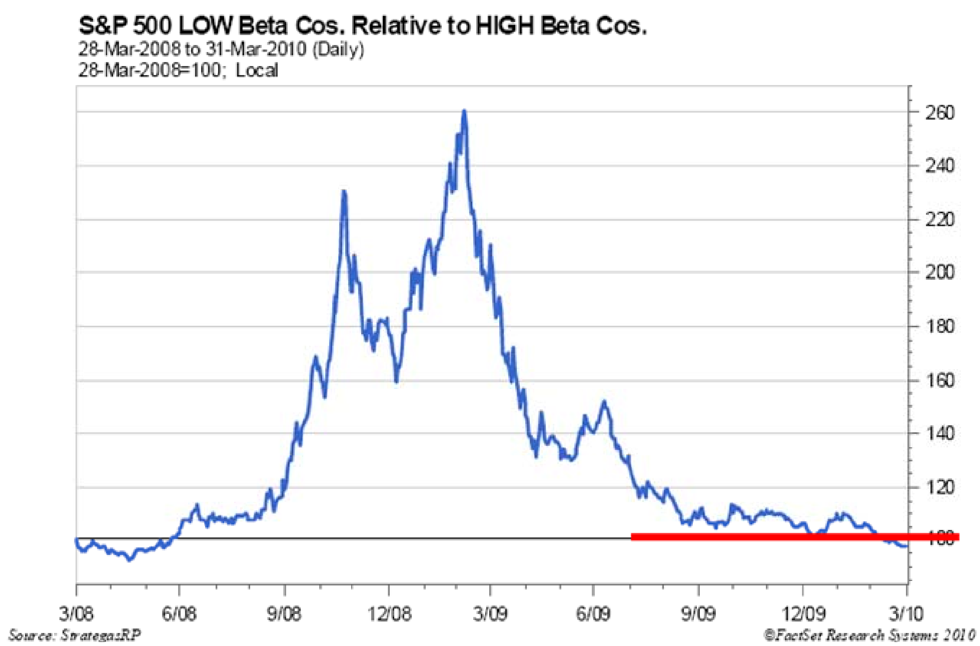


This crisis is as yet unresolved and remains a major issue that markets, for now, are looking past. International and emerging markets ended mixed for the quarter, and interestingly, China which led the advance in US stocks by roughly four months, was down over 5% for the period, and down almost 9% year-to-date as of this letter (in U.S. dollar terms).

Despite the problems in Europe, and the potential for additional sovereign difficulties, the S&P 500 Index gained over 5% for the quarter. The chart below displays its advance since the trough in March of last year:



An interesting characteristic of this rally has been the consistent outperformance of lower quality stocks (i.e. those without earnings or having lower credit ratings on their debt). The following chart demonstrates the relative performance between high and low beta stocks as a proxy for the above:

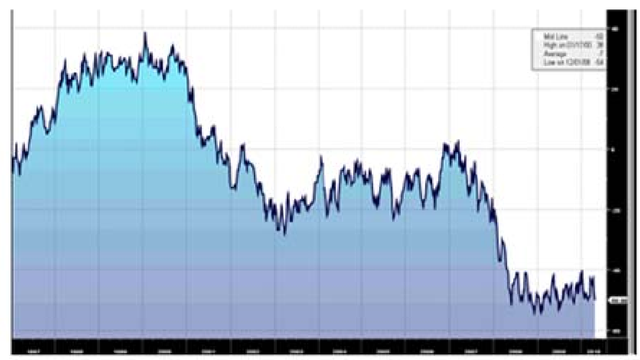


We expect this to change eventually as the rally matures and market participants begin to focus on earnings and dividends, but realize that as long as short term interest rates are at or near zero, the environment encourages the continuation of this type of speculation.

Despite the improvements in the markets and financial conditions in general, consumer sentiment remains stubbornly negative, most likely due to the uncertainty surrounding employment which is a lagging indicator. The charts below detail the most prevalent surveys with regard to the consumer from 1997 through the recent quarter:

Michigan Consumer Sentiment Survey

ABC Consumer Confidence Survey

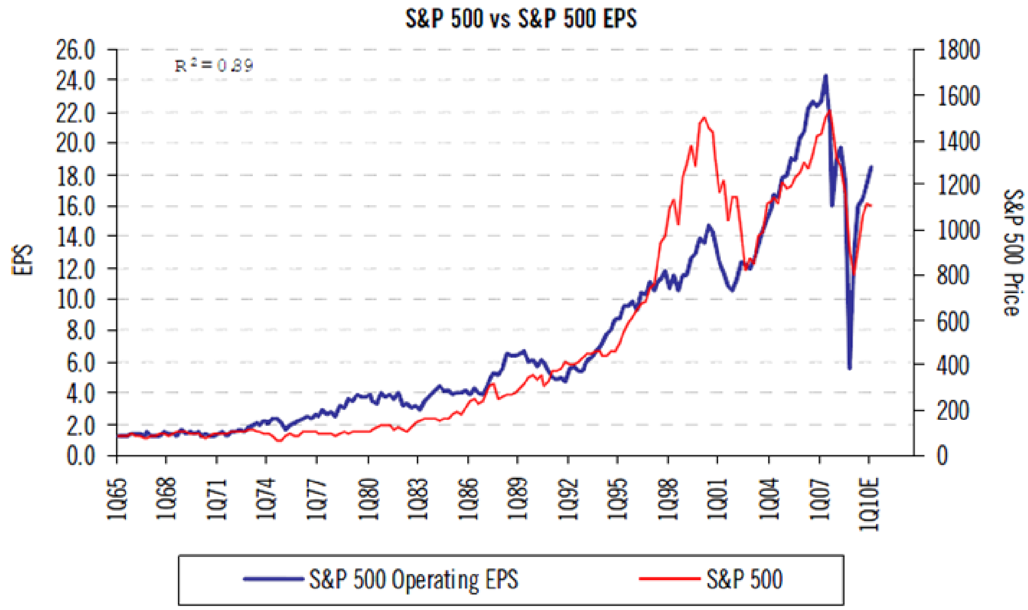


Source: Bloomberg

<u>Outlook</u>

"..low interest rates.. can, if held there too long, distort the allocation of resources in the economy. Artificially low interest rates tend to promote consumer spending over saving and, over time, systemically affect investment decisions and the relative cost and allocation of capital within the economy."
Thomas Hoenig. President Federal Reserve Bank of Kansas City

Despite the negative consumer sentiment, the economic data and earnings have been mostly positive, largely as a function of the Fed's overly accommodative monetary policy. The chart below shows that over time the S&P 500 tracks the progression of earnings, but often with greater or lesser amplitude:



Source: Citigroup

The change in amplitude is a function of what multiple the market is willing to pay for current and forecasted earnings. After earning a bit more than $65 in 2009, consensus forecasts for 2010 and 2011 are now roughly $80 and $94 respectively. These estimates place the S&P at 15 times forward estimates, or close to its historic average.

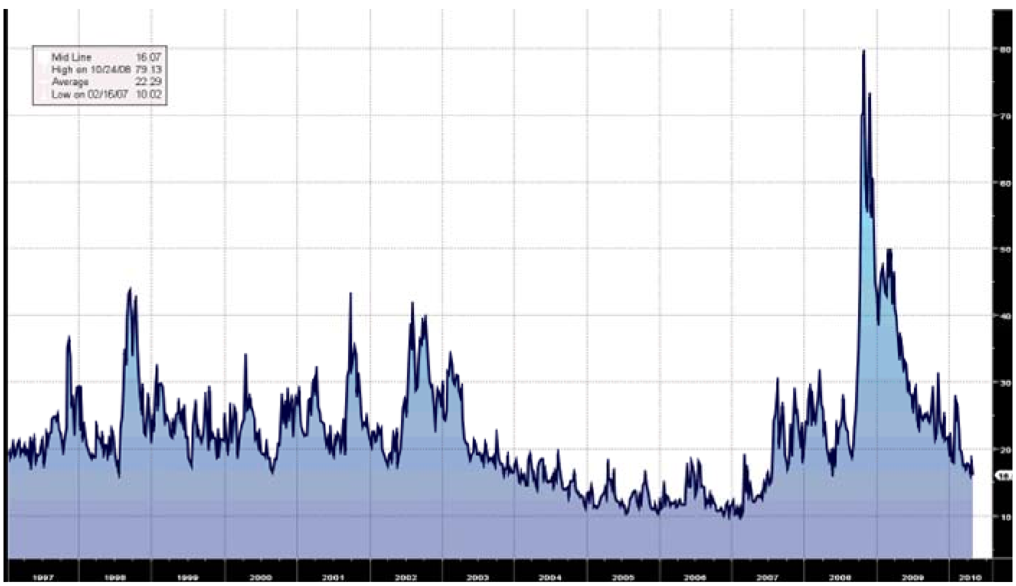
The chart above implies that if earnings continue to improve, it might be reasonable to assume that equity prices will follow with much of the debate centering on the "correct" multiple to apply to the earnings stream (the PE multiple). While many factors influence the multiple, the level of interest rates is a key element, which in turn is affected by inflation. Goldman Sachs uses the following chart to demonstrate the relationship between inflation and PE multiples for the stock market historically. While there are some anomalies in the data, generally higher inflation results in lower multiples:

Inflation	Average S&P 500 P/E
Less than 2.5%	18.6 X
2.5% - 3.5%	17.6
3.5% - 4.5%	12.1
4.5% - 5.5%	14.2
5.5% - 6.5%	12.8
6.5% - 7.5%	10.0
Greater than 7.5%	8.6

(a) For the period 1950-2007.
Source: Goldman Sachs

Globally, the MSCI World Index trades at slightly over 14 times 2010 estimates but at only 11.8 and 10.4 times 2011 and 2012 estimates respectively. Empirical evidence demonstrates that forward discounts of PE's are cyclical and vary with the economic data, so if the data continue to be positive, and most importantly if job creation gains traction, then the discount could narrow (all else being equal, i.e., interest rates ,etc). Forward earnings estimates have been rising steadily as analysts attempt to keep up with what appears to be rapidly improving fundamentals. It is equally likely however, that the analyst community has gotten ahead of itself especially with respect to 2011 and 2012, where a host of issues could create obstacles towards obtaining the newly projected numbers. The investor surveys we track continue to show a wide diversity in expected outcomes with regard to the stock market, interest rates and inflation, thereby implying a wide valuation range for domestic equities. Of course, other factors come into play with regard to multiples, most prominent would be taxes and regulation, and those appear to be going in the wrong direction.

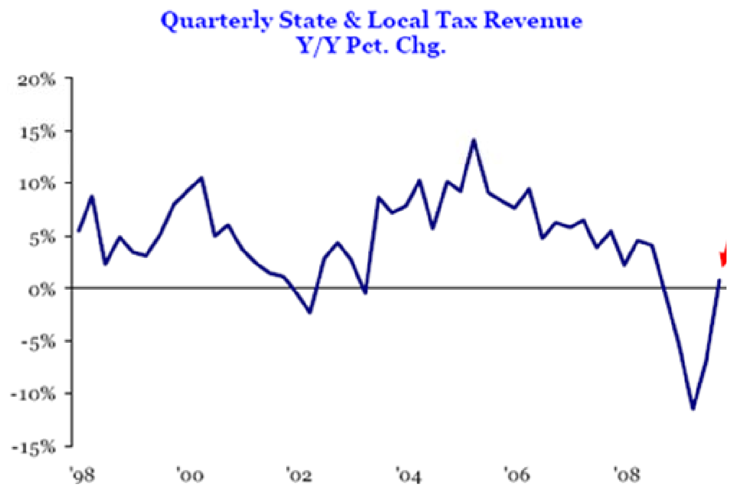
Despite this above normal dispersion among market participants, the VIX, a measure of volatility in the market, and often seen as a measure of investor anxiety, has drifted back to pre-crisis levels, reaching 16 from its high of 80 during the crescendo of the selling:



Source: Bloomberg

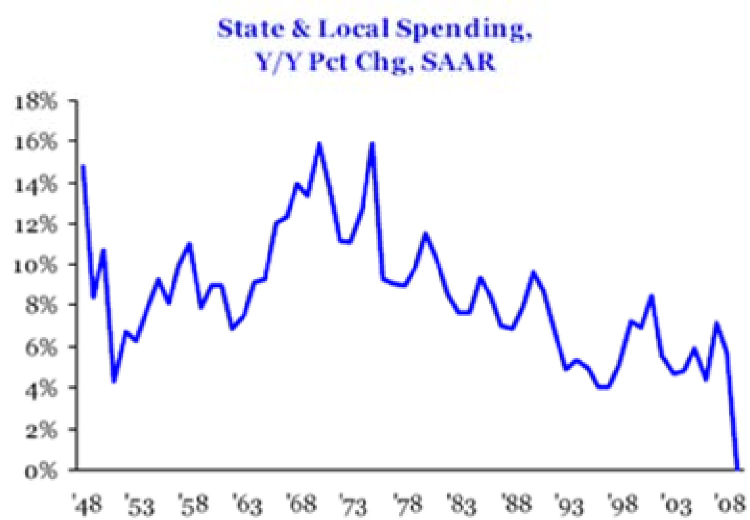
The current level while below the goldilocks period prior to the financial crisis, is at the low end of the post internet bubble timeframe. This is what is at the heart of Fed President Hoenig's comment at the beginning of this section. For while the Fed's accommodative policies have repaired the overall financial conditions in the market, they appear to be encouraging risk taking due to the artificially low cost of short term money, and are injecting an unwarranted dose of complacency into the markets. There is no question that low rates encourage debt over equity and consumption over savings – exactly the opposite behavior that we need to encourage right now. This is especially poignant given that many believe that it was because the Fed kept interest rates too low for too long that helped to precipitate the crisis.

We thought we should comment on the municipal bond market since it is getting some media attention. While overarching credit issues still exist at the state level, we may have reached a near term inflection point for state revenues. States receive an income stream from both sales and income taxes, so they tend to see a revenue increase before it shows up at the Federal level. The chart below shows that state tax revenues have started to turn for the better:



Source: Strategas

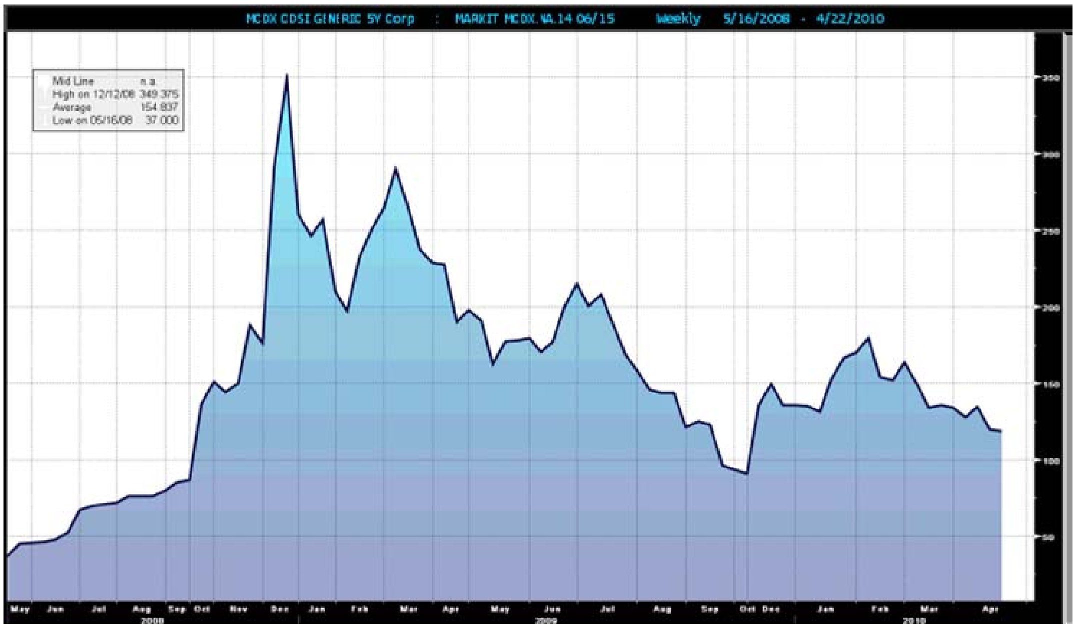
Since almost every state has constitutionally mandated balanced budgets, they have (for the most part) gotten their spending under control. The result could be a surprising turn in the quality of municipal credit, just when the media has been voicing their loudest concerns:



Source: Strategas

The improving credit thesis is confirmed by the decline in the MCDX, which represents the cost to insure a national portfolio of municipal bonds: rates spiked during the Lehman crisis, declined through most of the balance of 2009 and have again been declining since the mid-February Greek debt scare:

<u>Muni CDX Index</u>



Source: Bloomberg

While the widespread concerns around the state budgets cannot be cured until unfunded pension and health care issues are addressed, we may be past the worst of the near term budget issues. However, states will have to continue to cut costs as the economic landscape will likely not support the type of structural cost increases that were implemented over the past twenty years. It goes without saying, that selectiveness will remain paramount in the space.

In terms of recommendations, they have not changed much since last quarter. Below is our stated posture with respect to certain asset classes that we consider timely for those portfolios where an allocation is appropriate:

- For domestic equities, high quality large cap names remain the best value given that they are lagging so far in this rally. They are generally attractive because they tend to have internationally diverse revenue streams, growing exposure to the emerging markets, low funding costs, and many offer attractive dividend yields in comparison to bonds.
- Internationally, we would use any meaningful weakness in the emerging market space as an opportunity to average in. As we have stated before, many emerging countries have far better national balance sheets than do their developed brethren. Further, the development of a middle class capable of driving GDP through internal consumption will be aided by the expected strengthening of their respective currencies against the dollar.
- We continue to like long/short equity hedge funds especially as stocks trade at the high end of our expected trading range. Given the amount of uncertainty in the economy and government policy, we expect volatility to increase when the Fed signals a change in posture toward tightening, and these funds can play both sides of the market.
- In fixed income, inflation, which we view as a major risk, but not a certainty, is the largest concern of most investors we speak to. Should inflation surface, its timing is equally difficult to game. As such, we recommend a balance between availing oneself of the very steep yield curve while not exposing too much of a portfolio to extensive duration which would be hurt if inflation comes quickly. An intermediate ladder or a barbell strategy weighted towards the short end of the curve balances those issues effectively.

Please feel free to contact us to discuss any of the above, or any other questions you may have. As always, we thank you for your trust and confidence.

A copy of Constellation's Form ADV Part II is available upon request by calling Philip Frank at (212) 697-2500 or e-mail philip@constellationwa.com.