Middleburg Trust Company

MARKET COMMENTARY • APRIL 2010

OUTLOOK

Global markets have looked more favorably on risk-taking over the last month, as equity markets shook off February's losses and moved to positive territory for the year. This better tone has been supported by constructive economic data, as both consumer spending and corporate confidence have shown signs of life. The major central banks have been quiescent, emboldening investors to continue to take risks. Healthy corporate profits are beginning to stir some of the animal spirits previously lacking in the corporate world, starting with an uptick in merger and acquisition activity. But will this improving corporate confidence lead to growth in capital expenditures and employment?

The importance of corporate risk-taking is hard to overestimate. Consumer spending in the United States is benefiting from the positive wealth effect of the stock market rally and stability in the employment picture, continuing the stretch of better numbers that started during the Christmas retailing season. Leading economic indicators are showing their greatest strength since the early 1980s. But there has been little progress in adding new jobs in the economy, putting at risk the willingness of corporations to make the leap from betting on an inventory-led bounce to a growth-led expansion. Corporations need this confidence in the longer-term outlook, including the legislative and regulatory outlook, to make these investments and solidify the growth picture. Central bankers are playing their part in supporting the recovery through continued accommodative monetary policy. Importantly, they haven't yet reached the uncomfortable juncture where their inflation-fighting instincts clash with the job creation focus of politicians. With little progress to date on reducing the unemployment rate, the disinflationary impact of the jobless recovery continues to buy time for the central bankers. But this is a key to the whole tightening process — when will enough progress be made on reducing unemployment that the Federal Reserve and other developed nations' central banks will be able to start to raise rates? We don't think these conditions will present themselves until 2011.

U.S. EQUITY

- Markets rebounded as immediate concerns about sovereign risk abated.
- The environment remains constructive for U.S. equities.

The U.S. equity markets rose in February, with the S&P 500 returning more than 3% and even stronger performance from small- and mid-cap segments of the market. Most measures of volatility declined in the month, signaling a confidence in Europe's ability to manage the most pressing risks associated with Greece's sovereign debt issues. With almost all large-cap companies having reported for the fourth quarter of 2009, the positive earnings surprise rate stood at 73% with positive revenues surprises at 68%, suggesting that cost controls alone are no longer driving profit growth. We think this helps address the sustainability of profits, a key investor concern. Valuation levels, the business cycle and the interest rate environment suggest that further market gains may be realized.

EAFE & EMERGING MARKETS

- Inflationary pressures are centered in emerging regions.
- Global recovery is lifting profits in all regions.

The growth and inflation differential between emerging and developed markets is becoming a well understood differentiating factor driving global monetary policy. China and India have led central banks in pulling back financial market liquidity. Perhaps less well understood is how the global nature of today's economy is boosting multinational profit growth even in the slower growing regions of Europe and Japan. Consensus earnings growth for developed nations in 2010 and 2011 is 30% and 20%, respectively, modestly better than emerging markets growth of 29% and 18% for the same periods. Developed Europe is expected to report earnings growth of 21% in 2011, while Japanese growth is figured at 24%, as Germany and Japan should benefit from the upturn in global growth. This helps support continued investment in these regions, though at levels below our strategic targets due to the softer domestic outlook.

FIXED INCOME

- Conservative balance sheet management has improved corporate credit quality.
- Event risk is poised to increase as the economic recovery matures.

The financial crisis has led both investors and corporations to become more conservative in their investment philosophy. High levels of cash on balance sheets and an overall risk-averse mentality benefited the performance and credit quality of investment grade bonds. This reduced risk has helped investors become more comfortable allocating assets into the investment grade sector, particularly when alternative short-duration investments are yielding next to nothing. Although the high levels of cash on balance sheets are a constructive development, over a longer time horizon bond investors have cause for concern. Equity shareholders will eventually pressure corporations to return cash to shareholders via share buybacks, capital investment, or merger and acquisition activity, reversing the improvement in balance sheet credit quality.

GLOBAL REAL ESTATE

- The FTSE/EPRA NAREIT Global Real Estate Index returned 3% in February.
- U.S. real estate investment trusts outperformed the index, while Europe declined 3%.

In February, Moody's published positive results for the Moody's/REAL Commercial Property Price Index. The national index had a positive return of 4.1% in December. This is the first time since 2007 the index has shown two consecutive months of rising values. Although this is a positive sign, this index is transactions-based, and transactions remain well below peak levels. We continue to have concerns regarding the negative effect of banks' philosophy of "extend and pretend," and increasing evidence of borrowers giving properties back to their lenders. As banks look to sell these assets, they will put downward pressure on real estate values. As a result, we remain cautious on the sector in the near term.

COMMODITIES

- The global economic rebound supports oil prices.
- Metals remain particularly dependent on Chinese growth.

Global energy demand continues to grow, with the primary driver of incremental demand being Asia. The United States probably will generate modest demand growth over time, with Western Europe and Japan holding steady. Traditional market dynamics suggest that the recent strength in the U.S. dollar should weaken oil prices; their stability this year tells us markets are firmer than expected. Analyzing the prospects for industrial metals like copper, aluminum and steel starts and ends in China. The Chinese have a good track record of stockpiling commodities when prices are low and exiting as prices move up — and that situation may be occurring in certain parts of the metals markets today. We are focused on whether commodity imports may be peaking, or whether further growth in the economy will lead to continued strong buying.

CONCLUSION

The experience in the financial markets so far this year may be illustrative of a new phase in the market. After the outsized gains from March 2009 lows, stocks and other risk assets have gone from pricing in depression to a more normal cyclical outlook. We think the growth outlook for the United States and emerging markets continues to lead the global economy. The current valuations of both equities and corporate credit reflect these improvements, leaving the markets reliant on the strength of the economic expansion. Our primary concerns today surround the potential for disappointing growth in the United States, caused by weak credit creation, and the risk of slower growth in China, caused by monetary tightening enacted to fight inflationary concerns.

Commentary provided by Jim McDonald