THE CONROY REPORT
Quarterly Outlook
As of April 1, 2011

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Summary

Economic Outlook
The U.S. Economy continues to expand after the end of the recession. There was a 2.9% growth in real GDP in 2010 with steady growth throughout the year including 3.1% in the fourth quarter. We forecast a 2% growth rate in 2011. Large amounts of government stimulus still support the economy, but with diminishing returns. There is also significant turmoil worldwide and a high unemployment rate.

Investment Recommendations
Avoiding market risk will be an important theme this year. We continue to recommend that investors stay in cash or other money market investments to play it safe. However, we expect investment opportunities will arise throughout the year such as the current pricing on long-term U.S. Treasury Bonds.

Economic Forecast

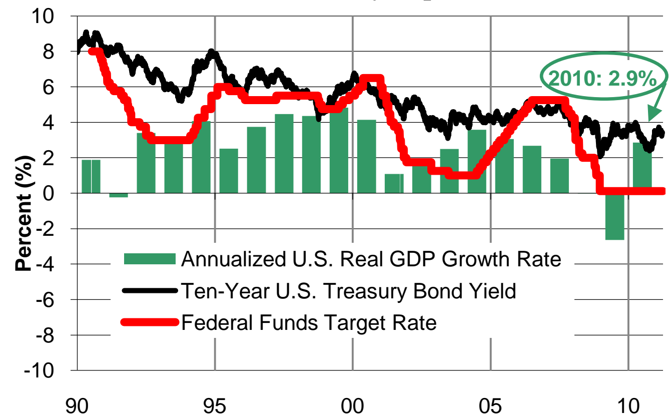
The U.S. economy continues to expand after the end of the 2008 to 2009 recession. Annualized U.S. Real GDP grew by 2.9% in 2010 (see **green bar** in Chart 1), which is 0.4% above the average historical annual rate of growth rate of the U.S. economy since 1990. The Bureau of Economic Analysis (BEA) stated the increase in real GDP in the fourth quarter came from personal consumption expenditures and nonresidential fixed investment. The BEA also reported an increase in exports and decrease in imports which may reflect that fact the U.S. Dollar (USD) has weakened substantially relative to foreign currencies. For example, one USD is now worth only about 70 Euro Cents (0.70 of a Euro Dollar) whereas it was worth more than 80 Euro Cents only a year ago.

We correctly forecasted that the U.S. economy would expand in each quarter of 2010. For example, on January 1 of this year we presented our argument that the U.S. economy would continue to grow in the fourth quarter of 2010. This proved to be an accurate forecast as the annualized U.S. GDP growth rate was 3.1% during that period. We also forecasted growth in each of the other quarters of 2010 where the rates were 3.7% in the first quarter, 1.7% in the second, and 2.6% in the third.

We forecast a modest 2% growth rate for U.S. economy in 2011. On the positive side, the government continues to provide ample stimulus to growth, but these efforts appear to have diminishing returns. Also, with the influx of dollars being printed by the government to back the monetary stimulus, the U.S. Dollar is weakening. This could result in higher exports, as it did in the final quarter of 2010. On the negative side, fiscal stimulus is quite limited as interest rates are very low, especially the policy controlled Federal Funds Target Rate (see **red line** in Chart 1). Achieving lower interest can stimulate borrowing which in turn can result in higher GDP. We continue to believe that sustained economic growth will require the private sector to do its part, along with the government, to address the country's high level of unemployment. In addition, natural disasters, specifically the earthquake and tsunami in Japan, are causing tremendous losses which will need large amounts of humanitarian and economic aid. Meanwhile U.S. foreign policy is being severely tested amidst preexisting and emerging diplomatic struggles, particularly in the middle east.

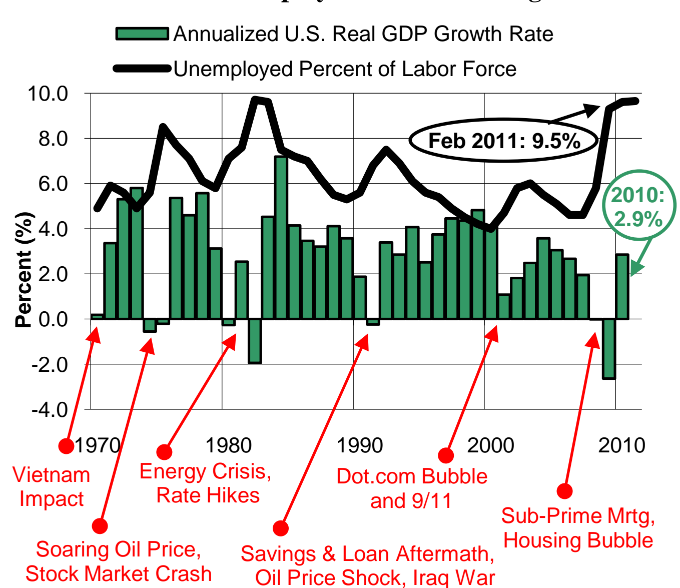
Attention must be placed on jobs. The U.S. unemployment rate remains around 10% with a recent reading in February 2011 of 9.5% (see **black line** in Chart 2). Throughout 2010 this rate stayed at this historically high level despite a 2.9% rate of growth in 2010. As stated above, with government fiscal stimulus having decreased effectiveness, diminished willingness by and ability of consumers to bail out the economy, and a more challenging international climate, this leaves the domestic private sector as a determining variable in the GDP equation. As such, further economic growth needs to result in job creation. If so, the unemployment rate will drop and consumers will be able to contribute more strongly to U.S. economic activity.

Chart 1. The U.S. Economy Expanded in 2010



Sources: Federal Reserve, U.S. Department of Commerce Bureau of Economic Analysis, Yahoo! Finance. U.S. Real GDP Growth Rate in chained 2005 dollars.

Chart 2. Unemployment Remains High



Sources: U.S. Department of Commerce Bureau of Economic Analysis, U.S. Department of Labor, Bureau of Labor and Statistics. U.S. Real GDP Growth Rate in chained 2005 dollars.

Investment Recommendations

We continue to recommend that investors stay in cash or other money market investments to play it safe. As discussed in our economic forecast, we believe the U.S. economy will have modest growth in 2011, but there is significant turmoil worldwide and this has the potential to disrupt stock and corporate bond markets this year.

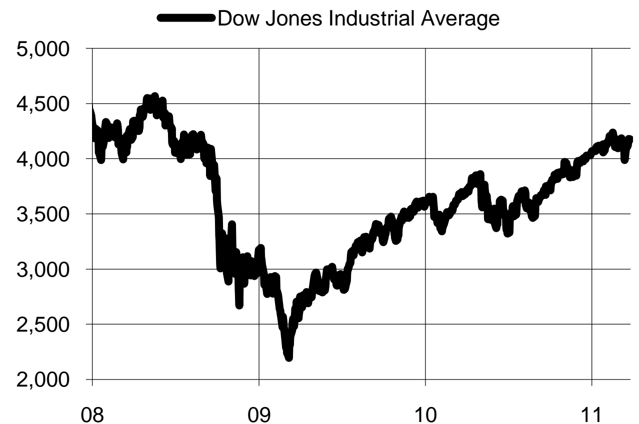
Our recommendation to invest in cash has worked well and will continue to protect against the volatility of market risk. The argument for investing in cash and money market investments is something we have presented since July 1, 2008. This strategy protected against the significant losses in stock and corporate bond markets that began around that time. As we held our course, we recognize that our strategy suffered as stock and corporate bond markets recovered, but our caution seems justified in many respects. For example, it took six months for the Dow Jones Industrial to lose half its value in the second half of 2008, but over two years for it to recover to those previous levels (see **black line** in Chart 3).

We believe long-term government bond yields are at more attractive levels (see **black line** in Chart 2)**.** With all the turmoil worldwide, investors may also look to U.S. government bonds as a safe haven, a place to invest that offers stability of principal in comparison to more volatile stock and bond markets. If this happens, government bond prices should rise and their yields, which move in the opposite direction, should drop. In addition, government bond yields may have more room to drop because they have moved higher by more than 1% during the end of 2010. In one respect, these yields reflect the market's expectations for economic growth - there is often positive correlation between interest rates and economic activity. As such, if the climate turns sour, then government bond yields may drop and their prices will rise.

Inflation pressure has been modest over the past two years, but there are signs of rising prices in certain sectors. Government bond yields also reflect expectations for inflation. For many months, we have stated concern about the potential for rising interest rates due to inflation pressure. Nevertheless, consumer prices dropped significantly at the end of 2009 (see **black line** in Chart 5) from very high levels and have stayed near or below average levels (see **red line** at 2.4% in chart 3)for over two years now. However, there are recent signs of rising prices in some categories, especially in fuel costs. Over the past year there was a 7.1% unadjusted 12-month percentage change in transportation costs (including a 19.4% increase in motor fuels), a 2.9% increase in medical care (with the largest jump of 5.8% in hospital care) and a 2.2% increase in food and beverages (with the largest increase of 6.8% in meats, poultry, fish and eggs).

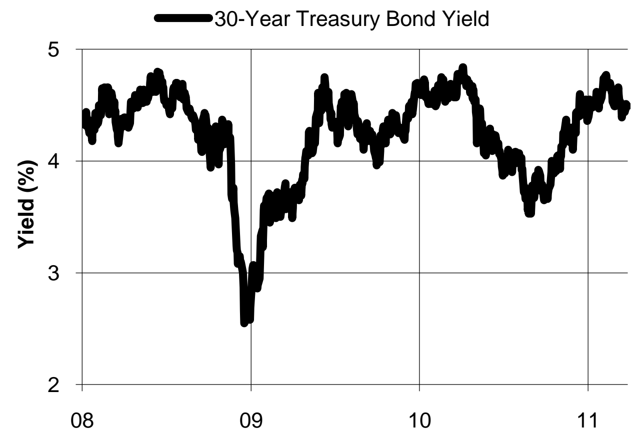
We were first alerted to the increasing attractiveness of long-term U.S. Treasury Bonds when their yields approached 5% last month. Currently, the yield on thirty-year government bonds are around 4.5%. Remember that the these bonds pay non-taxable interest. Most interest rates that consumers contend with have no tax break such as mortgage, automobile and credit card debt. Therefore, to compare government bond yields more fairly, investors should examine them on a basis that adjusts for their tax benefit. Corporations and top earning individuals have a tax liability of as much as 33% of their taxable interest income. The middle of the tax bracket for individuals is around 25%. Therefore, the taxable equivalent yield for a thirty-year government bond is currently 6% to as much as 6.8% depending on the tax bracket. We believe these higher levels are enticing.

Chart 3. Stocks Recovering Slowly After Sharp Drop



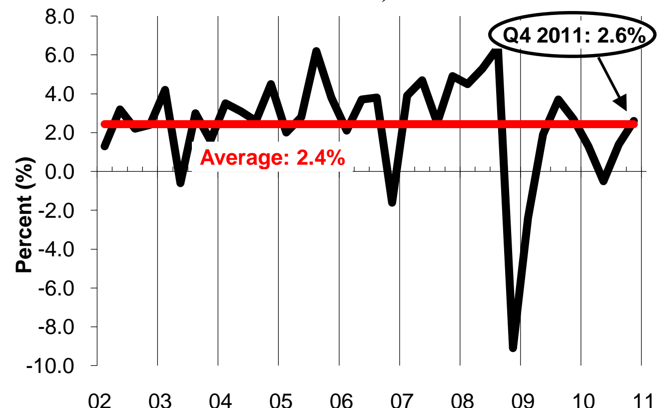
Sources: Yahoo! Finance.

Chart 4. Thirty Year Bond Yields Have Risen Again



Sources: Yahoo! Finance.

Chart 5. Modest Inflation, But on the Rise



Sources: U.S. Bureau of Labor Statistics.

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