APRIL 2010 — MARKET REPORT

LIFE AFTER THE HEALTHCARE BILL.

If you skew toward libertarian or more conservative views on how the country should be run, with the passage of the widely unpopular landmark U.S. healthcare bill, Team Obama has just sent you a proverbial pink slip… Your services as a participant in this democracy are no longer required…though your tax dollars most certainly are demanded.

With the health care bill now law, the U.S. stock market indexes continue to rise. This strikes most as counterintuitive, but as we have stated many times, stock markets like certainty above a politically unpopular legislation. The U. S. stock market is telling us there is little in the near future that can be foreseen to de-rail the recovery that we've witnessed since March of last year. While debates rage on as to the effects of Washington's latest entitlement, we are anticipating the effect to be a slower economic growth rate and the continued need of businesses to innovate in order to accommodate the increase in burden.

The government deficit requires the U.S. Treasury to borrow around $1.5 trillion last year and again this year. They have been holding big auctions for which, at first thought, it would be difficult to find enough buyers. Especially since foreigners have fewer dollars to invest in our Treasuries because the trade deficit that provided them with the funds has dropped from $700 billion to $500 billion. So who is buying the government debt?

One source is our own banks. In recessions, and this is no exception, banks stop making loans. To state the obvious, that's because borrowers are less interested in borrowing and banks are more fearful of lending. The safer alternative to lending is for the banks to buy Treasuries. In the current recession, banks have cut their commercial and industrial loans by about $300 billion and increased their holding of Treasuries by about the same amount. So this is one source for funding the government debt.

Although they have reduced their purchases, foreigners remain important to the Treasury auctions. During the recession, foreigners have shifted their preference away from buying agency debt, corporate bonds, and equities, toward safer U. S. Treasuries. The annual rate of Treasury buying from foreign sources is still running at about $400 billion.

Surprisingly the biggest buyer is not the big exporters of China and Japan, but England with about $200 billion (for the seven months to January, annualized). London is a financial center representing other countries looking to buy our bonds. Buyers could be banks, hedge funds, or hot money. The risk on this strategy is low as long as the short-term rate is kept low for an extended period, so leveraging the carry trade several times over can make this a very profitable investment on the small rate differential. Confirming this is the increasing portions of the auctions that are accepted for direct bidders, who are not the largest 20 or so primary dealers, or the indirect bidders who are thought to be mostly foreign central banks.

Of course, the Fed bought $300 billion of Treasuries in the last year, as it had announced.

We expected interest rates to be forced higher to attract future Treasury buyers, but rates have currently moved up only in small amounts. These sources have provided the demand to keep the bidding for Treasuries high enough to prevent rates from raising much.

This situation is precarious, because the profitable carry trade is dependent on the Fed keeping rates low, and because the banks buying Treasuries only works in a situation where regular lending is risky and so the usual loans are not expanded. We think this helps explain why the Fed is keeping rates down and how the carry trade keeps longer rates contained, even with the big deficits.

[1] Jan 11, 2010, Monday Morning Outlook , Brian S. Wesbury -- Chief Economist First Trust Advisors L. P.

If the economy really does continue to pick up so that lending starts, that would drive rates higher. Our own belief is that as foreign rates move up, the dollar would weaken, bringing a need to raise rates to protect the dollar. There are many moving parts, but it seems dangerous to build big government deficits on hedge fund leveraged carry trade Treasury purchases.

Economically sensitive companies in the industrials, materials, technology, and healthcare sectors are getting the most attention by us as well as others. We will remain as diligent as we have in anticipating any changes that would dramatically affect our holdings.

The number of stocks hitting 52-week highs is not necessarily a bad sign for the stock market.

As always, thanks for your trust.