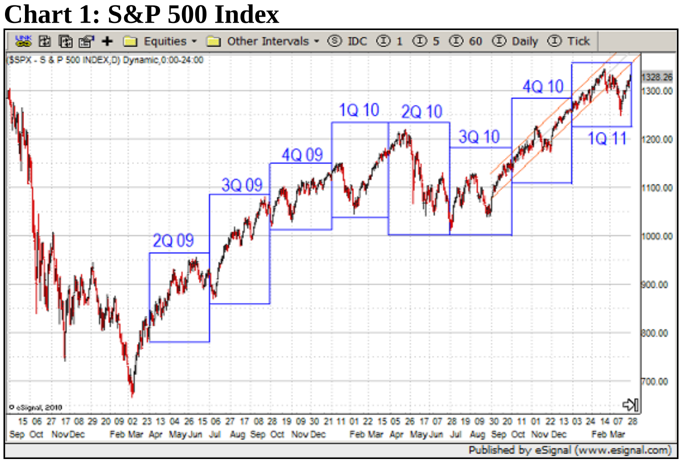
ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook — First Quarter, 2011

Equity Markets in January and February reflected a continuation of last year's positive sentiment. March, however, brought with it the closest thing we've seen to a correction since the spring of 2010 following the end of the first round of quantitative easing (QE1) by the Fed. March's setback – a *whopping* 6.4% for the S&P 500 Index of large-cap US stocks – was short-lived with the stock market having recovered its losses by the end of the month. Many strategists, us included, expected a deeper correction for global equities – especially given the magnitude of the previous run-up in prices and the recent series of negative shocks.

Chart 1: S&P 500 Index



Source: eSignal

In March, the current bull market celebrated its second anniversary and the financial markets have risen dramatically during this two-year period. Over the last 24-months, the cyclical tailwinds of fiscal and monetary stimulation have served to raise the animal spirits and investors' willingness to buy "longer-dated" (higher risk) assets such as equities and commodities.

Chart 2: VIX Index

Source: eSignal

During the same time frame, "fear" has declined, and "complacency" has risen. This is reflected in a very low VIX index reading (a measure of the cost of protecting against a market decline) (Chart 2) and a marked imbalance between bulls and bears in most investor sentiment surveys:

- Individual investors (AAII poll)—most bullish in six-years
- Newsletter advisors (I.I. poll 20-week average)—most bullish in seven-years
- Futures traders (trade-futures.com poll)—most bullish in four-years
- Mutual fund managers (% cash)—most bullish ever
- Hedge fund managers (BoA/ML survey)—most bullish ever
- Economists (news-org polls)—unanimously bullish
- Top global strategists (three national year-ahead panels)—unanimously bullish
- Even most 'bears' on the economy are bullish on stocks because of inflation

Source: M. Ramsey King Securities, Inc. and elliottwave.com

To put it mildly, and to state the obvious, market skepticism has not paid off.

The stimulation that was so necessary in keeping the world's financial and economic system from falling off the cliff has come at a cost (and with potential risks). The impact of policy has relieved us from the depths of the Great Recession, but has arguably both added to existing, and created a new set of issues to deal with, positioning the domestic economy with a potentially weak foundation for growth. Going forward, the critical assessment that must be made is whether artificial stimulation and policy support have allowed the global economy to gain substantial traction, allowing the recovery process to become self-sustaining.

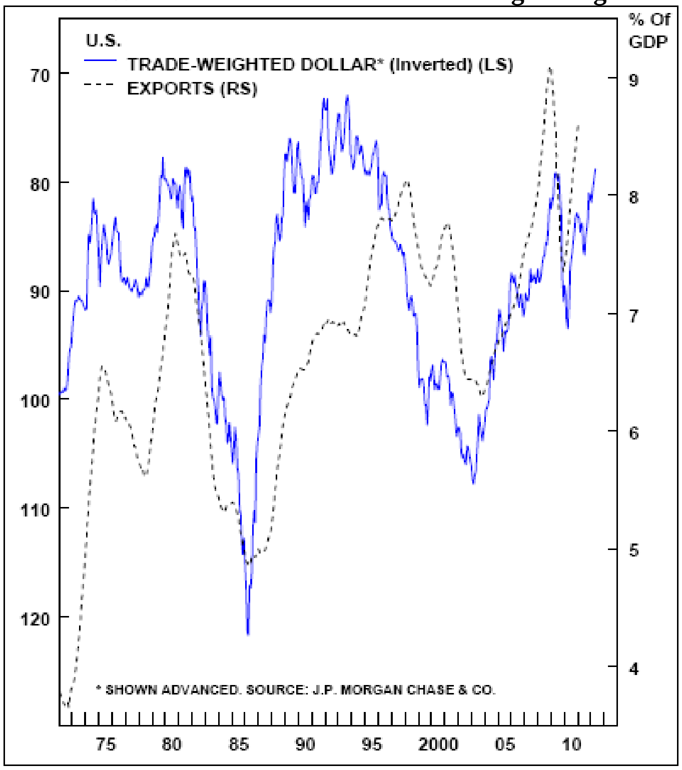
Some factors that favor sustainable growth as the stimulus is withdrawn include:

First, economic uncertainties may have held back hiring plans over the last two-years, but going forward, firms will begin to add more workers. Accelerating job growth is critical in that it will make income growth much more sustainable, easing concerns that the growth in consumption has been mostly propped up by government handouts.

Second, US manufacturing growth has been solid, a reflection of a strong export sector (Chart 3). The US dollar devaluation has cheapened US goods, making them more competitive. Additionally, strong labor productivity gains and a plunge in unit labor costs have added to the US manufacturing industry's competitive advantage.

Manufacturing as a share of the US economy has been rising over the last two years – the first time it has done so in at least five decades.

Chart 3: Weak US Dollar and Manufacturing Strength

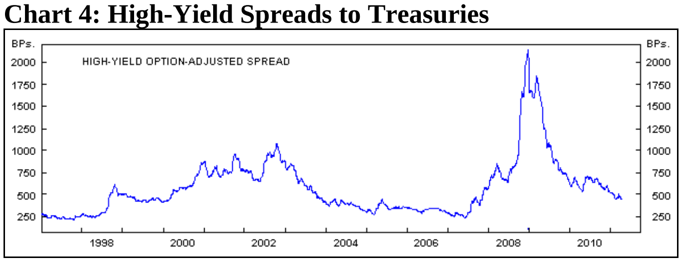


Source: BCA Research

Third, capital spending (capex) is likely to expand. So far, the capex recovery has been very hesitant. Although capex has grown by more than 20% since the second quarter of 2009, the level remains 22% below pre-crisis levels. However, now that productivity has surged, capex should become a more attractive way of boosting profitability.

Additionally, the markets just seem to *want* to move higher as investors have simply shrugged off a lot of bad news recently. Peripheral bond markets in Europe are again under severe pressure, the situation at the Fukushima nuclear power plant has continued to worsen and oil prices have been rising on the back of unrest in the Middle East and North Africa. Yet the S&P 500 finished the quarter close to its post-recovery February peak, corporate bond yield spreads have again tightened to pre-crisis levels (Chart 4) and commodity indexes are making new highs.

Chart 4: High-Yield Spreads to Treasuries



Source: BoA/ML and BCA Research

Over the last few months, the world has demonstrated once again how human and natural disasters can erupt suddenly, causing widespread personal tragedy, enormous property destruction and serious supply disruptions of critical commodities and manufacturing components. We find it interesting that while the consequences of both the Arab uprisings and the Japanese catastrophe are far from being quantifiable, global financial markets show no signs of stress.

In statistics, the "mode" is the most frequently occurring outcome while the "mean" outcome is the average of the *various* outcomes. This distinction seems particularly relevant in thinking about the balance of risks to the global economy. Based on the behavior of the financial markets, investors are focused on what is good and the outlook – consistent with the current *modal* outcome – is benign: global growth will remain above trend, inflation will remain contained and monetary policy will stay accommodative.

We, on the other hand, spend a lot of time considering the downside – I think that is natural when you manage other peoples' money. Many times, the further and/or faster markets rise, the more worried we become. While many investors are content having faith that the smooth sailing will continue, we can't ignore numerous and growing risks and potential outcomes (i.e. the various components of the "mean").

While the markets have been strong, the balance of risks is tilted increasingly to the down-side. These include: 1) The possibility that the current spike in oil prices becomes more severe; 2) The lingering impact of the earthquake on the growth in Japan and the global supply chain; 3) The end of the second round of quantitative easing (QE2) on June 30; 4) Continued weakness in the US housing market; 5) Rising inflation – particularly in emerging markets; 6) A "hard-landing" in China; and 7) Sovereign debt issues in Europe.

All of this at a time when the process of normalizing US monetary policy will soon begin. Falling unemployment in the US and increasing inflationary pressures signal that the Federal Reserve will likely shift towards neutral in a gradual process this year. Plus, increasing attention to the ballooning deficit signals that fiscal restraint is coming…at some point. Consequently, the wonderful world in which virtually all asset classes have performed well simultaneously over the last two years is likely to become much more challenging. Equities are looking increasingly extended and most industrial and agricultural commodities have risen exponentially.

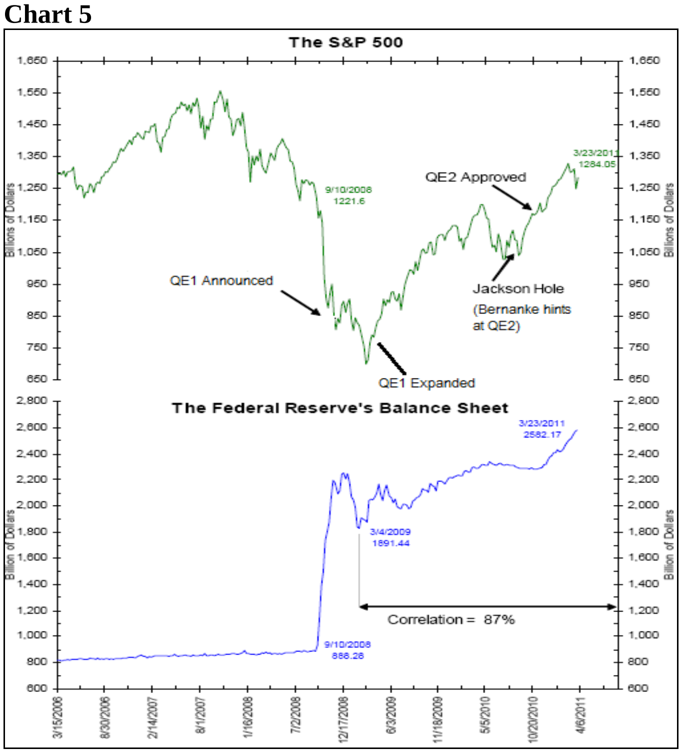
While the risks are impossible to quantify with certainty, the timing of number three – the end of QE2 on June 30 – is known. And while we can't be certain about the impact it will have on the value of "risk" assets (stocks, bonds, commodities, currencies, etc.), we think there are a number of reasons to believe quantitative easing has been an important driver of the strong returns on risk assets and, therefore, anticipate at least some stress as a result of its end:

- The purpose of QE2 was to boost stock prices. In his November 4, 2010 *Washington Post* op-ed, Fed Chairman Ben Bernanke wrote: "Higher stock prices will boost consumer wealth, help increase consumer confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous cycle, will support economic expansion."

  Then, when the stock market started moving up in January, Bernanke stated "The policies have contributed to a strong stock market as they did in March 2009 when we did the last iteration of this" – referring to QE1 – "the S&P is up 20% and the Russell 2000 is up 30%-plus."

- Stocks have responded very well to both rounds of quantitative easing. The top panel of Chart 5 below illustrates the recent performance of the S&P 500 and the timing of the Fed's quantitative easing programs. The bottom panel of the chart illustrates the size of the Federal Reserve's balance sheet. Since the Fed added to QE1 by buying $1.25 trillion of mortgages and $300 billion of Treasuries in March, 2009, there has been a very high correlation – 87 percent – between the stock market and the size of the Fed's balance sheet. The only significant correction we have had in the last two years was the time period *between* QE1 and QE2.

Chart 5

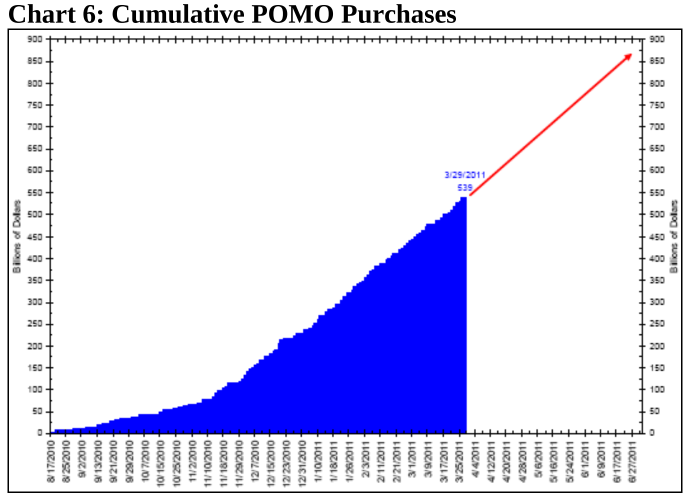


Source: Bianco Research, LLC

How does quantitative easing help raise stock prices? Everyday the Fed purchases Treasuries at 11:00 (permanent open market operations – or POMO). According to the Fed's Portfolio Channel Theory, the cash received by the sellers of the Treasuries will go wherever it is treated best – right now that means risk assets. POMO is literally an operation to get money out of Treasuries and into risk assets – equities in particular.

Chart 6 below illustrates the progress the Fed has made toward its announced goal of purchasing $600 billion of Treasury securities by June 30, 2011. The target is actually closer to $900 billion including the additional $250 to $300 billion in agency and mortgage backed security reinvestment that is included in its daily POMO activity. Based on these estimates, the Federal Reserve still needs to buy between $275 and $360 billion of Treasury securities before reaching its desired goal. This will be supportive of risk assets over the next few months.

Chart 6: Cumulative POMO Purchases



Source: Bianco Research, LLC

So, if quantitative easing has helped lift the stock market (i.e. the market has gone beyond where it would have in its absence), we think there is a risk of a decline in stock prices at the conclusion of the program.

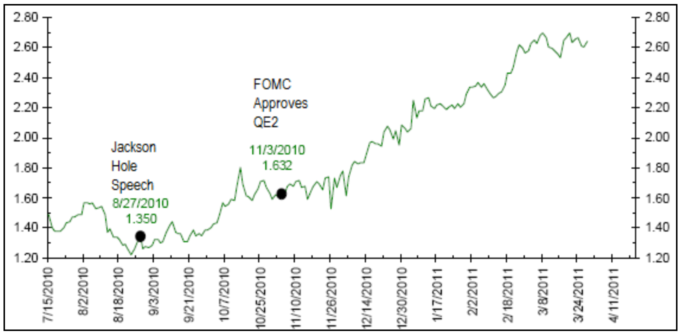
The outlook for inflation is also an important factor here. As long as market participants believe inflation is not a problem, flooding the market with liquidity is generally bullish.

Bernanke does not think inflation is a problem. He has said that he thinks inflation will remain quite low for some time and that – at most – we could see a temporary blip because of commodity prices, though we should not worry about it.

If we get to a point where there is a perception of too much inflation, then excess liquidity becomes bad. Again, this isn't a problem as long as the market participants believe inflation expectations are under control.

Chart 7 below illustrates inflation expectations as measured by the TIPS (Treasury Inflation Protected Securities) market. The difference between yields on five-year notes and five-year TIPS, known as the break-even rate, is a gauge of expectations for consumer prices over the life of the debt and is believed to be one of Bernanke's favorite measures of inflation expectations (he has mentioned in testimony many times). While the level isn't problematic, the uptrend has been unmistakable since QE2.

Chart 7: 5-Year Breakeven Rates



Source: Bianco Research, LLC

Traditional inflation measures also appear to have bottomed. While this is particularly true in the case of commodities, many of the "core" (i.e. non-food and energy) have also gained recently.

So, excess liquidity is bullish for risk assets as long as inflation expectations remain muted. If, on the other hand, inflation expectations begin to rise, the Fed will have to withdraw liquidity from a market that has become highly dependent on it.

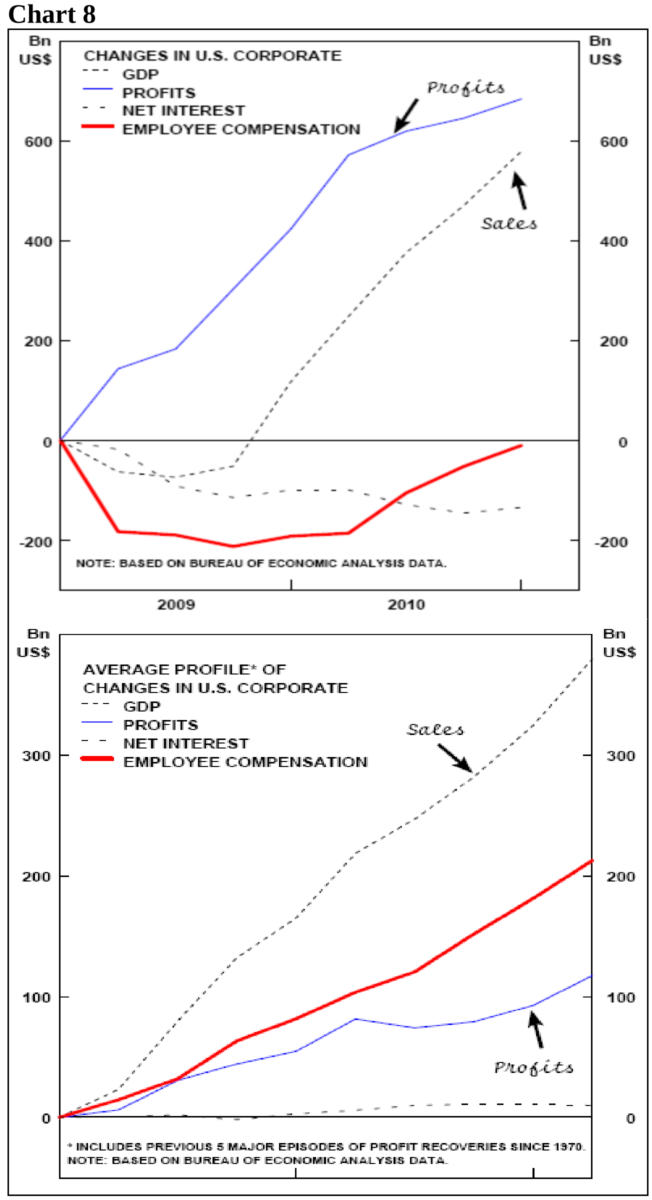
While much of the market believes that at some point inflation will rise and things will end badly, the prevailing sentiment seems to be: it's not going to happen tomorrow, so why worry? It is as though market participants believe that a well choreographed and measured pace of balance sheet reduction and interest rate increases will provide ample opportunity to make portfolio adjustments in order to avoid the fallout. It rarely works that way.

Central banks, on the other hand, find themselves in a situation of having the wolf by its ears – they can't hold it forever, but they dare not let it go. At some point, the response of "more money" to every question will have to change, especially if the question turns out to be rising inflation.

For now, the bull market in stocks remains intact. It has, however, likely entered a new phase. In simple terms, we see the speed of price appreciation slowing, with more frequent interruptions or corrections as a result of shifts in macroeconomic, financial and monetary conditions (i.e. as tailwinds transition to headwinds). Why? In addition to the known risks highlighted earlier:

- The speed of the stock market rally since March 2009 has set a peacetime record. There are also some unique features to the current profit recovery. Chart 8 compares the path of GDP (a proxy for sales), profits, net interest and employee compensation over the last two years versus the average profile of the previous five major profit recoveries since 1970. This is the first time the net increase in corporate profits has exceeded the net increase in GDP. This is because this is the first time ever total wage increases have stayed at zero during a recovery, which – when combined with lower interest costs – has allowed profit growth to exceed sales growth. Additionally, the stimulus has been massive. The bailout packages, zero interest rates, the sharp decline in the US dollar, and dramatic liquidity injections into the economy have all fostered a speedy rehabilitation of corporate-sector profitability.

Chart 8



Source: BCA Research

The bottom line is that all of this is unsustainable and it is highly unlikely that stock prices and corporate earnings will double again in the next two years. In other words, profit growth and stock market returns should slow noticeably.

- There will be no new policy support for the economy and equity markets after QE2 ends in June. Fiscal policy will be tightened in 2012. It is only a matter of time until the Fed shrinks its balance sheet and raises interest rates.

- A further escalation in oil prices and materials costs could cut into corporate profits, further slowing earnings growth.

- The US dollar may stabilize and even rally going forward, especially versus the euro and the Japanese yen. Interest rate differentials have driven the dollar down recently, but over time, economic growth differentials will matter more and a firmer dollar may not be welcome news for stocks.

- There is strong pressure for the Obama administration to implement some kind of fiscal austerity in 2012 and the market will rush to discount its impact way before actual measures take effect.

As we highlighted in last quarter's newsletter, the returns over the last two-years rank highly in the context of post-recession stock market recoveries (Table 1). While there is historical precedent for three consecutive years of post-recession gains, large first- and second-year returns have tended to be associated with lower third-year returns.

Table 1: S&P 500 12-Mo. Post Recession Returns

MARKET TROUGH	PRICE RETURN First Year	Second Year	Third Year
August, 1953	35.2	41.0	5.6
November, 1957	32.6	10.4	(5.7)
October, 1960	26.5	(17.3)	28.8
June, 1970	37.1	7.5	(2.7)
September, 1974	32.0	25.5	(8.3)
July, 1982	51.8	(7.3)	26.7
October, 1990	29.1	6.7	1.7
February, 2003	36.1	5.1	6.4
February, 2009	50.3	20.2*	
Median	**33.9**	**7.1**	**6.0**
Mean	**35.1**	**8.9**	**7.8**
**12 Months Ended Feb. 28, 2011*			

Source: BCA Research and Morningstar

So, after a powerful recovery following a huge decline, we are cautious in our outlook given the monetary and fiscal environment we anticipate along with the numerous potential market stresses we can identify. Our portfolios are invested defensively and could easily become more so as we approach the end of the second-quarter. However, we plan to use any significant corrections to move to a more aggressive investment strategy if the financial markets seem to be overreacting to the down-side.

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