Darkness on the Edge of Town

Review

"Foreign investors in U.S. dollar assets have seen big losses measured in dollars, and still bigger ones measured in their own currencies. While unlikely, indeed highly improbable for public sector investors, a sudden rush for the exits cannot be ruled out completely." **The Bank for International Settlements**[1]

The performance* for the indices we track over the relevant time periods is outlined below:

Benchmark Performance
Data as of March 31, 2011

	1Q11	1 Year	3 Years	5 Years	7 Years
Barclays 5 Year Muni	0.61%	3.25%	5.06%	5.13%	3.99%
Barclays Aggregate	0.42%	5.12%	5.30%	6.02%	4.77%
S&P 500	5.92%	15.65%	2.35%	2.62%	4.46%
Russell 1000	6.24%	16.69%	2.98%	2.93%	4.95%
Russell 2000	7.94%	25.79%	8.57%	3.35%	6.60%
iShares MSCI EAFE	3.36%	10.42%	-3.01%	1.30%	6.24%
iShares MSCI Emerging Markets	2.05%	18.46%	4.32%	10.70%	16.19%

Source: PSN Informa

A review of other assets and their corresponding returns since the August 27th Jackson Hole speech that indicated the Fed would start a second round of quantitative easing and for the latest quarter is also shown below, hard assets are leading the way:

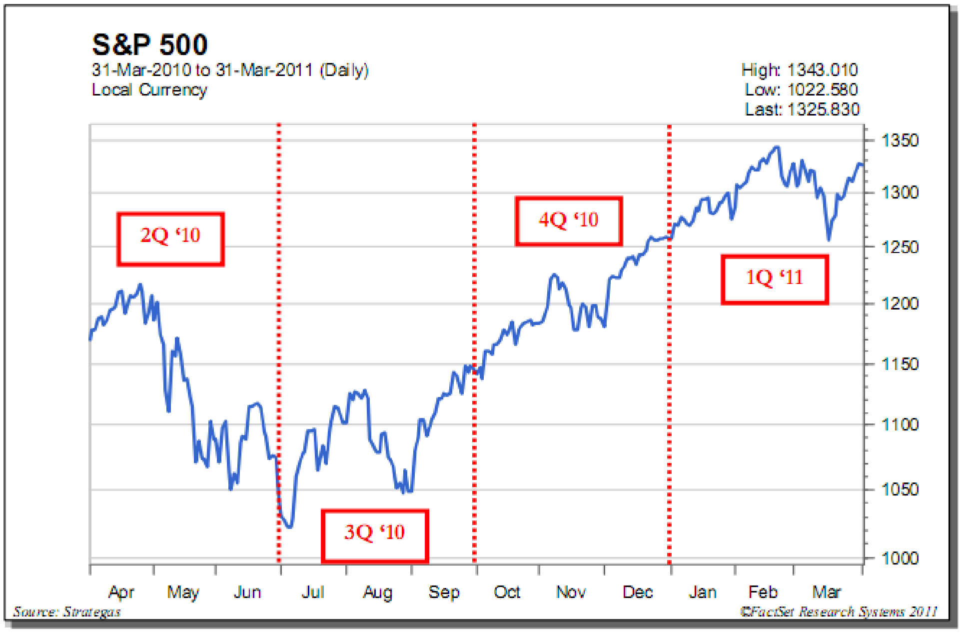
	Since 8/27/10
Cotton	124.9%
Silver	99.0%
Corn	64.7%
RBOB Gasoline	59.5%
Heating Oil	51.1%
Coffee	49.2%
Crude Oil	42.0%
Soybeans	38.0%
Sugar	35.8%
Aluminum	28.5%
Copper	27.8%
Lean Hogs	25.3%
Nickel	24.2%
Live Cattle	24.0%
Orange Juice	21.0%
Natural Gas	20.2%
Gold	16.4%
Wheat	15.2%
Cocoa	10.4%

	1Q 2011
Cotton	38.3%
RBOB Gasoline	26.7%
Silver	22.6%
Heating Oil	21.5%
Lean Hogs	17.5%
Crude Oil	16.8%
Live Cattle	12.7%
Corn	10.2%
Coffee	9.8%
Aluminum	6.7%
Nickel	5.6%
Gold	1.2%
Soybeans	1.2%
Natural Gas	-0.4%
Cocoa	-2.7%
Copper	-3.1%
Wheat	-3.9%
Orange Juice	-5.5%
Sugar	-15.6%

Source: Strategas is an independent organization not affiliated with Constellation Wealth Advisors LLC.

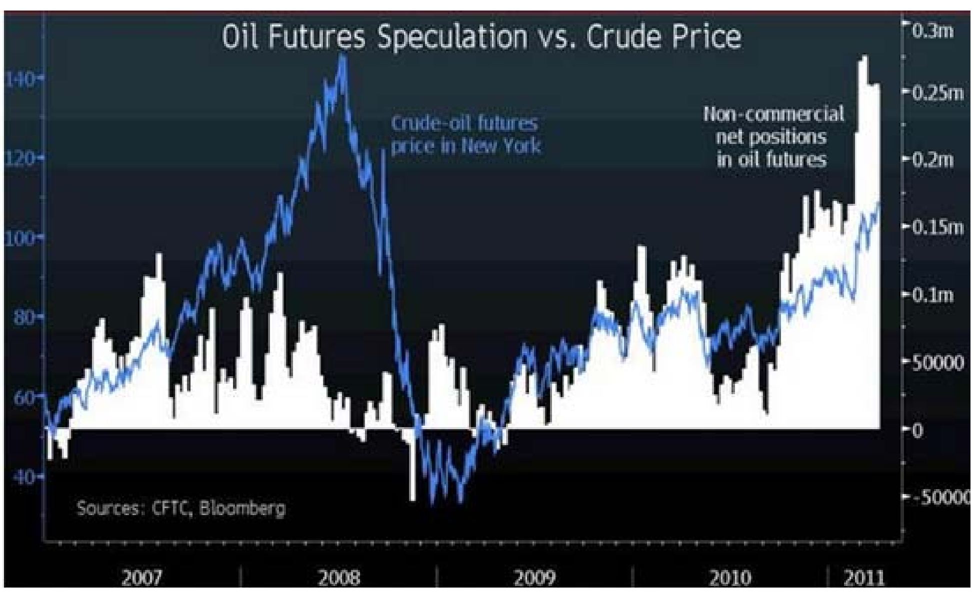
[1] The Bank for International Settlements (BIS) is an international organization which fosters international monetary and financial cooperation and serves as a bank for central banks and is not affiliated with Constellation Wealth Advisors LLC ("CWA").

The S&P 500 had its strongest first quarter since 1998 despite the devastating natural disasters in Japan and the outbreak of violence and upheaval throughout the Middle East:

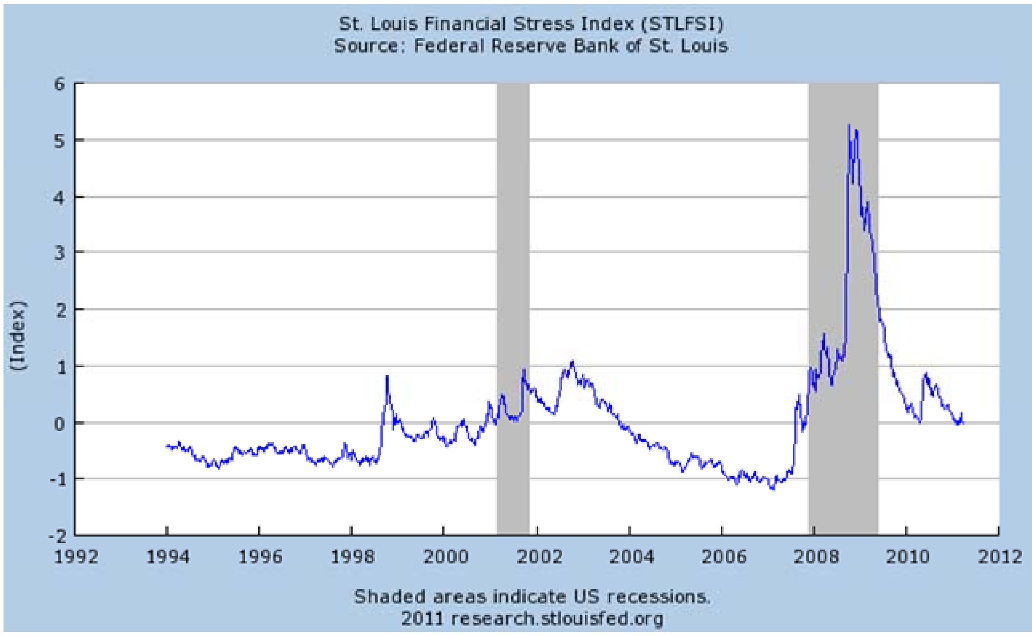


Source: Strategas

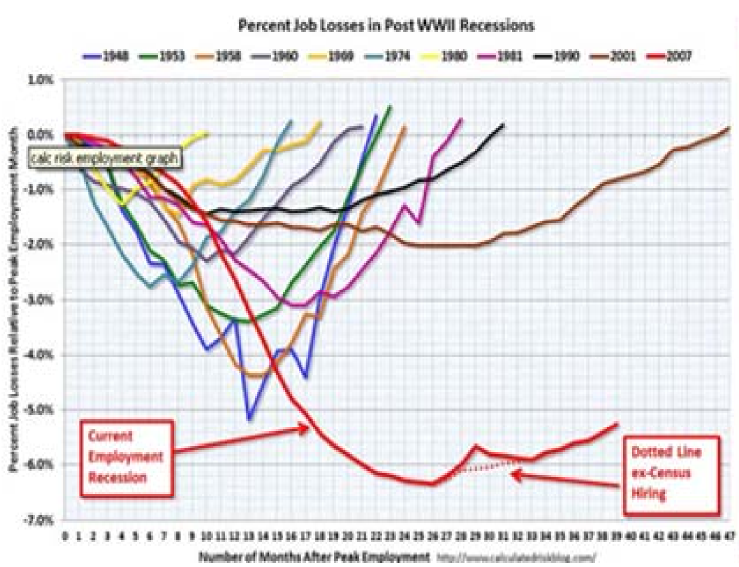
The tensions in the Middle East caused pressure on the price of oil, as concerns about supply drove speculators into the market (shown as the white shaded area below). Notice how much more speculative money was driving oil in this cycle versus the last spike in 2008. Perhaps, given the uneasiness of investors with the Fed's quantitative easing campaigns, investors seeking a hedge against the sinking dollar played a part:

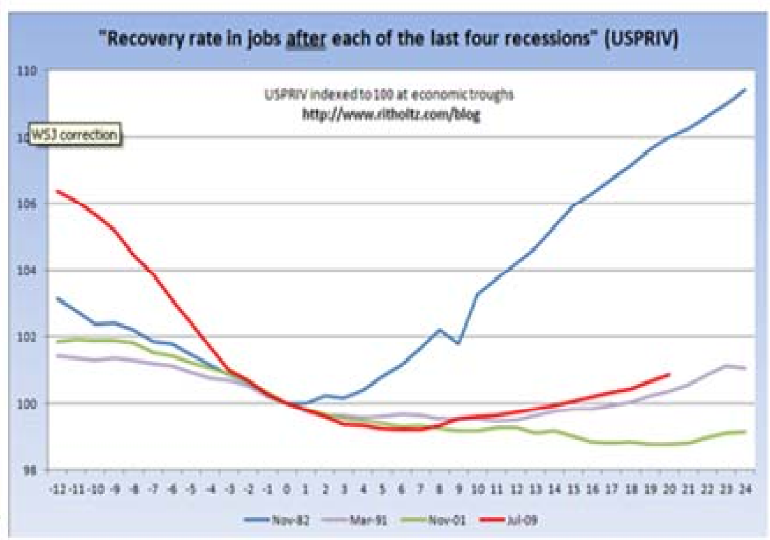


Despite the geopolitical turmoil however, financial conditions remained "normal" as evidenced by the St Louis Fed's Financial Stress Index (which uses 18 weekly data series involving interest rates, yield spreads and other indicators):



Employment has continued to improve recently. We have included the chart on the left before that tracks the change in employment since the **peak** of employment in each series (in the latest, cycle that would be in 2007) and shows this cycle as the weakest. The chart on the right however, shows the change in jobs since the recession **ended** versus the last three recessions; with the latest recession shown in red on both charts. Looked at this way, the change in jobs has actually been better in this cycle (post recession) than in the prior two cycles, but less than the 1982-3 recession. We will need to see a continued improvement in jobs, as well as income, for us to believe in the sustainability of the cycle.





Outlook

"*We do what we have to do even if it's difficult.*" **ECB President Jean-Claude Trichet**

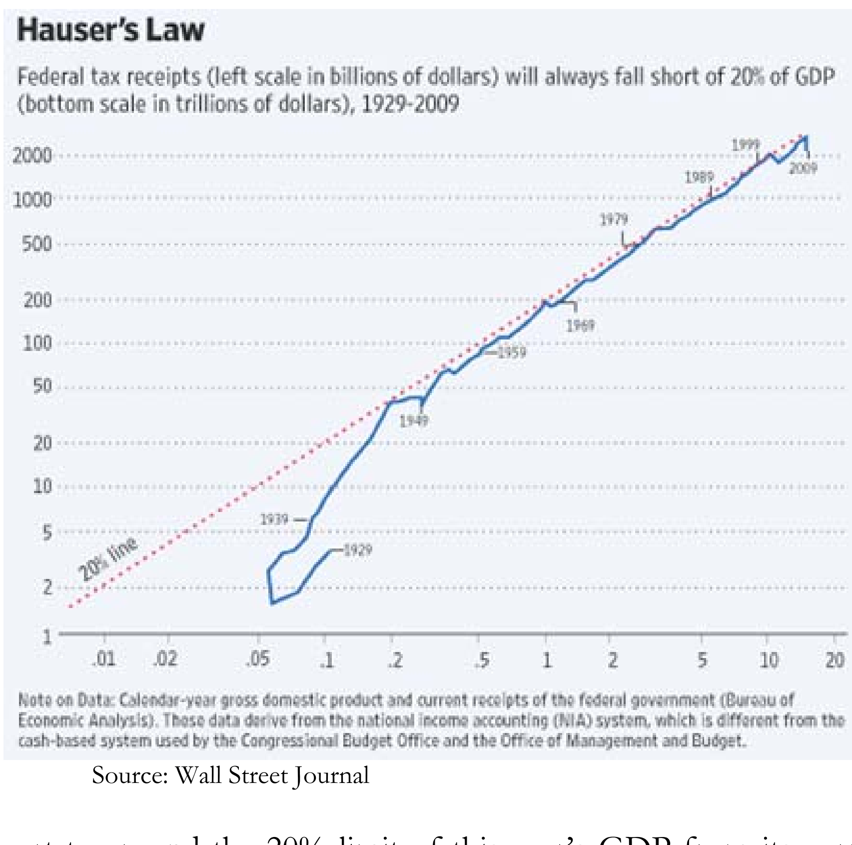
"*A fool and his money are soon elected.*" **Will Rogers**

Arguably, the biggest issue hanging over the markets and the economy is the build-up of government debt since the financial crisis started in 2007; we have discussed this issue in prior letters. In that time period, US government *public* debt outstanding has increased from $4.34 trillion in 2007 to $9.13 trillion today (including the social security debt, the total is now $14.2 trillion pushing against the much publicized debt ceiling).

Many analysts have discussed the debt in terms of debt to GDP – but a more meaningful analysis is to compare the national debt to the government revenues. After all, it must be serviced and repaid by these revenues. For fiscal year 2011, the government is projected to receive roughly $2.2 trillion in revenue and expenses are estimated to be $3.7 trillion, for a deficit of $1.5 trillion (or over 60% of income). If we add existing debt to this analysis, we get over $14 trillion of debt on only $2.2 trillion of revenue or almost 6.5 times debt to revenue. This puts the government in the same position as a sub-prime lender with $100,000 of income that has borrowed $650,000 and is still borrowing every year with no end in sight.

The recent debate in Washington as of this writing was whether to cut $33 billion or $40 billion from the spending for the remainder of this fiscal year. Since this is less than 1% of the spending budget we would argue that it doesn't matter other than for symbolic purposes. Even Paul Ryan's plan to decrease spending over the next decade, which is by far the most aggressive one out there and has been called radical by some, does not balance the budget until 2041 – that could stretch the limits of bond investors' patience.

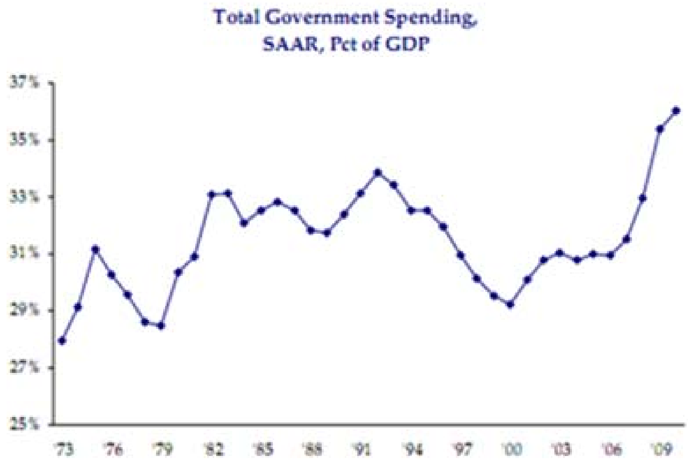
Some might hope that revenue can be enhanced through increased taxes. To be sure, current revenue is depressed (at roughly 15% of GDP) as a residue of the financial crisis and the recession that followed. Typically, government revenue tends to max out at the 20% of GDP level for any sustainable period. Referred to as Hauser's law, it is diagramed below:

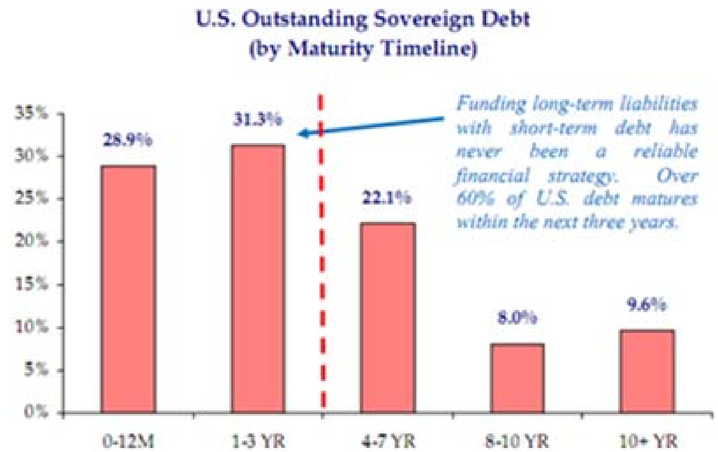


Source: Wall Street Journal

If revenue were to revert to around the 20% limit of this year's GDP from its currently depressed level, that would generate just under $3 trillion. With expenses running at $3.7 trillion and growing quickly, that still leaves annual deficits at a level that increases the debt burden at an unacceptable rate. The point is that this problem can't be solved by revenue alone and expenses need to be addressed quickly. Unfortunately, politics and dissension have prevented progress towards a solution so far.

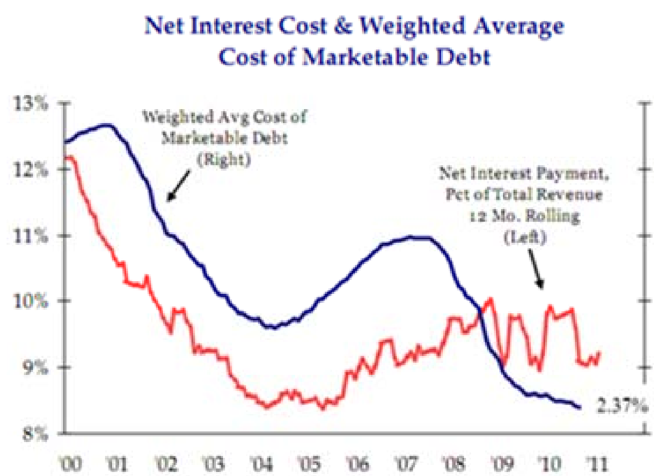
The budget situation is reaching levels that could create a multitude of problems. The chart on the left tracks government spending as a percent of the overall economy – it is at multi-decade highs. Empirically (per Reinhart and Rogoff), government spending at this level has resulted in lower rates of growth and lower price to earnings multiples for stocks. The chart on the right shows that over 60% of the current public debt comes due in the next 3 years. This is critical for several reasons but most importantly, if rates rise, which is likely, the interest expense to service the debt will reset quickly and further pressure annual deficits:





Source: Strategas

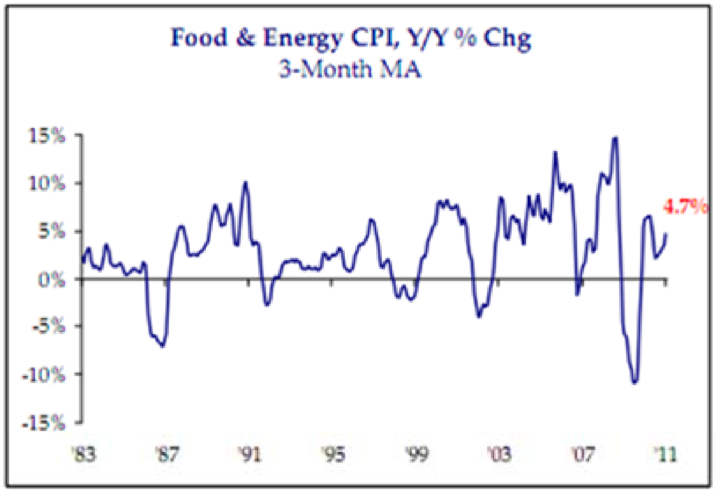
The cost to service the debt is shown on the left chart below and averages just below 2.4%. Some would argue that this rate is artificially depressed by the Fed's purchases; the graph on the right tracks these purchases and shows that the Fed is now buying 70% of recent Treasury issuance. The combination of maturing debt, new required issuance due to massive deficits and the Fed eventually having to cease being the buyer of last resort could have a nontrivial effect on the level of rates required to attract new buyers.

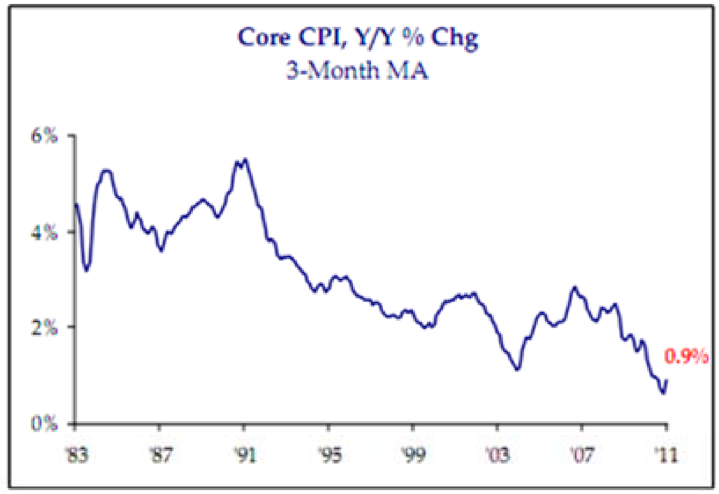


Source: Strategas

We want to be optimistic that fiscal sanity will prevail in Washington and that the difficult spending decisions will finally be addressed. However, it is hard to maintain that optimism while following the events closely on the news and in the newspapers.

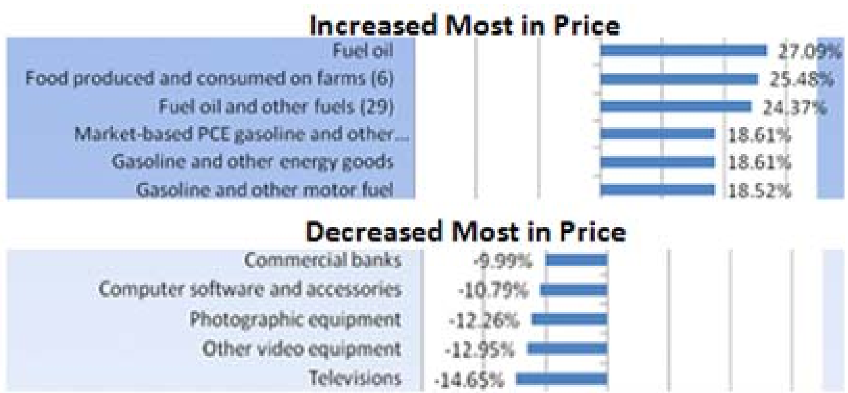
As for inflation – there is still a debate about whether current Fed policy, rising energy prices, the $1 trillion of bank reserves sitting on deposit at the Fed and the improving economy will conspire to cause an inflation problem. Here is what the data are saying: the chart on the left shows the level at which food and energy prices are rising. The chart on the right shows that this pressure has yet to be felt on the broader Consumer Price Index ("CPI measure") (which has many flaws but it is what the Fed is looking at so we will too):



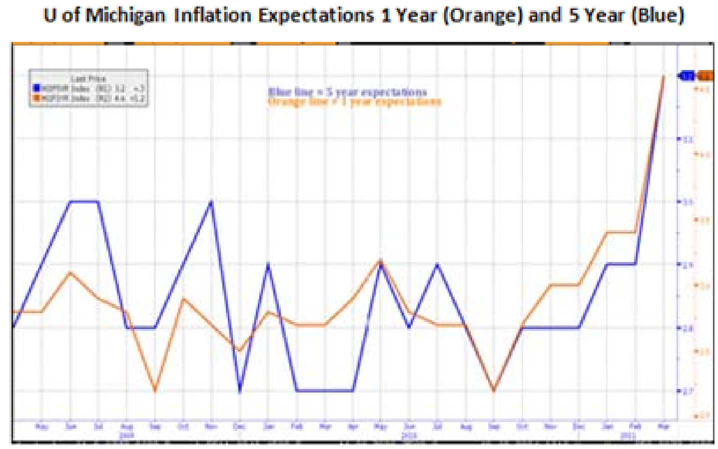


Source: Strategas

Below are the components with the biggest increases and decreases from the latest CPI report:



This analysis shows that what is increasing in price are those items purchased regularly (food, gas, etc.) and those that are decreasing are purchased infrequently. The result is that the consumer feels the impact of the increases far more than the averages would suggest. Further, the total cost pressure from food and energy (they now make up almost 22% of income, and nearing an all time high) is straining budgets and increasing consumer expectations about inflation in the near future. The right chart is from the University of Michigan sentiment survey and shows the recent spike in 1 year and 5 year inflation expectations. The left chart shows what the markets are discounting – apparently having faith that future Fed policy will bring inflation down after the initial spike:



Source: Strategas

Additionally, the latest NFIB (National Federation of Independent Businesses) survey shows a spike in small business' plans to raise prices (red line). This has historically been a good leading indicator of headline CPI by three months (grey line):

Source: GaveKal is an independent organization not affiliated with Constellation Wealth Advisors LLC.

Being concerned about inflation is certainly not a variant view, but we wanted to relay the data that we analyze to show what the market is discounting. Having a firm conviction would involve being able to guess what happens in Congress and at the Fed. A further extension of QE or a failure to address the entitlement time bomb would chip away at the market's belief that the US will get back on track. Since our exit from the gold standard, our dollar is backed only by faith and confidence, and the last two years might have permanently damaged those beliefs. We are concerned that foreigners, who currently own 50% of outstanding treasuries, may come to feel about the dollar as Chris Rock felt about Donald Trump's bid for the presidency, "I won't vote for him. I'm afraid he'll leave us for a younger, prettier country". There are many younger better looking currencies right now.

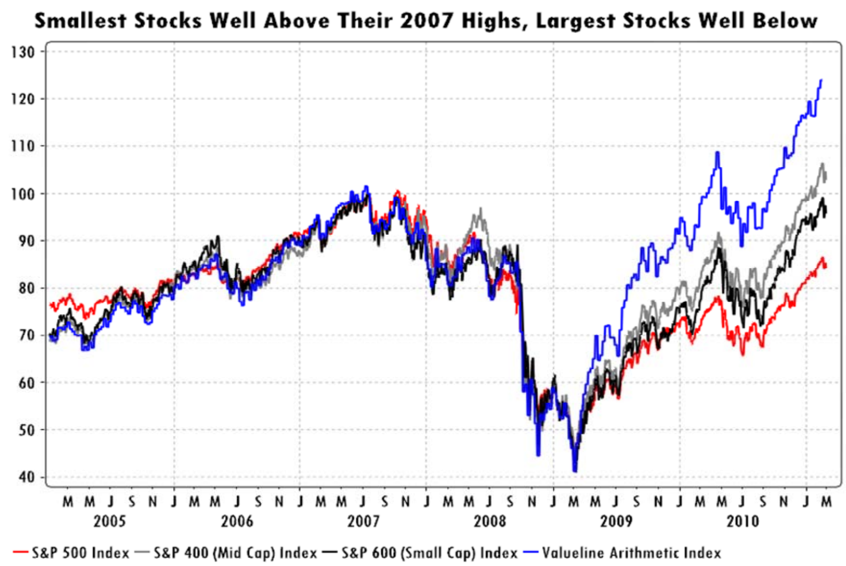
Recommendations

We are not calling for a dollar crisis or a runaway inflation scenario. However, it seems prudent to open oneself to the possibilities. Politicians on both sides appear oblivious to the approaching tipping point of the federal balance sheet and may need the markets to force their hand to do the right thing.

The Federal Reserve's next move is also uncertain. The FOMC is divided, although it seems the more dovish members, led by Chairman Bernanke and Vice Chairwomen Yellen will get their way. Most market participants assume the end of the QE program will have a disruptive effect on the bond market. However, there is a school of thought that believes the end of QE2 (if it does end) will bring forth a decrease in interest rates as the stimulative effects of the printing are removed.

As for oil, it seems likely to maintain an uncertainty premium for the near future given the widespread nature of the unrest in oil producing regions and uncertainty about the dollar. That coupled with rising consumer inflation expectations and the Feds QE programs have sown the seeds for inflation at some point, although it might take longer to permeate into the core CPI numbers than many market participants believe. We are open to the various outcomes; it is a matter of assigning probabilities, sizing the bets and remaining flexible. In this light we offer the following recommendations:

Equities: we maintain a somewhat constructive view of the domestic equity market especially the large cap dividend paying stocks. The sentiment indicators we follow however point to a need for some consolidation of recent gains at a minimum or even a possible correction. Valuation metrics remain at or below historical averages and the best values are in the large mega-cap space as illustrated below (the red line is the S&P 500 Index versus Midcap in grey, small cap in black):



Source: GaveKal

A further support to equities may come from the catch up needed by institutional holders to get back to historical levels of exposure. The chart below shows the percent of private pension and household holdings of equities; pensions are particularly under-exposed:

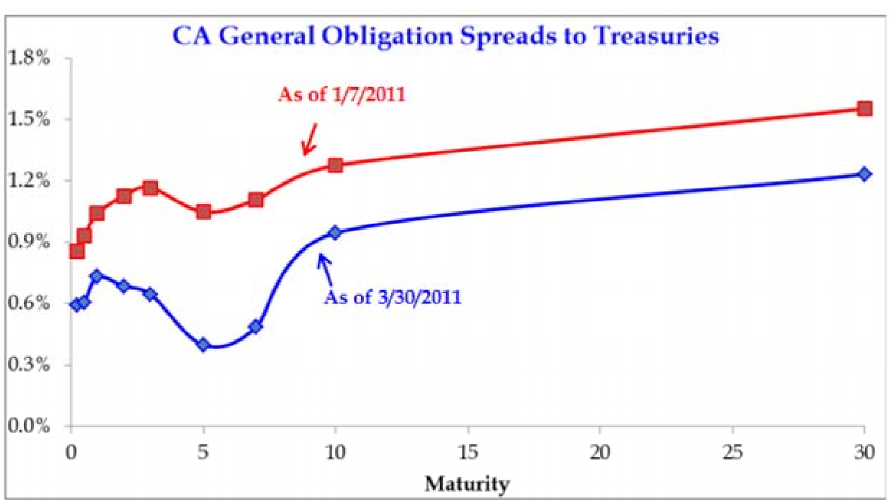
Corporate Equity Holdings as % Financial Assets

	Private Pensions	Households
1996	43.5%	20.2%
1997	43.2%	23.0%
1998	45.1%	25.0%
1999	42.8%	28.4%
2000	44.1%	24.5%
2001	47.1%	21.2%
2002	43.2%	17.1%
2003	46.4%	19.2%
2004	47.5%	19.1%
2005	45.3%	18.7%
2006	44.8%	20.1%
2007	41.7%	19.0%
2008	35.1%	14.0%
2009	33.6%	16.6%
2010	32.6%	17.9%

Source: Federal Reserve Flow of Funds Accounts, Table L.118

Corporate balance sheets remain in great shape and merger and acquisition activity is picking up. Some market observers question the ability of corporate profit margins to stay at these historically high levels. Granted some cost increases will pressure these margins, but by definition one cannot be concerned about inflation and at the same time believe margins will compress meaningfully.

Fixed Income: we continue to recommend a defensive posture in fixed income portfolios. Given the doubt that a serious budget will be passed, rates are likely to move up in intermediate and long dated securities causing the curve to steepen. Such a posture entails a barbell or ladder weighted toward the short end of the curve. Some exposure to foreign currency either directly through purchases of sovereign treasuries or through a mutual fund or ETF is recommended. This is the first cycle that the Fed is behind other central banks in raising rates; historically when monetary policy differs, the most visible impact is usually expressed in currencies. This cycle has stayed true to that rule as the dollar seems to trade lower on a daily basis and has been hovering near historic lows. Municipal bonds have rallied after being dislocated at year end following Meredith Whitney's appearance on 60 minutes. Valuations are back near historic norms to treasuries but money continues to bleed out of municipal-based mutual funds. The chart below shows the rally in California (one of the lower rated states) municipal yields since year end:



Source: Strategas

Alternatives: we recommend exposure to the hedge fund space as we expect volatility to continue in the equity as well as the commodity and currency markets. Although off to a slow start this year, quality long/short hedge funds add efficiency to a portfolio; increasing returns for the same or lower level of overall risk. They also can participate in markets where individual investors cannot easily gain exposure such as CDS and commodity futures. Cash flow real estate is ideal for the environment we are in; the fundamentals are improving and the inflation hedge aspect to the investment is very appealing.

If you have any questions or comments on the above, please feel free to contact us. As always, we thank you for your trust and confidence.

Indices

Barclays 5 Year Municipal Bond Index is composed of 35% state general obligation bonds, 50% revenue debt and 15% pre-funded bonds.

Barclays ("Capital") Aggregate Bond Index, is a broad base index, maintained by Barclays Capital and is often used to represent investment grade bonds being traded in United States.

S&P 500® index has over US$ 4.83 trillion benchmarked, with index assets comprising approximately US$ 1.1 trillion of this total. The index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities.

Russell 1000 measures the performance of the large-cap segment of the U.S. equity universe and is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are reflected.

Russell 2000 measures the performance of the small-cap segment of the U.S. equity universe and is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

iShares MSCI EAFE measures the performance of publicly traded securities in the European, Australasian and Far Eastern markets.

iShares MSCI Emerging Markets Index is designed to measure the equity market performance in the global emerging markets. The index consists of 21 emerging markets with the three largest sectors by component weighting were financials, energy and materials.

**Past performance is not a guarantee of future results.*

Disclosure

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