CENTURION Asset Management

610 W. Germantown Pike, Suite 150
Plymouth Meeting, PA 19462

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In this month's Market Letter we will review the first quarter of 2010, the state of the economy, and consider future opportunities for bond investors.

Q1 2010 Review

In the United States, equity markets battled back from January losses to post a solid first quarter. The S&P 500 Index gained nearly 4.8% for the first quarter, while the Dow Jones Industrial Average and the tech-heavy Nasdaq posted returns of 4.1% and 5.6%, respectively. From an S&P 500 sector standpoint, industrials, financials and consumer discretionary were the big winners in the quarter, each generating double-digit returns; on the other side of the ledger, telecom services and utilities were down by 5.7% and 4.6%, respectively. In terms of market capitalization, small-caps nearly doubled the performance of large-cap stocks, while mid caps were also very strong. Value names outperformed growth across capitalizations.

Internationally, equity market performance was mixed on the quarter. The MSCI EAFE Index inched ahead only 0.22%, weighed down by sharply negative euro zone performance; Portugal, Italy, Greece and Spain all posted double-digit declines. Asia-Pacific, on the other hand, outperformed even the U.S., led by strong performance in Japan. The MSCI Emerging Markets Index was up a little over 2% for the quarter, with particular strength in Europe and the Middle East; China was one of the few emerging markets unable to generate a positive return in the period.

Yields on U.S. Treasuries ended the first quarter fairly close to where they began; if slightly lower at the front end of the curve. The Barclay's Capital U.S. Aggregate Index was up nearly 1.8% over the first three months of the year. For the quarter, risk-based assets rallied versus sovereign debt. Excess returns in the corporate bond market were led by the strong performance of financials. Securitized assets also performed well. Commercial mortgage-backed securities (CMBS) posted nearly 800 basis points of excess return as that market began to thaw; Dealogic reported that nearly four times more CMBS were issued in the first quarter of 2010 compared to the same period in 2009. Fixed-rate agency residential mortgage-backed securities also outpaced Treasuries despite the March 31 cessation of the Federal Reserve's mortgage purchase program. Non-agency residential mortgage-backed securities continued to receive a strong bid from Public-Private Investment Program participants. U.S. high yield securities were well ahead of Treasuries on the month, as was emerging market debt thanks to the vitality of Asian markets.[1]

The Economy

Macroeconomic data appeared to have gained some positive momentum during March, and prospects for a sustained recovery remain favorable; that said, major uncertainties — from high unemployment to significant economic slack — persist. But these too are turning.

March payrolls showed that 162,000 jobs were created for the month, 123,000 of them from the private sector with the rest from the hiring of census workers.[2] The jobs report also showed some upward revisions in the private sector from January and February. Even though the jobs story is improving at a slow pace, we believe it points toward an accelerating pattern through the spring and summer quarters. Tax refunds and infrastructure outlays have become extra support for spending to improvements. Exports and earnings are beating estimates, and production increases coupled with inventory decreases all add up to momentum that will continue to build.

There is a high degree of certainty by most economist that the Fed will continue their stance of keeping the "exceptionally low levels of the federal funds rate for an extended period" language in their statements for another quarter or two. However, their upcoming meeting on April 27-28th may be a time when they could begin the removal of that language, which would be a signal that the economy has strengthened and they perceive growth – hello inflation – in the not too distant future. We believe they will not remove the statement, rather, they will modify a word or two, perhaps exchanging "exceptionally low" for "low".[3]

Regardless, we feel the rate environment will stay relatively stable through the rest of 2010, as the Fed remains mostly accommodative for the next 3 quarters. This places Fixed Income investors in a favorable position to continue to hold their bonds, and still hold on to the gains they have experienced the past two years.

Bonds

There has been an enormous amount of conjecture over the direction of interest rates, inflation, and bonds, so allow us to shed light on our impression of the fixed income asset class.

In March, well-known bond manager Bill Gross of PIMCO stated “Bonds have had their best days,” on Bloomberg radio. Another well known bond investor, Dan Fuss of Loomis Sayles – his bond fund beat 95 percent of competitors in the past year – said he agreed with Gross, but stated, “I do think very strongly that we will soon see – soon being next year sometime – the start of a long, gradual rise in interest rates in the U.S. and in other parts of the world.” With these two significant figures in the fixed income asset class speaking so glumly about “bonds”, it begs for clarification as to what an investor should fear.

There is an important distinction between what Gross and Fuss have said, and whether all bonds are in fact at risk for a large correction. Let us ask a deeper question, “Which sector of the bond market?”

They are not referring to ALL bonds in the market, they are mostly referring to the highest quality bonds, namely AAA rated bonds and Treasuries. Frequently bonds are generalized to be of the same type. However, each asset class has multiple types of securities that an investor can choose. In stocks you may choose a large company stock, say GE, or a very small company’s stock. As such, an investor will find bonds that are Treasury bonds, or Corporate bonds, or Municipal bonds, among others. These perform independently of each other and offer an investor the opportunity for diversification, and opportunity.

Our position has been to invest in lower quality bonds for the past twelve months. As such, investors have been rewarded nicely as the market value of low quality bonds has risen the most. Today the question about whether to hold at risk bonds and avoid treasuries is a tricky one. The perfect trade would be to hold risk bonds during a recovery, then transition some of those bond positions eventually to higher quality bonds after the market has fallen for the safest bonds. At that point you may find the high quality bond will be fairly close in yield to the low quality bond, but in fact the high quality bond will not have as much downside risk.

For those investors who currently hold government bond mutual funds, they have experienced stability in their investment, but are now faced with risk relating to potentially rising interest rates. In order to avoid losing principal on those funds, those investors may consider a transition to corporate, mortgage-backed, and lower quality bond funds.

Unlike individual bonds, bond mutual funds do not have a maturity date when the investor is assured to receive their principal. Thus, the investor may be faced with two options; make changes, or watch your seemingly safe and stable government bond fund lose a high percentage of its value.

Synopsis

The combination of a recovering economy, relatively low interest rates, and improving corporate profits, creates a wonderful opportunity for risk assets. As a result, we hold our position that investors continue to favor Equities over Fixed Income assets, but within Fixed Income favor low quality over high quality bonds in the near future.

Considering the content of this month’s Market Letter, you may have questions. If you are uncomfortable with your current investment plan, we encourage you to call us to discuss your situation. Please call 610-629-0660, or email us at PaulL@centurionassetmgt.com , to discuss your feedback or questions.

Sincerely,

Paul G. Liebezeit, CFP®
Principal
Centurion Asset Management, LLC
www.centurionassetmgt.com

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[1] ING Investment Management;1Q10 Review, 4-12-2010
[2] Blackrock Investment Commentary; 4-5-2010
[3] Morgan Stanley Strategy Forum; 3-15-2010

Important Disclosures

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