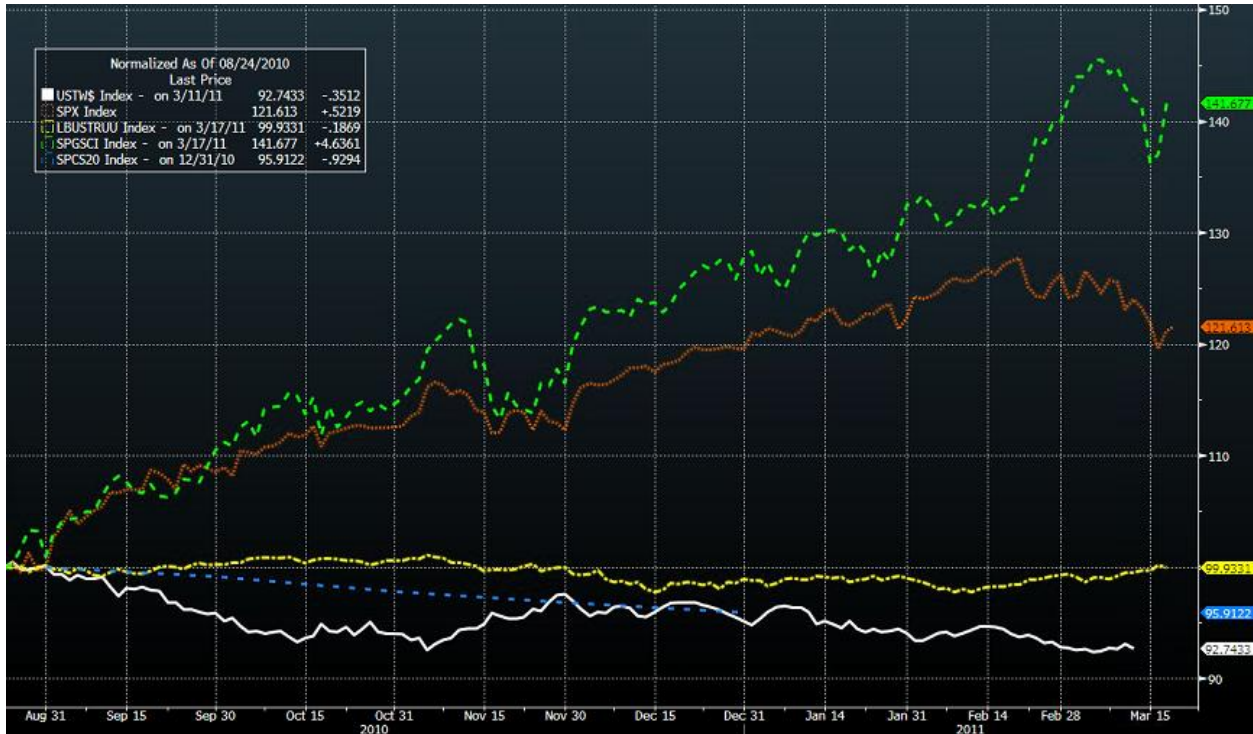


The “green light” flashed by the Fed’s bond purchase program, announced by Fed Chairman Ben Bernanke last August and discussed in our January Harmonic Notes e-newsletter, continued to blaze in its full glory. Stocks continued to rise until mid-February then faded by about -6% through mid-March. Treasury bond yields reached their most recent peak a few days earlier, then began to decline as more investors began to share Harmonic’s concern about asset valuations in the face of geopolitical concerns.

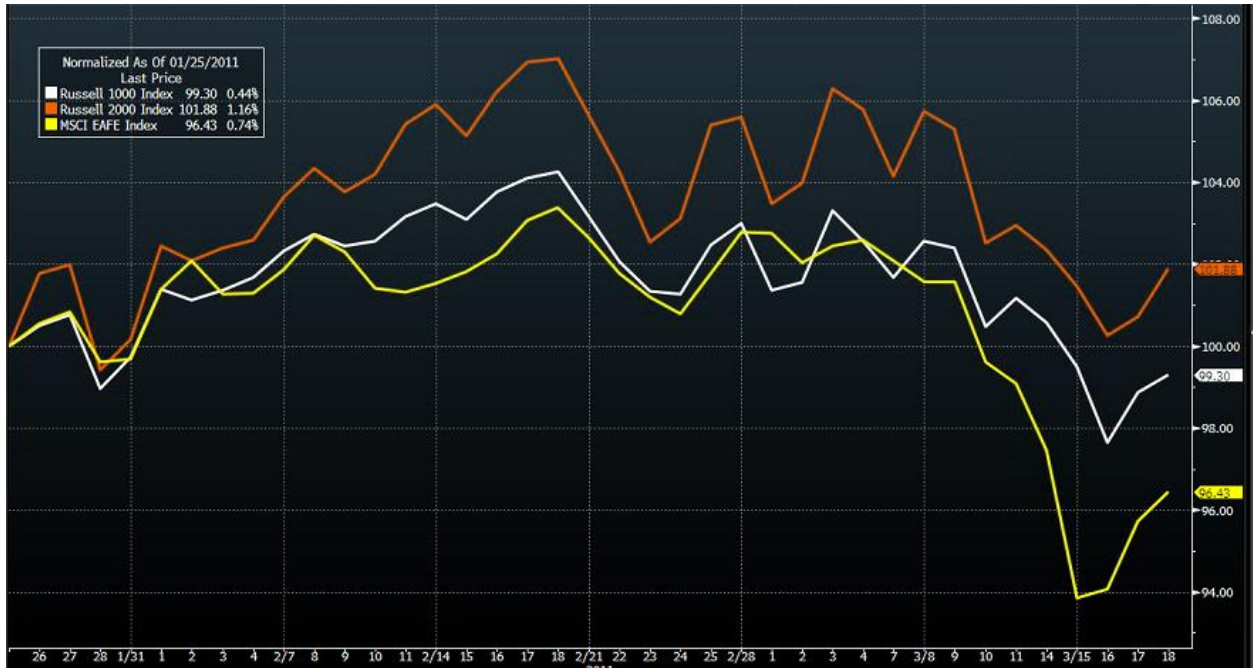


US Trade Weighted \$ (white solid), Barclays Aggregate Bond Index (yellow dashed), Case-Shiller monthly 20-city home price index (blue dotted), S&P500 (red dotted), S&P Goldman Sachs Commodity Index (green dashed) –daily 8/24/10 to 3/18/10, normalized as of 8/24/10 {GRAPH: BLOOMBERG}

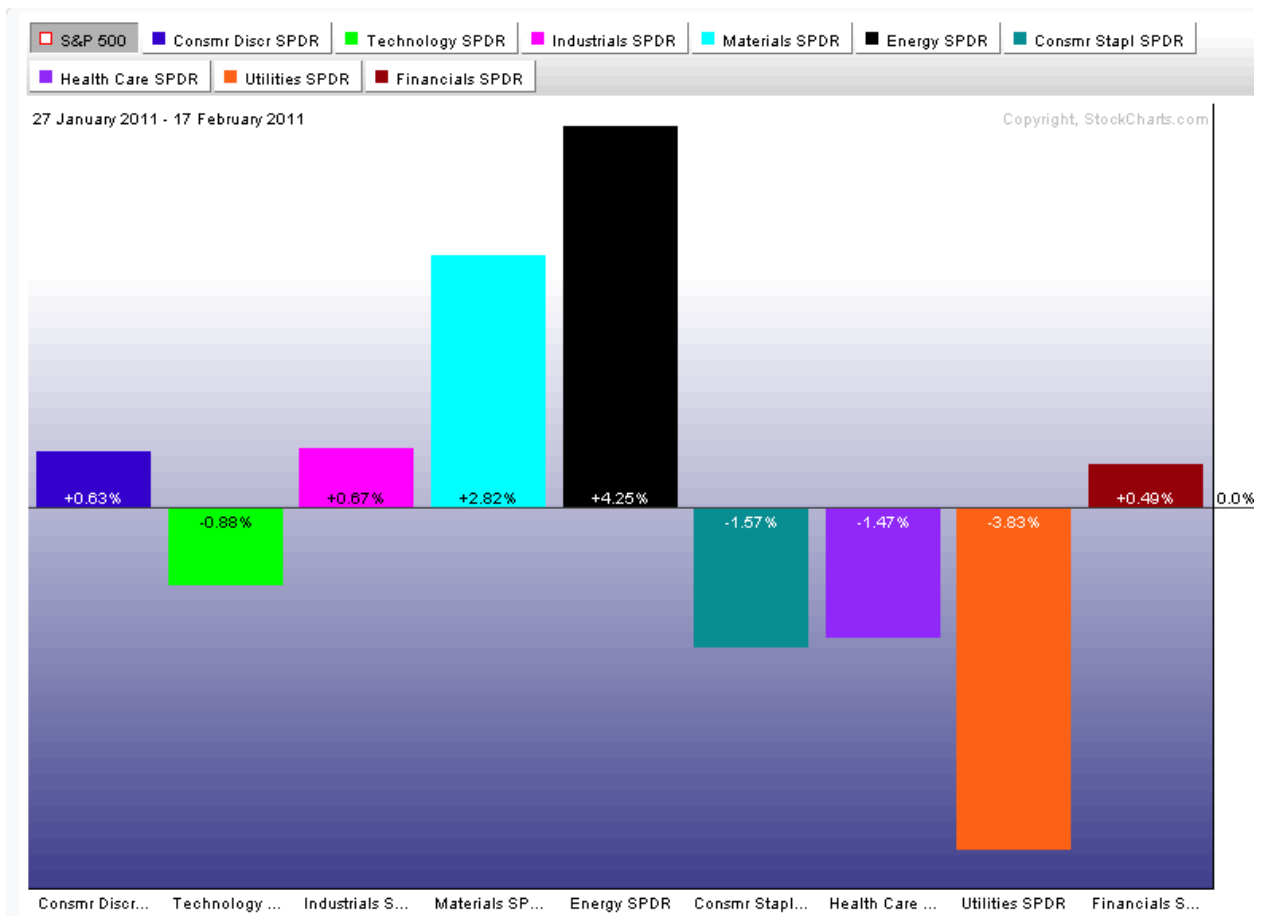
Divining the expected performance of stocks and other asset classes post-QE2 has become a recent preoccupation for many investors, made more complex by the recent natural and manmade disasters in Japan.

STOCKS

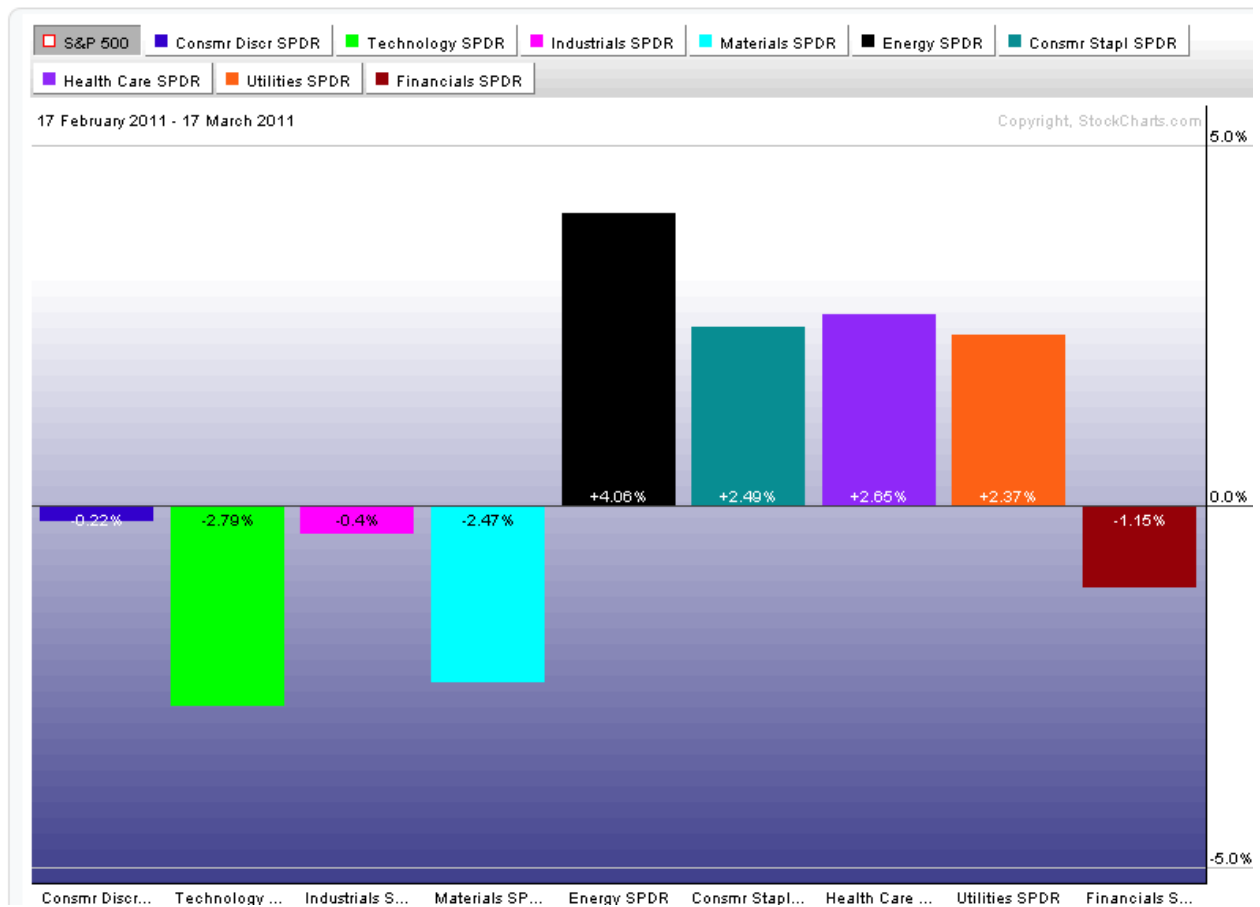
US stock indices moved about 5% higher after we distributed our mid-January newsletter, with the “risk on” trade firmly intact until mid-February. Small company stocks continued to outperform those of large firms and cyclical sectors outperformed more defensive ones. Foreign stocks lagged slightly. However, the concerns that we voiced in our last missive seem to have permeated investors’ psyches, and stocks began to falter in mid-February touched off by a sharp rise in the price of oil caused by unrest in the Middle East. Stock indices reached their most recent low on March 16 on a cascade of poor economic news and fears about a nuclear catastrophe in Japan, only to rebound sharply the following day when the crisis seemed to be in hand.



Relative performance of largecap stocks (Russell 1000 – white), smallcap stocks (Russell 2000 - orange) and developed market foreign stocks (MSCI EAFE – yellow); 1/25/11 to 3/17/11, indexed to 1/25/11 value {GRAPH: BLOOMBERG}



S&P500 sector performance relative to the S&P500 index, 1/27/11 – 2/17/11. Note the outperformance of the more cyclical sectors (consumer discretionary, technology, industrials, materials, energy) {CHART: StockCharts.com}



S&P500 sector performance relative to the S&P500 index, 2/17/11 – 3/17/11. Note the reversal of the earlier period's performance and strength of the defensive sectors (consumer staples, healthcare, utilities) {CHART: StockCharts.com}

As we noted in the last newsletter, though, hopes are high for stocks in 2011. The consensus among stock market forecasters is that the market will end 2011 higher. Most argue that higher sales volumes and wider margins will lift earnings and that P/E multiples will expand as the economy continues to strengthen.

S&P 500 Year-End 2011 Strategist Price Targets*

Firm	2011 Year End Target		Expected 2011 % Chg at Start of Year	Expected 2011 % Chg Now
	1/4/2011	Current		
Deutsche Bank	1,550	1,550	23.25	23.25
Goldman Sachs	1,450	1,500	15.30	19.27
Barclays	1,420	1,450	12.91	15.30
Bank of Montreal	1,350	1,430	7.34	13.71
HSBC	1,320	1,430	4.96	13.71
JPMorgan	1,425	1,425	13.31	13.31
UBS	1,325	1,425	5.36	13.31
Bank of America	1,400	1,400	11.32	11.32
Citigroup	1,400	1,400	11.32	11.32
Wells Fargo	-	1,390		10.52
Oppenheimer	1,325	1,325	5.36	5.36
Credit Suisse	1,250	1,250	-0.61	-0.61
Morgan Stanley	1,238	1,238	-1.56	-1.56
Average	1371.08	1401.00	9.02	11.40

*From weekly Bloomberg survey.

{CHART: Bespoke Investment Group, as of 3/9/11}

Also, several market omens bode well for stock performance this year. First, this is the third of the four Presidential election cycle.

Presidential Stock Cycle
S&P500 Performance in Third Year of the First Term
(1955 -2003)

	<u>3rd Year</u>	<u>S&P500</u>	<u>S&P500</u>	<u>2nd Year</u>
Ike	1955	26.40%	45.02%	1954
JFK	1963	18.89%	-11.81%	1962
LBJ	1967	19.64%	20.09%	1966
Nixon	1971	10.79%	0.10%	1970
Carter	1979	12.31%	1.06%	1978
Reagan	1983	17.27%	14.76%	1982
Bush 41	1991	26.31%	-6.56%	1990
Clinton	1995	34.11%	-1.54%	1994
Bush 43	2003	26.38%	-23.37%	2002
Obama	<u>2011</u>	???	<u>13.44%</u>	<u>2010</u> *
Average		21.34%	4.20%	
High	1995	34.11%	45.02%	1954
Low	1971	10.79%	-23.37%	2002
# of Up Years		9		6
# of Down Years		0		4

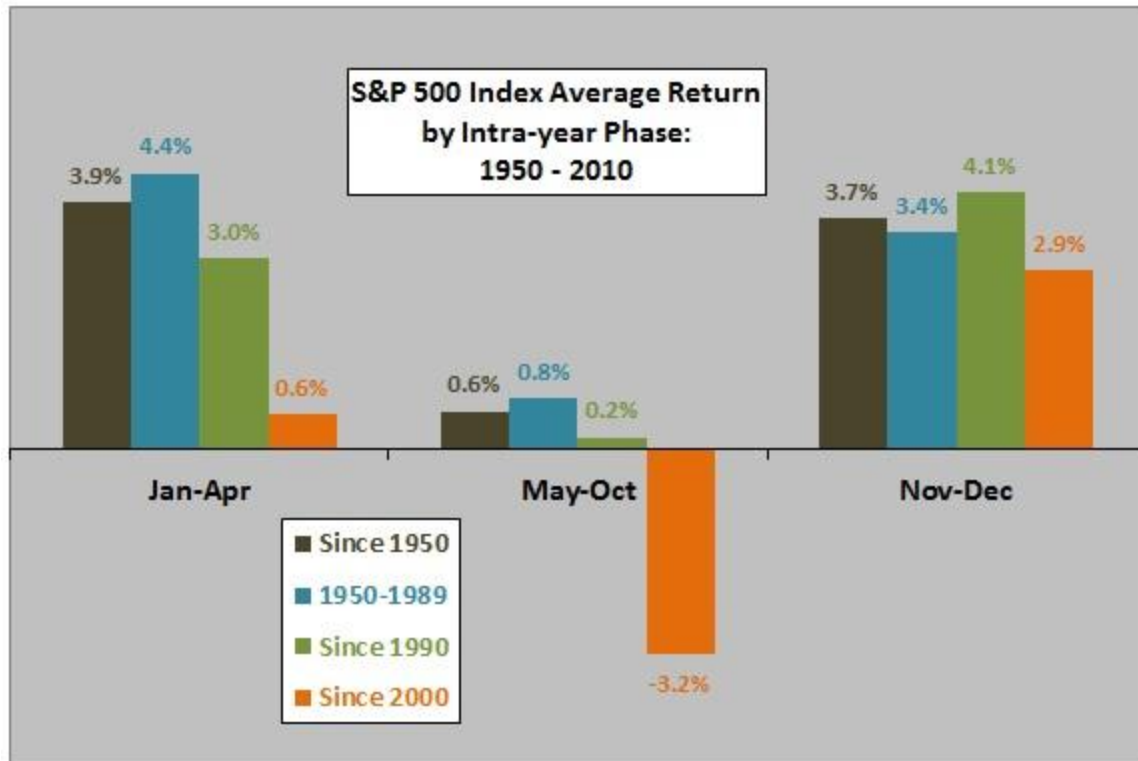
* Based on assume 2010 S&P500 closing price of 1265

macromon.wordpress.com

Second, market participants also note that January's +2.3% return bodes well for the remainder of this year. According to the book Seasonal Anomalies, "for the 71 years spanning 1940-2010, when the S&P 500 Index is up (down) during January, it is up (down) for the rest of the year 86.4% (48.1%) of the time. For 1994-2010, when January is up, the rest of the year is up 80% of the time."

More fundamentally, expectations are for strong corporate earnings for first and second quarters of 2011. Indeed, Standard & Poor's suggests that 1H11 earnings will hit new record highs.

Even considering the hopefulness and bullishness, we remain skeptical. We're wondering if another old market axiom will hold true this year: "Sell in May and go away".



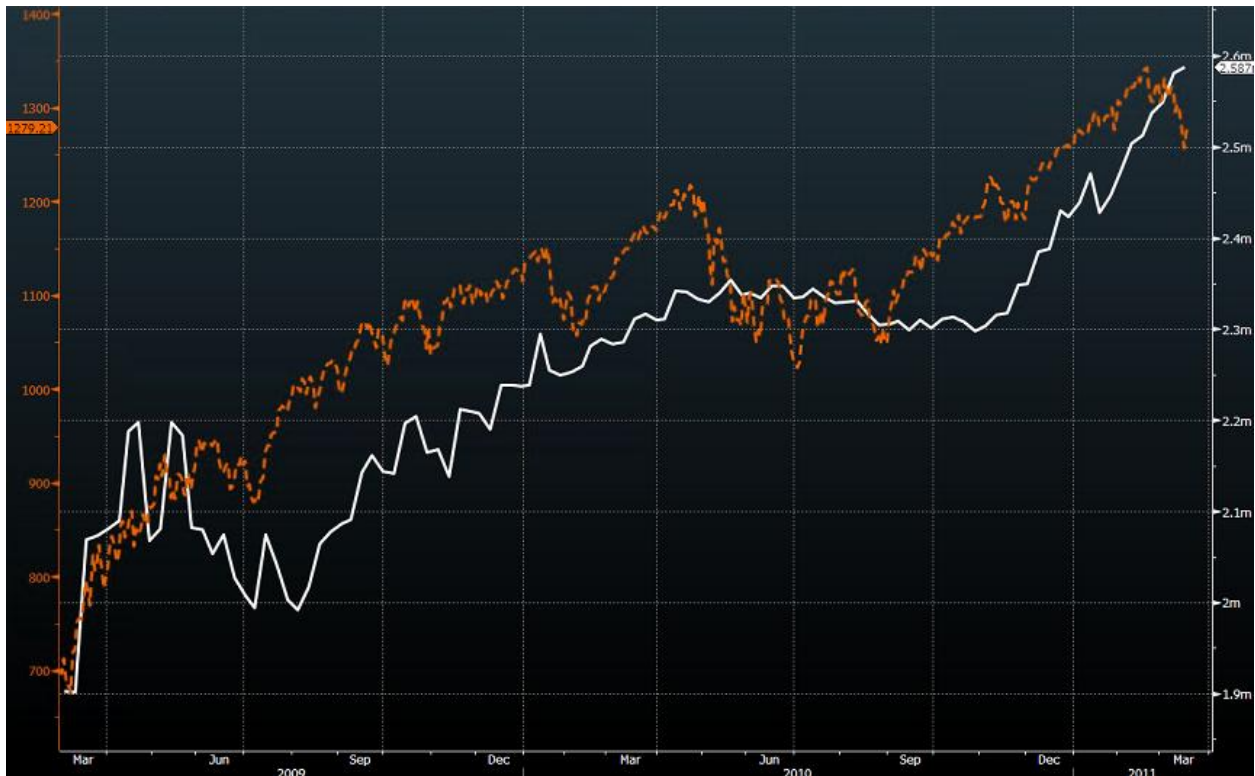
{CHART: CXO ADVISORY GROUP}

Even in the third year of the Presidential election cycle there's a distinct performance tilt in favor of the first half of the year.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
← Average*	4.4	1.4	2.1	3.4	1.6	2.1	-0.2	1.4	-0.4	-1.1	-0.2	3.3
2011	2.3	3.2	-3.6									
2007	1.4	-2.2	1.0	4.3	3.3	-1.8	-3.2	1.3	3.6	1.5	-4.4	-0.9
2003	-2.7	-1.7	0.8	8.1	5.1	1.1	1.6	1.8	-1.2	5.5	0.7	5.1
1999	4.1	-3.2	3.9	3.8	-2.5	5.4	-3.2	-0.6	-2.9	6.3	1.9	5.8
1995	2.4	3.6	2.7	2.8	3.6	2.1	3.2	-0.0	4.0	-0.5	4.1	1.7
1991	4.2	6.7	2.2	0.0	3.9	-4.8	4.5	2.0	-1.9	1.2	-4.4	11.2
1987	13.2	3.7	2.6	-1.1	0.6	4.8	4.8	3.5	-2.4	-21.8	-8.5	7.3
1983	3.3	1.9	3.3	7.5	-1.2	3.5	-3.3	1.1	1.0	-1.5	1.7	-0.9
1979	4.0	-3.7	5.5	0.2	-2.6	3.9	0.9	5.3	0.0	-6.9	4.3	1.7
1975	12.3	6.0	2.2	4.7	4.4	4.4	-6.8	-2.1	-3.5	6.2	2.5	-1.2

Monthly S&P500 total return in third year of Presidential election cycles since 1975

That seasonal weakness in the markets may be exacerbated by the conclusion of Fed's QE2 bond purchase program in June.



S&P500 (orange, left scale) and Federal Reserve total assets (white, right scale), 3/2/09 – 3/17/11

As noted above corporate earnings have been exceptionally strong, but sharply higher commodity prices have the potential to create margin pressure. Should increased demand appear as the economy strengthens, growing payrolls present a second source of increased margin pressure. In short, we think there's a low probability of margin expansion driving further earnings growth.



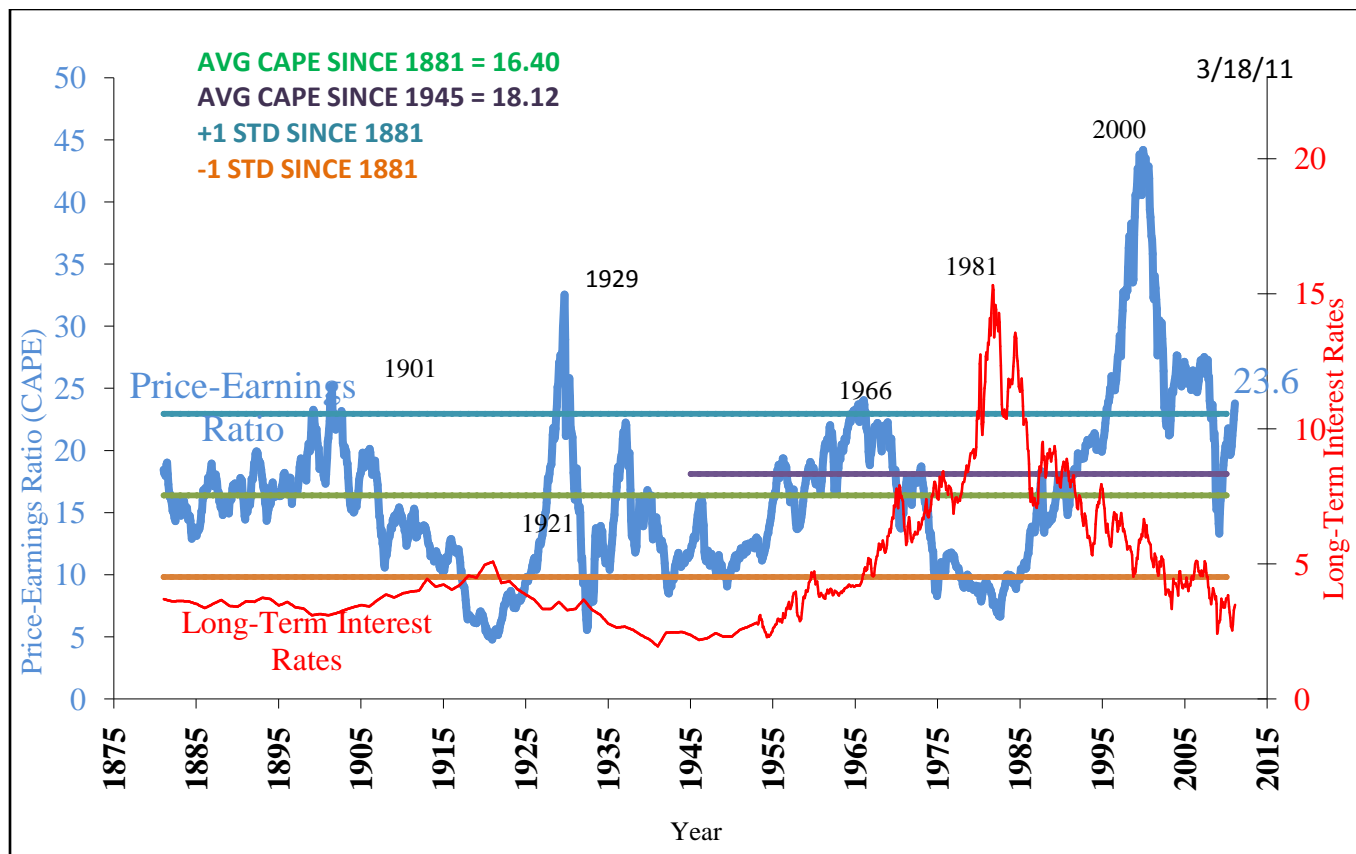
Corporate profits % of GDP (white), S&P500 (red), log scale quarterly Dec 1947 – Dec 2010 {GRAPH: Bloomberg}

Also, stocks appear expensive, or nearly so, on valuation metrics we watch. The S&P500 market-cap to GDP ratio, after touching 120% in late February, remains near that critical threshold.



S&P500 market cap to GDP ratio, 5/14/04 – 8/18/11 {GRAPH: Bloomberg}

The inflation-adjusted trailing 10-year average PE ratio (Cyclically-adjusted PE, or CAPE) is more than 1 standard deviation over its long-term average.



<http://www.econ.yale.edu/~shiller/data.htm>; Harmonic Investment Advisors calculations

It's worth noting that higher interest rates suggest a lower fair value for stocks.

A longer term headwind is that P/E multiples are in a multi-year contractionary phase, so even if corporate earnings remain solid the index level may decline.



S&P500 P/E ratio, weekly, 1/2/70 – 3/18/11 {GRAPH: BLOOMBERG}

All in all, we've enjoyed the run-up in stock prices as much as anyone. But...

- the market sentiment's clearly become more nervous,
- we're nearing the end of the most favorable calendar period,
- valuations are, if not rich, nearly so, AND
- economic and market behavior post-QE2 is anything but clear.

We're not expecting a crash, but things may get a little dicey for stocks later this year.

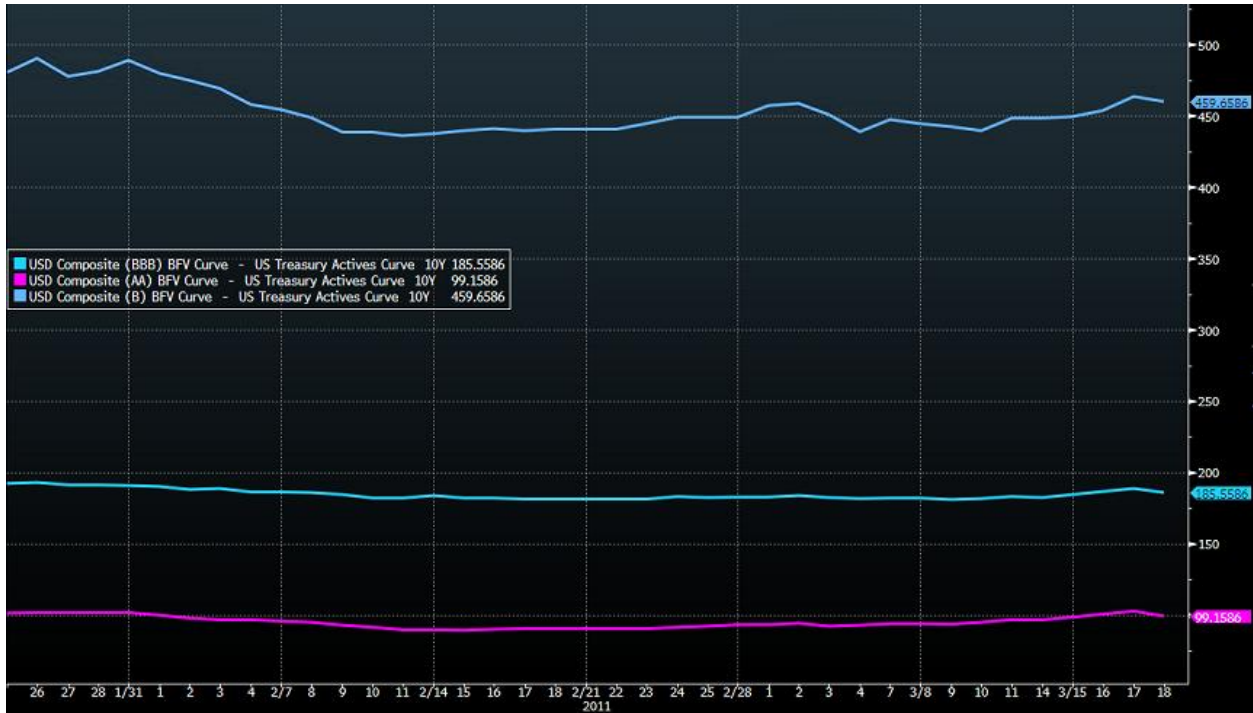
BONDS

Global bond yields tracked the performance of stocks over the past two months, with yields rising through mid-February and then turning lower as market participants bought bonds to reduce their risk profile.



US (white), EU (orange), UK (yellow) and Japan (blue) 10-year government bond yields, 1 year (daily) ending 3/18/11 {GRAPH: Bloomberg}

Yield spreads between Treasuries and the highest risk bonds – aka “junk” – behaved similar to stocks, contracting until mid-February then widening over the past month. Yield spreads on higher quality bonds have remained fairly stable. Spreads indicate the additional yield investors require to accept the risk of holding a non-Treasury bond, so contraction suggests less risk aversion.



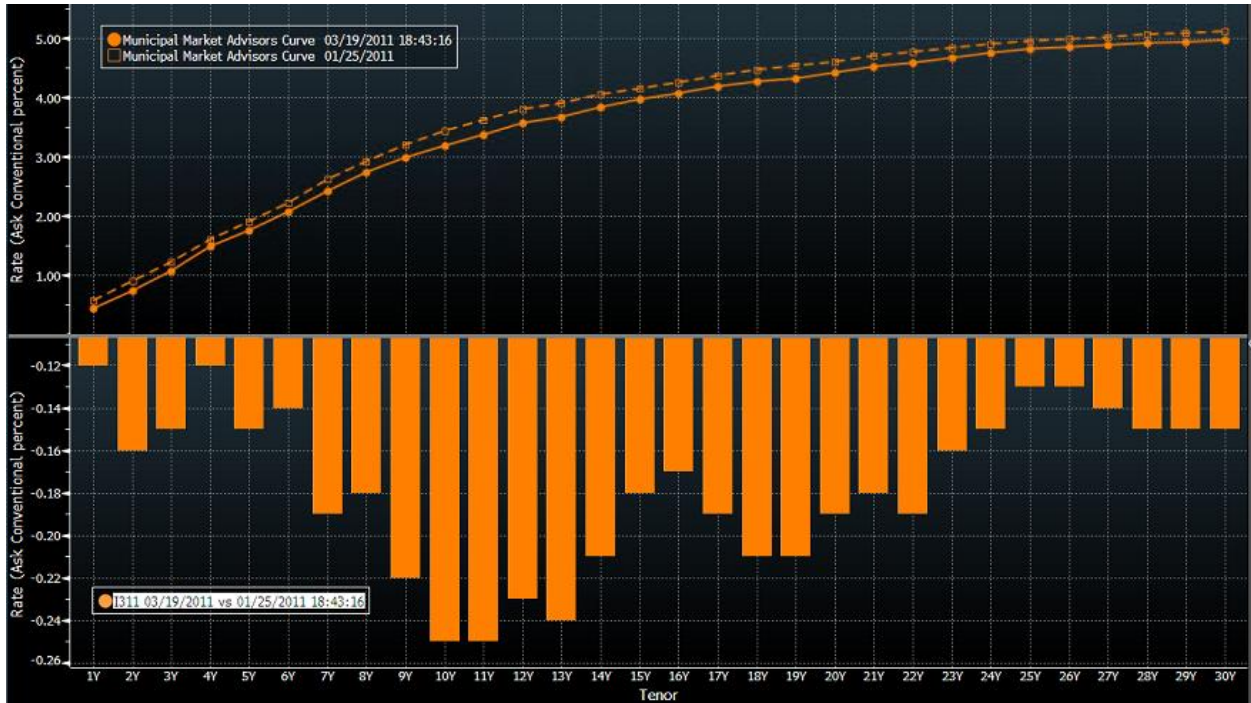
"B"-rated (top), "BBB"-rated (middle) and "A"-rated (bottom) 10-year corporate bond yields, 1/25/11 - 3/18/11 (daily) {GRAPH: BLOOMBERG}

As one would expect given the inflation-creating potential of an additional \$900 billion sloshing around in the economy, inflation expectations have risen since Bernanke's speech. Those expectations are easiest measured by the spread between inflation-protected bonds and nominal bonds (For a discussion of TIPS yields please see the Economic Insight section of this newsletter). While down slightly from their recent peak, inflation expectations over the next 10 years remain at a historically average 2.40% (240 basis points). Expectations for inflation over the next 2 years, however, have risen by about 1.0% over the past 3 months.



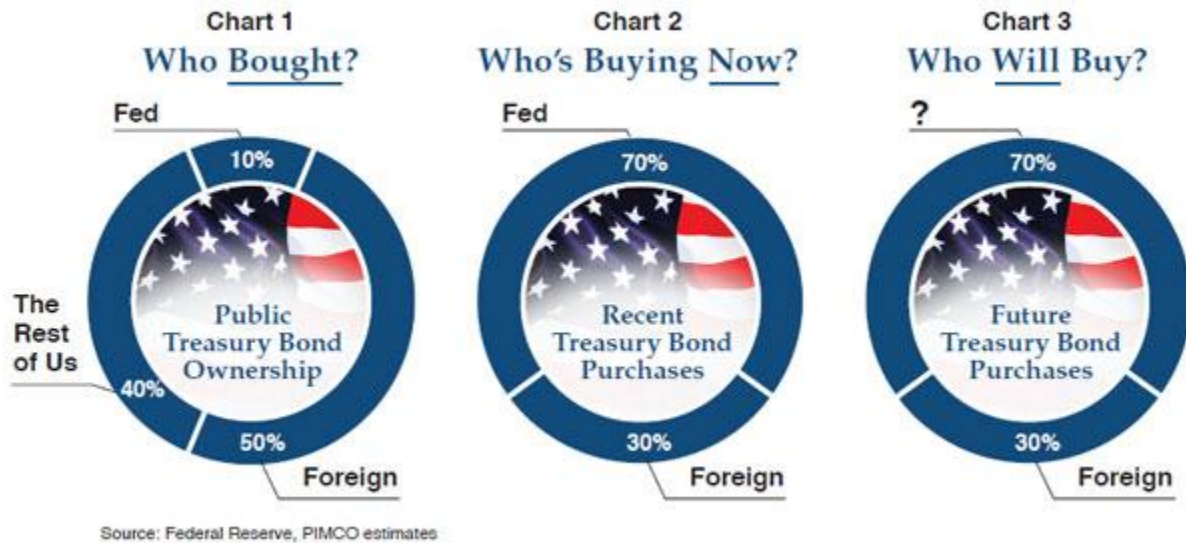
Yield difference between 2 Year (dotted, bottom) and 10 year (dashed, top) maturity TIPS and nominal Treasury bonds, daily 3 months ending 3/18/11 {GRAPH: BLOOMBERG}

After weathering a pounding fueled by supply concerns and default fears, the municipal bond market rebounded somewhat as investors speculated, as we proposed in our January newsletter, that the selloff had been overdone.



TOP: Generic municipal bond yield curve 1/25/11 (dashed) & 3/18/11 (solid)
 BOTTOM: yield change in basis points
 {GRAPH: BLOOMBERG}

Our expectation is for somewhat higher bond yields in the coming months, given rising inflation expectations. We also share the concern, noted in Bill Gross's recent Investment Outlook piece for PIMCO, that when the Fed stops purchasing Treasury and mortgage-backed securities in June that a significant adjustment may take place.



Source: Federal Reserve, PIMCO estimates

{GRAPH: PIMCO}

The rise in yields will likely be interrupted by occasional flights-to-quality, such as the recent cataclysm in Japan and downgrades of “peripheral” European countries like Portugal and Ireland.

Harmonic’s bond clients are positioned conservatively: We’re underweighted in that asset class as a whole and we’ve preferred bonds that have short maturities with attractive credit profiles.

COMMODITIES

Commodity prices have been one of the star performers since the Federal Open Market Committee announced QE2. Not all commodities have reacted alike however.

Anyone who’s purchased gasoline in the last few months is aware of the latest spike in energy prices. Oil has dropped back to about \$100 after hitting its most recent high above \$105, rocketing 25% in less than one month. As noted in this month’s Economic Insight food commodity prices have risen sharply as well.

Given its historical role as a hedge against uncertainty, gold is perhaps the ultimate asset for risk adverse investors. The spot price of gold climbed along with other commodities through November; however, since then it has traded sideways, somewhat contradicting the inflation concerns suggested by inflation-protected bonds.



TOP: Spot gold (orange), Brent crude oil (green) and Bloomberg Food & Fiber commodity index (purple)
BOTTOM: S&P Goldman Sachs commodities Index
Daily 8/24/10 to 3/18/11, normalized to 8/24/11 {CHART: BLOOMBERG}

Commodity prices are subject to demand destruction; for instance, if the price of gasoline gets too high, people will begin carpooling or riding their bikes to work. Analysts differ on the exact figure but seem to agree that that demand destruction may kick in if oil rises much beyond current levels. We notice, though, there’s been much less complaining about high gasoline prices than when they last spiked in 2008, evidence to us that Americans are behaving normally – after an adjustment period they adapt. This type of behavior drives economists crazy because it’s “irrational” but we think it supports a long-term bullish view on commodity prices. There’s no more oil, gold, or natural gas being made, so to speak, but barring a multi-year global recession demand isn’t likely to abate for long.

REAL ESTATE

Harmonic gives clients exposure to the commercial real estate market via real estate investment trusts. One advantage of using real estate in an investment portfolio is that the real estate cycle is somewhat different than the stock and bond cycles. However, since REITs are a type of common stock they have a moderate correlation with the stock market. That, and the fact that REITs usually offer a relatively high yield, has pulled them higher in recent months. Since our last newsletter REITs performed in line with the S&P500 until risk aversion set in, and then benefitted from their higher yield and lower volatility compared to the broader stock market.



*Dow Jones US REIT Index (white solid) & S&P500 (orange dotted), daily 1/25/11 to 3/18/11, indexed to 1/25/11
{GRAPH: BLOOMBERG}*

POSITIONING

With only a temporary tactical change, we're positioned as we were in January. At that time we were overweight equities in order to take advantage of the rally, having shifted client assets towards stocks and commodities while lightening up on bonds when it became clear the Fed intended to put its money where Bernanke's mouth was. As our concern rose about a near-term correction, in late January we hedged a portion of clients' stock positions, a tactical trade which proved prescient as the Middle East erupted. We expect to remove the hedge shortly.

We continue to focus on high quality stocks rather than more speculative ones. Also, as noted above we've shortened the maturity of our bond portfolios, preferring to capture yield by taking more credit risk, which we have the skills and experience to evaluate, instead of duration risk.