Fourth Quarter | January*, 2010*
Constellation Quarterly

A Different Kind of Recovery?

In Review

The following displays the performance of the major indices for the 4th quarter and full year 2009:

Benchmark Performance
Data as of December 31, 2009

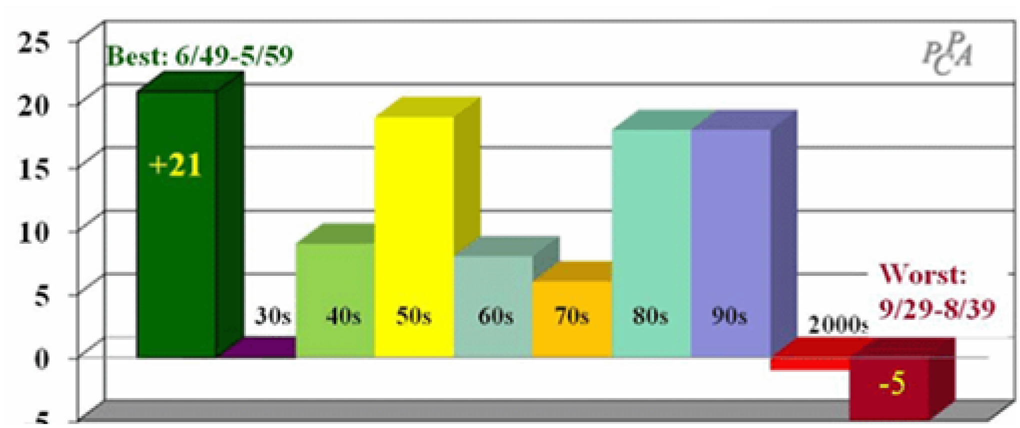
	QTR	YTD	3 Year	5 Year	7 Year
Barclays 5 Year Muni	0.55%	7.41%	6.11%	4.50%	4.19%
Barclays Aggregate	0.20%	5.93%	6.04%	4.97%	4.76%
S&P 500	6.04%	26.46%	-5.63%	0.42%	5.52%
Russell 1000	6.07%	28.43%	-5.36%	0.79%	6.01%
Russell 2000	3.87%	27.17%	-6.06%	0.51%	8.65%
iShares MSCI EAFE	2.18%	31.31%	-6.07%	3.44%	10.10%
iShares MSCI Emerging Markets	8.31%	71.66%	4.94%	15.10%	n/a

Source: PSN Informa

The equity markets were up slightly more than 6% for the quarter with most of the gain coming in the first three weeks of November. Gold was up 8% despite a December correction as the dollar began a respectable countertrend rally. Most notably, the ten year treasury note had one of its worst quarters in years; its price decline pushed the yield to maturity from roughly 3.3% at the end of September to over 3.8% by year end. For the year, the treasury market had its worst performance since at least 1978 (-3.5%) when Merrill Lynch began tracking the index. The increasing supply of treasury issuance caused by the ballooning budget deficit, coupled with the Treasury's desire to push out the average maturity of the government's debt, applied pressure to the long and intermediate portions of the yield curve.

The close of the recent quarter also marked the end of the decade, so we thought it would be useful to provide some perspective on how assets fared relative to other decades over the past century. For the 2000's, stocks as measured by the S&P 500 index had their worst performance since the 1930's, showing a negative return despite the greater than 60% rally from the March lows as seen below:

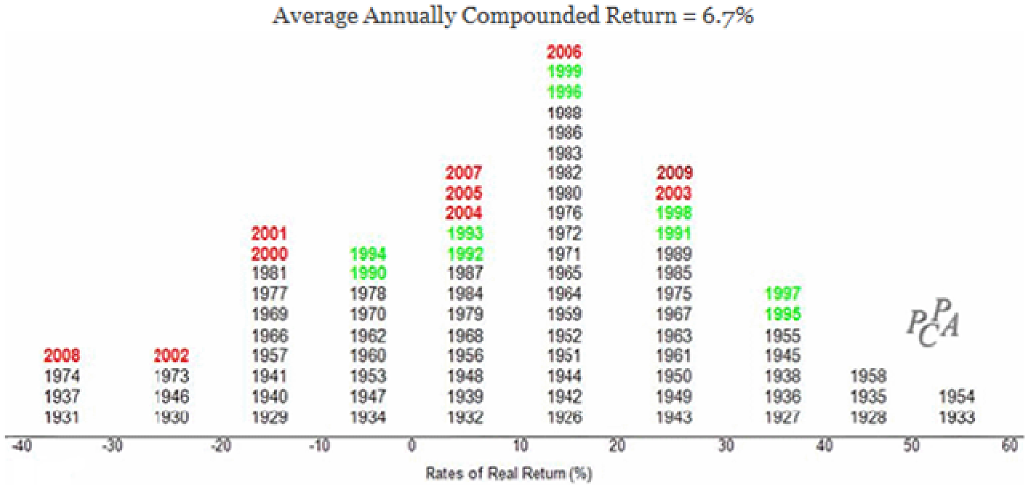
Annualized S&P500 Returns by Decade



This decade's return is somewhat skewed downward because the period began with an overvalued technology and telecom sector whose stocks dominated the S&P 500 index weightings at the time. The following chart shows how the last ten years ranked relative to history (adjusted for inflation), with years from the 2000's marked in red and those from the 1990's in green. Clearly, 2008 was one of the worst years on record, while 2009 was better than average:

Return History for Common Stocks 1926-2009 (inflation adjusted)

Average Annually Compounded Return = 6.7%



All charts courtesy of PPCA Inc.

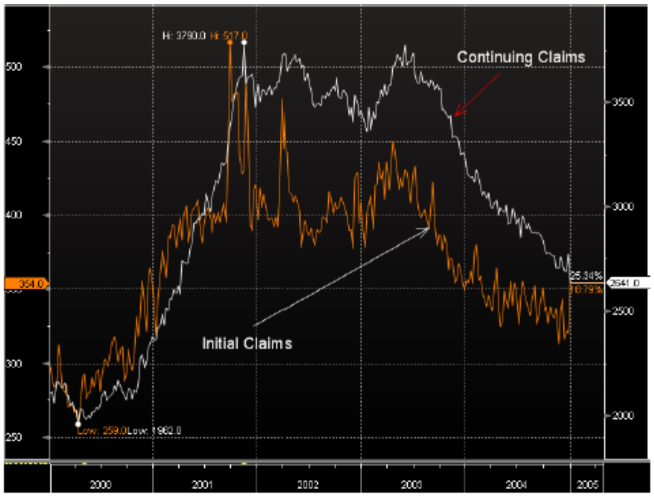
Relative to other asset classes, stocks also performed poorly. If an investor had put $10,000 into the investments below on January 1, 2000, they would have been worth the following amounts on December 31, 2009:

- S&P 500 $ 9,090
- Venture Capital $ 8,800 (for 1999 vintage funds)
- 10-year Treasuries $ 18,000
- Raw materials $ 13,803
- Gold $ 37,852

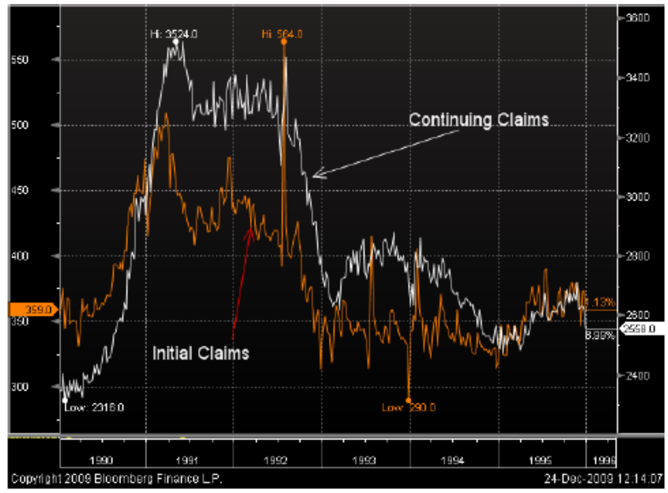
Source: www.paul.kedrosky.com

As for the economy, our focus has been on the job market which will be instrumental to the sustainability of the recovery. Since the recession began, the economy has lost roughly 8 million jobs. Many economists have been relieved by the decline in Initial Jobless Claims (a weekly data series that tabulates the first time filers for unemployment insurance) which continued their downward trend during the fourth quarter. This data series peaked at almost 700,000 in March of 2009, and has since declined to the mid 400,000 level as shown in yellow on the chart below:

Normally, as Initial Claims peak and then start to decline substantially, you would begin to see a commensurate decrease, or at least a consolidation, in the Continuing Claims data (this is the total number of individuals currently receiving unemployment benefits, including the recent extensions; shown in white); this has not yet occurred in this cycle. Even in the "jobless recoveries" following the 2001 and 1992 recessions, the Continuing Claims data stopped rising shortly after Initial Claims peaked as seen below:



Early 2000s recession



Early 1990s recession

Source: Millar Tabek

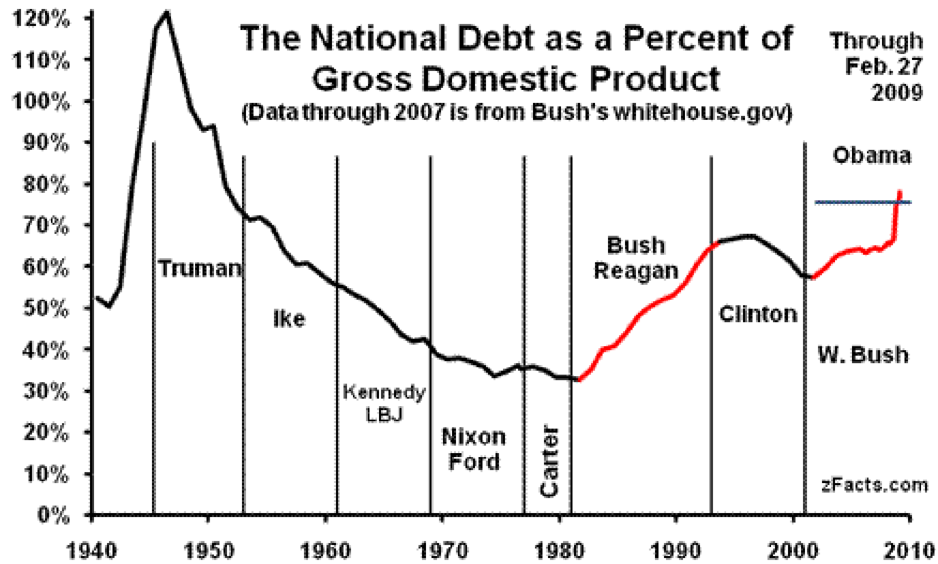
The concern is that the stubbornly rising Continuing Claims data speak to the potential increase in "structural" unemployment that could linger for years. A "normal" economic recovery process generally begins with increased corporate profits that lead to an increase in employment which in turn drives an increase in consumption. If the claims data are speaking to a cycle with different characteristics, this virtuous cycle would be broken and reinforce our belief in the subdued nature of this recovery. It may be too soon to draw any definitive conclusions, but we will monitor these data series closely to determine if this key component of the recovery story falls into place.

Outlook

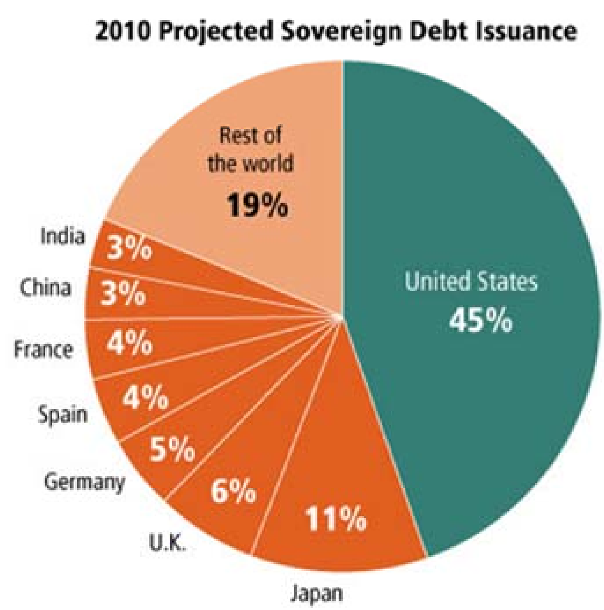
"The less government interferes with private pursuits the better for the general prosperity"
Thomas Jefferson

With the economy poised to register its second consecutive quarter of growth, it appears that the massive federal intervention and stimulus has prevented Depression 2.0 from occurring. However, the economy's ability to grow on its own at a level sufficient to sustain the recovery is still in doubt. The government's efforts came with a price; the federal balance sheet as measured by government debt to GDP is beginning to reach alarming levels.

The total U.S. debt now stands at roughly $12.3 trillion (this figure includes the public Treasury debt **plus** the money borrowed from the Social Security System), up 50% from as recently as 2006. That level brings the U.S. debt to GDP ratio to 84%, and it is projected to move much higher in the near term due to projected large future budget deficits. The chart below provides some context relative to history:

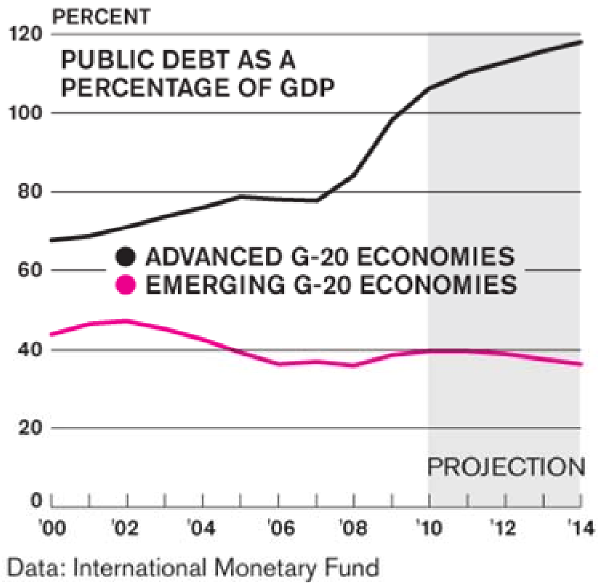


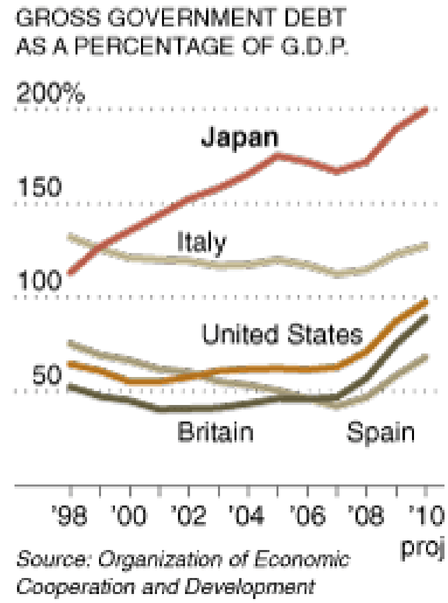
A recent study by economists Reinhart and Rogoff finds that a 90% debt to GDP ratio is the tipping point at which sovereign debt levels begin to impinge on economic growth – with countries that breach that threshold growing one percentage point less than countries that have not. The U.S. isn't alone with respect to its borrowing needs; roughly $4.5 trillion in sovereign debt is estimated to be issued this year (an amount that is almost triple the average for mature economies over the past five years according to Forbes) as follows:



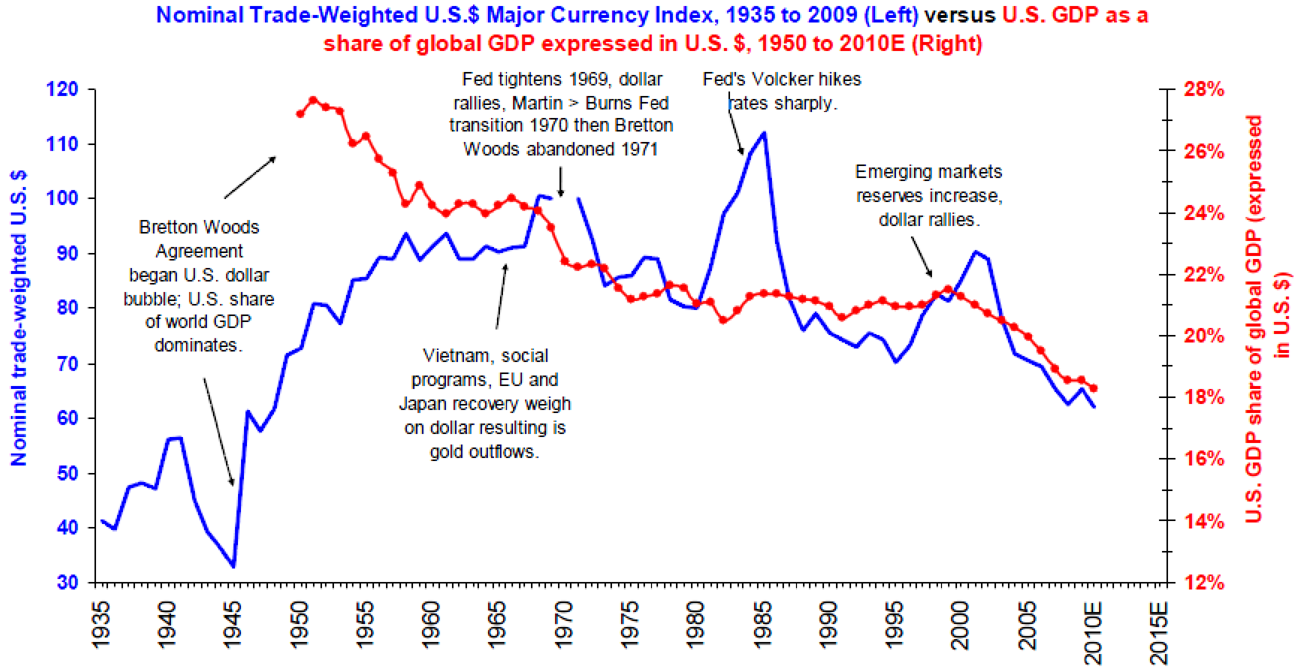
Source: Forbes

That supply could sustain the pressure on the intermediate to long end of the treasury curve that began in the fourth quarter, pushing interest rates even higher. With this high level of issuance and the projected amounts to follow, the developed world's debt to GDP ratio is estimated to take the following path:





Given the above, the world's developed economies will most likely see their growth rates moderate at best, while emerging markets would continue to take a larger share of global GDP. Over the long term, that should result in the dollar continuing to weaken. While we expect periodic rallies in the dollar when risk aversion returns to the market (possibly when economic growth begins to disappoint), we would expect the record Treasury issuance to continue to weigh on the dollar unless corrective action is taken. The chart below demonstrates that the dollar's value (shown in blue) has declined over time in line with the US's share of global GDP (in red):



Source: Stifel Nicolaus

To further complicate matters, the Fed must balance the forces that may weigh on the bond market (investors demanding higher rates to offset the perceived risk of the growing deficit) with the economy's need to keep rates low to support the financial system and the housing market. Or as Howard Marks of Oaktree Capital stated in his letter to investors: "Global considerations call for higher rates, but fighting domestic economic weakness relies on low rates. Resolving this dilemma won't be easy…or painless"

The pending debt supply and potential higher interest rates along with other impediments to growth we have mentioned in previous letters (consumer deleveraging, increased taxes, regulation, etc.), reinforce our belief that stocks may remain in a trading range for the intermediate time horizon. While the movement of stocks to the upper end of our range has forced us to revisit (as we are constantly doing) the assumptions inherent in our view, we are holding firm for now.

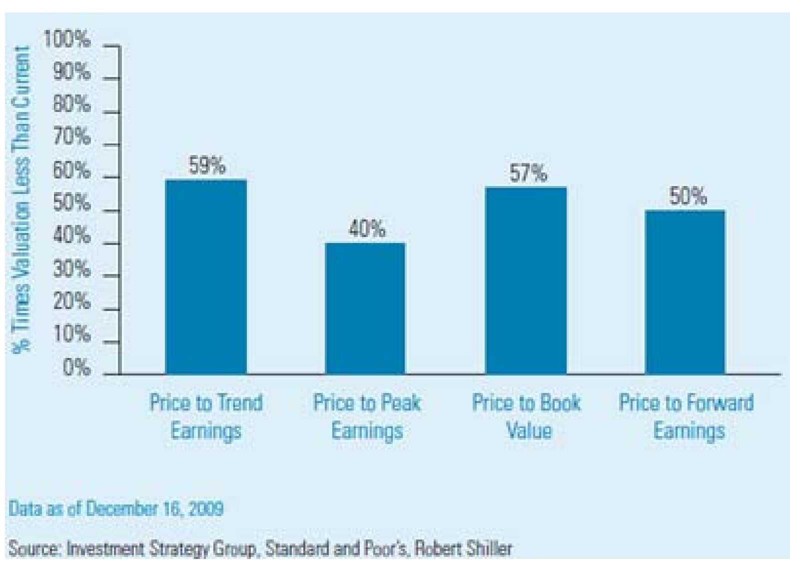
The same cannot be said for Wall Street strategists, several of whose views are summarized in the chart below:

	S&P 500 Target	S&P 500 EPS	GDP % Growth
BoA / Merrill Lynch	1,275	$73	3.2%
Barclays	1,120	$66	3.5%
Citigroup	1,150	$73	2.2%
Credit Suisse	1,125	$76	2.7%
Deutsche Bank	1,325	$81	4.9%
Goldman Sachs	1,250	$76	2.1%
JPMorgan	1,300	$80	3.5%
Morgan Stanley	1,200	$77	2.9%
UBS	1,250	$80	2.6%
Average	**1,222**	**$76**	**3.1%**

Source: Birinyi Associates

At a time when we feel that uncertainty about the macro environment and the diversity of outcomes should be at their peak, earnings and GDP estimates by Wall Street's market strategists are in a surprisingly narrow range. Perhaps most telling was that not one pundit was calling for a decline in equities for this calendar year. This sentiment was echoed in the recent Barron's Roundtable (January 18, 2010 issue) even though some participants in that discussion were bearish on the macroeconomic outlook. Such groupthink evokes memories of Bob Farrell, a long time Merrill strategist who's "Ten Market Rules to Remember" include "when all the experts and forecasts agree – something else is going to happen".

The $76 consensus EPS for the S&P 500 in 2010 places the market at roughly 15x forward earnings. The chart below shows the percentage of times the market has been valued at less than current levels on a variety of metrics:



To us, this places equities at a level close to fair value. In fact, one could argue that the confidence in the forward earnings should be discounted given the almost unparalleled circumstances surrounding this downturn. The consensus number of $76 represents an increase of over 30% from 2009's earnings and implies a GDP growth rate that could be a challenge given the economic headwinds we have described.

In terms of recommendations, below are some opportunities that we consider timely for those portfolios where an allocation is appropriate:

- We continue to like selective long-only equity investment managers who have proven to be good stock pickers through complete market cycles. We reiterate that large capitalization domestic equities remain a cheap way to play the international and emerging growth story. In addition, dividend oriented strategies, for many reasons, including their ability to do well in inflationary environments, remain an attractive alternative.

- Selective hedge fund investments such as long/short equity as a replacement or complement to existing long-only managers is also recommended to capitalize on the potential range bound nature of the market. As many of you know, we recently created an investment vehicle to facilitate this allocation.

- Selected areas of cash flow focused real estate, purchased with reasonable leverage and an experienced operator may be attractive again. The increasing benefit of the tax shelter nature of real estate and reasonable valuation opportunities are part of the investment thesis.

- The huge influx of money into bonds last year helped to support a rally in prices, with many bond categories outperforming equities for 2009. As a result, spreads have tightened dramatically relative to treasuries, and now offer less favorable risk reward profiles. With respect to portfolio structure, we favor a five to seven year duration ladder or a barbell approach that limits the portion of the portfolio farther out on the curve. We reiterate that credit quality is paramount given the uncertainty of the recovery.

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.