



When Will the U.S. See Job Growth?

By Taylor Graff
Senior Associate

As the economic recovery gains traction, financial markets and economic statistics have seen significant improvement. The greatest exception has been employment. While the massive job losses of 2008 and most of 2009 have abated, the economy has yet to experience any significant job growth. Employment has always been considered a lagging economic indicator (meaning that economic growth precedes employment growth) but in recent recessions, that lag has painfully become longer giving rise to the term “jobless recovery”.

Will this be a jobless recovery? What are the implications for the Federal Reserve and financial markets?

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Looming Taxes Support the Municipal Bond Market

By Steve Shutz, CFA
Vice President

Fixed income investors in the top marginal tax bracket are feeling the pain. Two critical pieces of legislation were recently approved that will surely boost the demand for tax-exempt income. First, the enactment of the Health Care Bill created a new surtax of 3.8% on unearned **taxable** investment income for individuals with adjusted gross income (AGI) above \$200,000 and joint filers with AGI above \$250,000 (effective January 2013). The surtax, along with the phase out of the Bush tax cuts, will increase the maximum federal tax rate to 43.4%, from the current rate of 35%.

If you live in Maryland, this will push the combined State and Federal max marginal tax rate from 41.1% to close to 50.0%. In some states (for example, CA, NJ, NY, RI) the combined rate will be even higher.

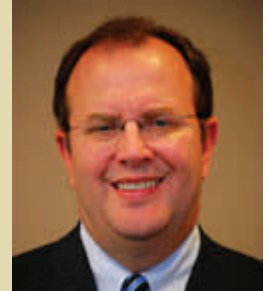
In a second piece of legislation, the House Ways and Means Committee approved a three-year extension of the widely successful Build America Bond (BAB) program, which has cut close to 30% of the tax-exempt supply from the municipal market.

The combination of higher future taxes and lower expected supply should provide considerable support for the tax-exempt market. Looking forward, what is the after-tax impact on municipal portfolios?

Full article available on our website: www.cavcap.com.

Dear Client

By James Dugan
President &
Chief Investment Officer



Historically, two-thirds of the U.S. economy has been driven by consumer spending and consumers are not going to freely spend unless they are employed. Though we have seen a business rebound in the U.S. the length and breadth of the recovery will be stunted unless household finances rebound. In addition, employment is the key to anticipating the actions of the Federal Reserve.

The current level of unemployment stands at 9.7%. With this in mind, we need to remember that the Federal Reserve has two legislated mandates – price stability and full employment. Our colleague, Taylor Graff, conducted interesting research on the utilization of the labor force by looking at the percentage of people who are able to work who hold jobs. This provides a more interesting perspective compared to the often-cited unemployment rate which can be skewed by people starting or giving up on a job search.

The graphic on the back page shows the employment participation of the U.S. population going back to 1947. The available population is anyone 16 and older (no age cap) who is not institutionalized (i.e. prisons, asylums, nursing homes). From 1947 to 1977, the workforce participation rate was consistently between 56% and 58% of the population. The 2% swings coincide with growth and recessionary periods.

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EQUITIES, COMMODITIES, & REITs MARKET REVIEW

One Year and Counting

The recovery is now one year old and currently shows no signs of exhaustion. The 12-month returns for every asset class reflect both the misery of early 2009 and the extensive improvement since. The last twelve months also show how quickly conditions can dramatically change in financial markets. No matter how clear the outlook appears, no one knows the future's designs.

- 2010 had a rough start as the S&P 500 dropped 3.7% in January amidst the crisis in Greece, the worst month since February 2009.
- But the S&P 500 quickly bounced back with gains of 2.9% and 5.9% in February and March.
- For the fourth straight quarter, REITs are among the top two performers and REITs have more than doubled since the March 2009 bottom.
- The dollar strengthened to its highest point since May 2009 causing international stocks and commodities to underperform U.S. stocks.
- Additionally, sovereign default concerns hurt European stocks especially in Portugal, Greece and Spain, which were the worst performers among developed economies.

Equity Index Returns (%)
As of 3/31/10

Index	QTR	12 Months
S&P 500 Index (large-cap U.S.)	5.39	49.77
Wilshire 4500 Index (small- and mid-cap U.S.)	9.86	66.53
MSCI EAFE Index (international - developed)	0.87	54.44
MSCI Emerging Market Index (international – emerging)	2.40	81.08
DJ Wilshire REIT Index (real estate)	9.81	113.47
S&P GSCI Commodity Index	-0.89	25.87

Source: Bloomberg

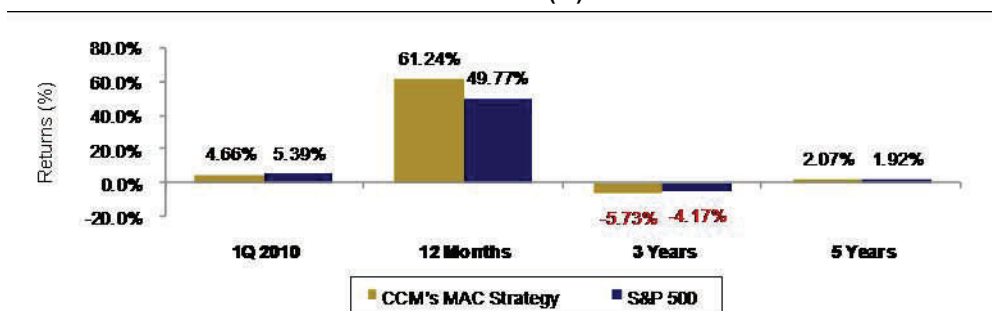
MULTI-ASSET CLASS (MAC) STRATEGY

During the first quarter of 2010, the MAC returned 4.66%, slightly underperforming the S&P 500 return of 5.39%. The weak performance of commodities (-0.89%) slightly outweighed the strong performance of REITs (9.81%). In contrast, over the last 12 months, the strong performance of REITs outweighed the weak performance of commodities, leading the MAC strategy to outperform the S&P 500.

With twelve months having passed since the financial crisis ended, the question becomes when and where will the next crisis strike? Inflation? Deflation? Interest rate spike? A major sovereign default? Double-Dip recession?

In spite of what some pundits suggest, no one knows for sure and the best way to prepare for the unknown is diversifying your financial risks across asset classes. With allocations to six different asset classes, diversification is the foundation of CCM's Multi-Asset Class Strategy.

CCM's MAC Strategy* vs. S&P 500
Returns (%)



* Multi-Asset Class

strategy (MAC)

returns based on Dow Jones Total Stock Market Index (U. S. Equities), MSCI EAFE (Developed International Equities), MSCI EM (Emerging Market Equities), S&P GSCI (Commodities) and Wilshire REIT indices. Performance does not reflect the effect of trading, management, and/or ETF fees. Past performance does not guarantee future results. All returns are through time period ending 3/31/2010. All returns greater than one year are annualized. The above statistics do not reflect allocation to U.S. Fixed Income which may be added depending on a client's tolerance for risk and/or income needs.

FIXED INCOME SECTOR RETURNS

- Long-term interest rates moved in a tight range. 10-year Treasuries traded between 3.56% and 3.88%, ending the quarter at 3.83%. This is virtually unchanged from the previous quarter.
- Worries about sovereign risk in Europe were offset by strong mutual fund flows and improving economic figures. Corporate bond spreads rallied, with the Barclays Credit Index spreads having declined from 1.57% to 1.36%. High-yield spreads also declined, moving from 6.17% to 5.70%.
- The Federal Reserve completed its MBS buying program on March 31. MBS prices rose modestly during the quarter, outperforming Treasury bonds. The coming months will test whether mortgage rates can stay low without Fed support.
- Yields on intermediate tax-exempt munis backed up sharply during the last two weeks of the quarter. Short-term maturities just beyond money market range (3yr – 6yr) experienced the biggest selloff, rising by as much as 35bps for 4-year AAA's.
- Shorter intermediate yields had become unsustainably low, with muni yields inside of 5-years reaching as low as 50% of the yield of a

Fixed Income Returns (%) As of 3/31/10

Index	Duration	Yield	QTR	Last 12 Months
Treasury ¹	5.10	2.37	1.12	-1.18
Agency ²	3.27	2.16	1.19	3.31
Credit ³	6.28	4.28	2.27	20.83
MBS ⁴	3.72	4.01	1.54	5.21
Barclays Capital Aggregate ⁵	4.68	3.47	1.78	7.69
High Yield ⁶	4.35	8.47	4.62	56.18
Merrill Lynch 1-12 Year Municipals ⁷	4.12	2.53	0.79	6.13

¹Barclays Capital Treasury Bond Index; ²Barclays Capital Agency Index; ³Barclays Capital Credit Index; ⁴Barclays Capital MBS Index; ⁵Barclays Capital Aggregate Index; ⁶Barclays Capital High Yield Index; ⁷Merrill Lynch 1-12 Year Municipal Bond Indices

comparable U.S. Treasury (historic averages are above 80%).

- Yields the long-end of the tax-exempt muni curve ended the quarter unchanged. The supply inhibiting effect of Build America Bonds (BABs) continue to have a profound effect on market dynamics.
- Even after the March selloff, total quarterly returns for intermediate muni portfolios remained positive.

FIXED INCOME PORTFOLIO ACTIVITY

TAXABLE BOND PORTFOLIOS

- Maintained below market interest rate risk, although we do not forecast a 10-year Treasury rate much above 4%. As the market moves to that level, CCM is likely to reposition duration to neutral.
- Made extensive use of new issue Build America Bonds. Newly issued bonds are typically priced at wider spreads than secondary trading, and subsequent to issuance these bonds tend to improve in price.
- Utilized high-yield ETFs where allowed by policy and appropriate.
- Remained underweight MBS, but added to 15-year and other shorter-termed agency mortgages. Aside from the end of the Fed purchase program, MBS are particularly vulnerable to an increase in interest rates outright or just an increase in interest rate volatility. CCM finds other sectors more compelling.

ENHANCED CASH PORTFOLIOS

- Based on our Fed forecast, CCM continues to favor 1-2 year bonds over shorter securities. The Fed is likely to hike rates sometime in the next 12-months,

but with 2-year bonds yielding well over 1% but cash equivalents yielding near zero, the risk/reward favors longer bonds.

- Reduced positions in callable agencies. Similar to MBS, callable agencies are vulnerable to any shift in interest rates, but do not enjoy the same curve roll advantage that 1- and 2-year non-callable securities have.

MUNICIPAL BOND PORTFOLIOS

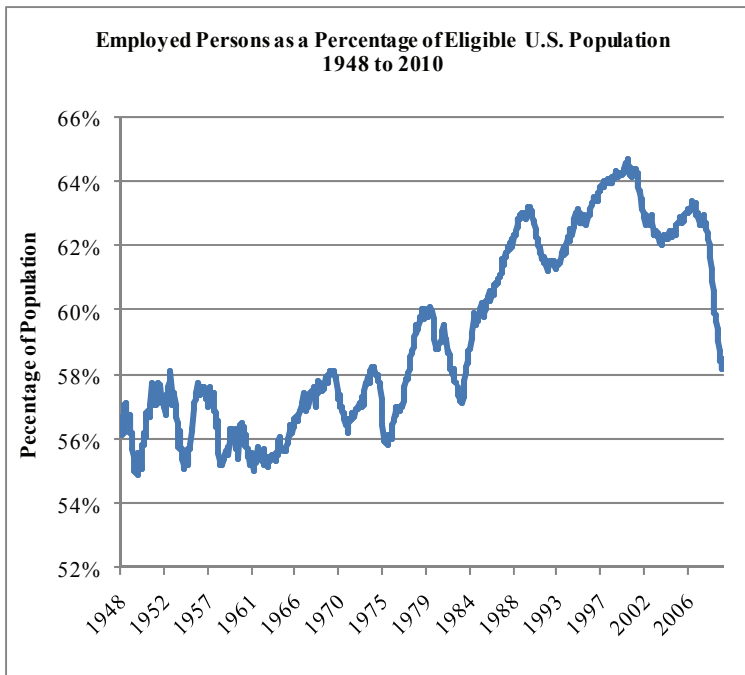
- Muni portfolios maintained average durations below benchmark for the entire quarter favoring a defensive rate posture.
- Duration was shortened during 4Q 2009 by selling high quality tax-exempts with maturities inside of 6-years as they traded at significantly overvalued levels.
- Portfolios added exposure to strong single-A and AA- rated essential service revenue credits. Current spreads on these bonds are wide enough to add incremental after-tax yield, even in the highest-tax states, while also improving portfolio diversification.

Dear Client

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From 1976 onward, employment participation trended upward as more women entered the workforce. This dovetailed with baby boomers coming of age and stay-at-home moms who went back to work as their children got older. During this rising tide, if there was a recession, employment participation declined by around 2%. This was congruent with previous decades.

Employment participation reached an all time high of 64.3% in January 2000 – just before the dot-com bust. In the 2003 – 2007 recovery, employment participation did not recapture that previous high. In this recent recession, employment participation declined by 5% – the worst drop in the postwar era. We are currently at 58% participation. The economy has a long way to go to get back to the post '80's average of 63%. Bottom line, we certainly don't see inflationary pressures coming from wages given the labor supply overhang. Therefore, we do not expect a material change in Federal Reserve policy until late 2010 or early 2011.



Source: BLS, CCM calculations

CCM WELCOMES NEW ADDITION

Stacy Landsman, and her husband Jon Guth, welcomed their second child, Rebecca Adele on March 9th. Rebecca joins big brother Miles. All are doing well.



A Balanced Approach for Long-term Investors

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Cavanaugh Capital Management (CCM) is an independent registered investment advisor. CCM specializes in active fixed income and passive equity strategies. If you would like more information about the firm, or its investment strategies, please contact Director of Marketing Doug Hinton at 410.769.6115 or dhinton@cavcap.com. You may also visit our website, www.cavcap.com.

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