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MANAGEMENT

INVESTMENT ASSESSMENT
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As usual, investment advisors and market strategists are engaged in a debate about the future direction of stock prices. Bulls see marked improvement in corporate profits, low interest rates and an increase in consumer confidence, and thus, a continuation of the current market rally. The Bears believe a double-dip recession may unfold, resulting in another market drop.

The key to a continuation of an improving economy and stable financial markets is the Federal Reserve's promise to keep interest rates at virtually zero for an "extended period". U.S. inflation is running at an annual rate of just over 2%. It is true that the Fed has decided to stop adding liquidity into the mortgage market, but it hasn't taken any steps to pull money out. A case for the Bulls is further supported by an absence of competitive investment vehicles: bonds offer very low yields, and both the residential and commercial real estate markets lack appeal to investors.

Here are the issues likely to effect the direction of financial markets in coming months:

Technical Market Conditions
Despite a substantial improvement in the equity market, investors remain cautious. After a very powerful twelve month market rally, stock prices are still lower than they were ten years ago. Broad market indexes reached peak levels in 2000. The DJIA is now 22% below its all time high and the S&P500 remains 25% from its peak reached in 2007. So we have a cyclical bull market rally in a secular bear market. What's the reason for this long-term underperformance? The markets are still working off investment "bubbles" of historic proportion that occurred in both the stock market and the real estate market. The stock market rally has been fueled by unprecedented government action to curtail a global financial meltdown.

Global Markets and Inflation
In a relatively short period of time, the financial markets are going to have to deal with commodity inflation. Commodity inflation results from classic causes but it is not the wage-push inflation of years past. Inflation is tame in the developed countries because the U.S. and Europe have struggling economies experiencing slow recovery. At the same time, commodity inflation has already taken hold in the emerging markets. Countries like China, India, and Brazil continue to register high rates of growth. They are now the major buyers of raw material, setting the price for copper and iron, and they play an increasingly important role in the demand for energy. So the developed world, largely the U.S. and Europe, face the probability of increased commodity prices even while experiencing sluggish growth.
Although it is widely expected that the countries of the developing world will out-perform the markets of the developed world, namely the U.S. and Europe, that's not what is happening at the moment. Countries like China, India and Brazil are experiencing inflation and are trying to cool off growth rates exceeding double digits. China is raising interest rates and shrinking its money supply to stabilize growth.

Government Stimulus and Interest Rates
The Fed has promised to keep interest rates low for an extended period. The question remains, can they pull it off? The primary reason to hold interest rates down has been to allow a recovery in the housing market. Just a few days ago, the Federal Reserve stopped their program of buying mortgage backed securities. You'll recall that in late

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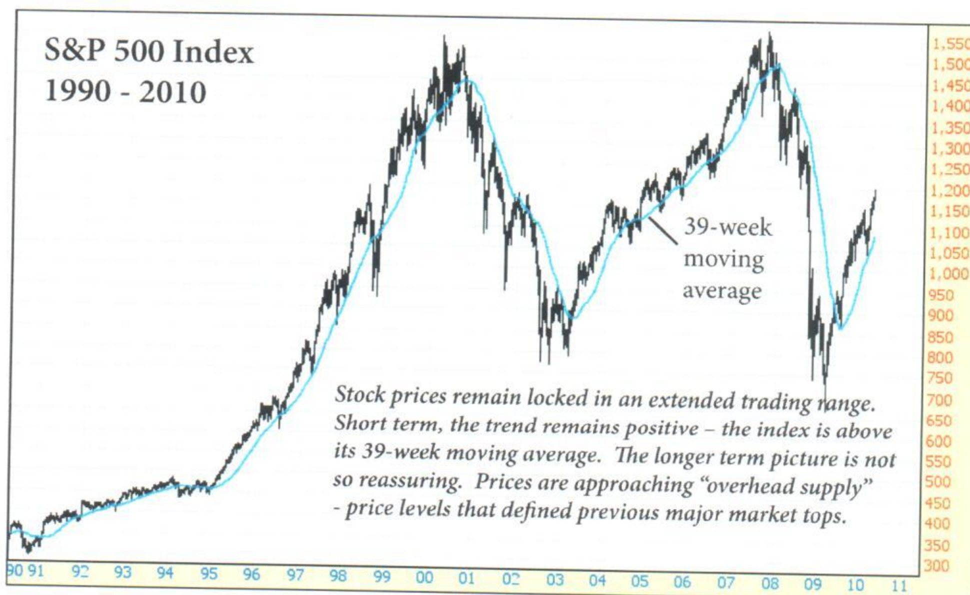
2008, the Fed announced plans to buy up to $500 billion worth of mortgage backed securities, backed by Fannie Mae and Freddie Mac. Four months later, they committed another $750 billion, bringing the total to $1.25 trillion. The end to all this stimulus would seem to be higher interest rates.

Summary

What's holding the market up? That's a question being asked as the equity markets continue to grind higher. Stock prices continue to rise as investors warm up to the market. The fact that investors are becoming more complacent is a sign that the market advance may soon stall.

The stock market is "overbought", registering only an 8% decline in February-March. Investors should anticipate a larger price retracement or correction in the next few months. Yes, the economy is improving, but concern remains over the effect on the recovery as two trillion dollars worth of government stimulus ends.



Doubts over the continued recovery of corporate earnings, coupled with increased selling pressure as stock prices return to 2007-2008 levels, is likely to trigger a market decline over the next few months. We recommend maintaining cash reserves to take advantage of a lower risk investment opportunity.

Craig F. Cooper

For more information about our services, please visit our website, www.rinconpacific.com, or contact us at (949) 369-0393, or via email: mspoo@rinconpacific.com

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With investment services designed for serious investors, Rincon Pacific Management combines the benefit of traditional investing with proper investment timing. Our methodology seeks to identify the best opportunities available, based on each client's individual objectives and risk tolerance.

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