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## ***Markets Getting Trickier***

### *Transitions in Global Markets Are Beginning*

We stated in January that our expectation for 2010 was for Q1 to be “more of the same” and *then* “things would get trickier”. By getting trickier, we largely suspected markets would begin to fret about Fed tightening and potential tax hikes. It appears we are here ahead of schedule and for reasons different than first anticipated. In our December monthly commentary, we stated the following:

Dubai World deferred payments on about \$80 billion of debt. After a brief sell-off, stock markets basically “yawned” and marched higher. If you are at all like us, you are tired of hearing how “small” the Dubai debt situation is compared to the amount of bad bank loans that have been written-off. Yes, that is true, but let us not forget that those bad bank loans brought the financial system to its knees! We believe in the cockroach theory. That is, when you see one, there are usually many more that you do not see. The day after the default, we reduced our market exposure and shorted a couple areas of the market. As our clients know, we are believers in the secular commodity demand theme, including gold, and the corresponding weak dollar story. However, this trade is crowded and due for a counter-trend reaction. The door will get awfully narrow when the dollar begins to correct upwards. Thus, we also have reduced some of our tactical energy exposure. Consensus seems to believe that a dollar rally is a 2010 event; however, it could start sooner. *(Please note we archive our commentaries on our website under the “online material” tab. These comments can be referenced here [http://www.blueshorescapital.com/portfolioFiles/HIcPF-ecYxU-Ejupw-December\\_2009\\_Commentary\\_&\\_Charts.pdf](http://www.blueshorescapital.com/portfolioFiles/HIcPF-ecYxU-Ejupw-December_2009_Commentary_&_Charts.pdf) )*

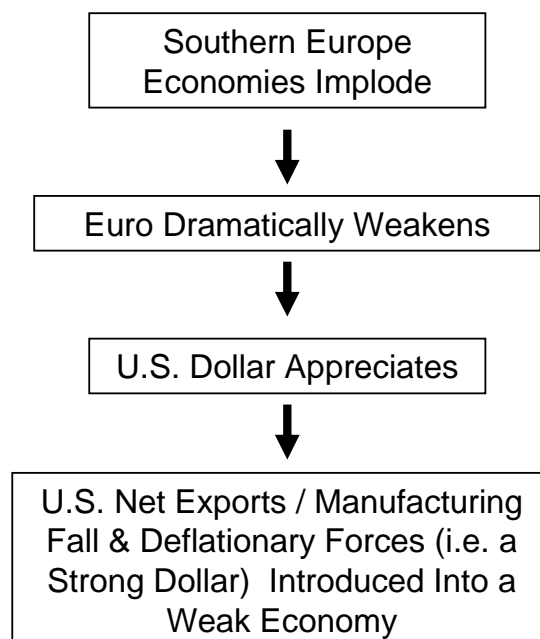
It now appears more of the cockroaches are appearing, except they are called PIGS! (Portugal, Italy, Greece, Spain). Southern Europe is in trouble as the periphery Euro economies are under increased duress from their weak fiscal conditions and debilitating recessions/depressions.

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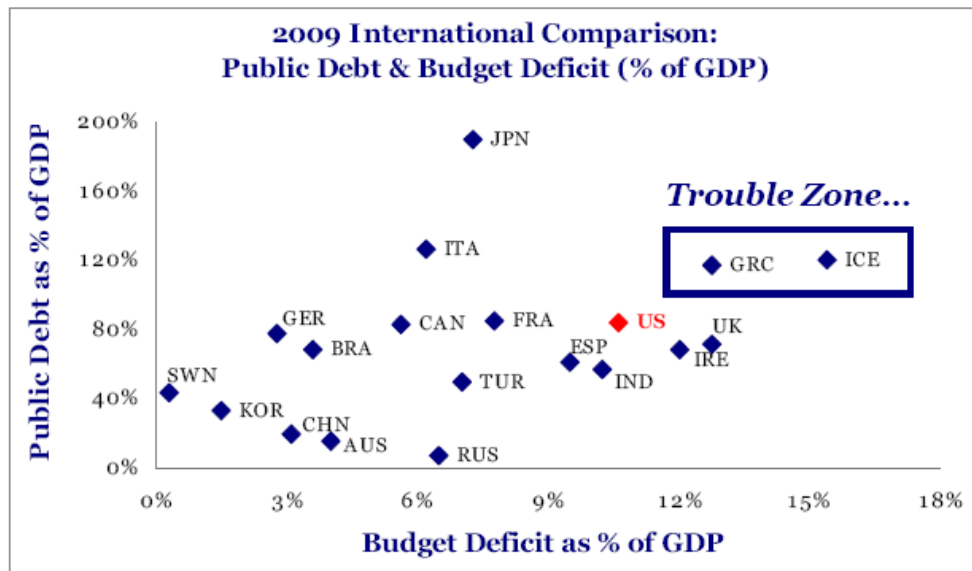


There appears to be a chain reaction that is occurring that could cause continued issues for global equities and the so called “reflation” trade.

### ***What Could Go Wrong***



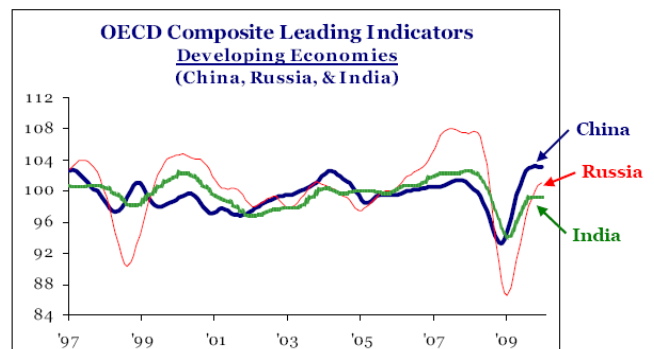
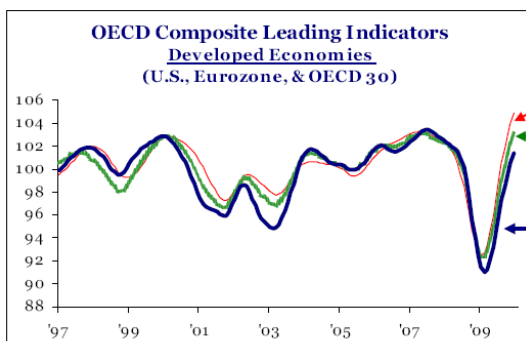
Our “*What Could Go Wrong*” schematic is *not* our base case, but its probability appears to be rising. Despite the strong rally in financial markets from the March 2009 low, investors should not forget that we are still in the early innings of the deleveraging process and the “debt issue” remains, in our opinion. Debt has simply been transferred (and continues to transfer) from the private to public sector. In our view, the drama that is unfolding in the PIGS will likely unfold in some of the developed markets down the road. However, that does not appear to be this year’s issue.



Source: StrategasRP

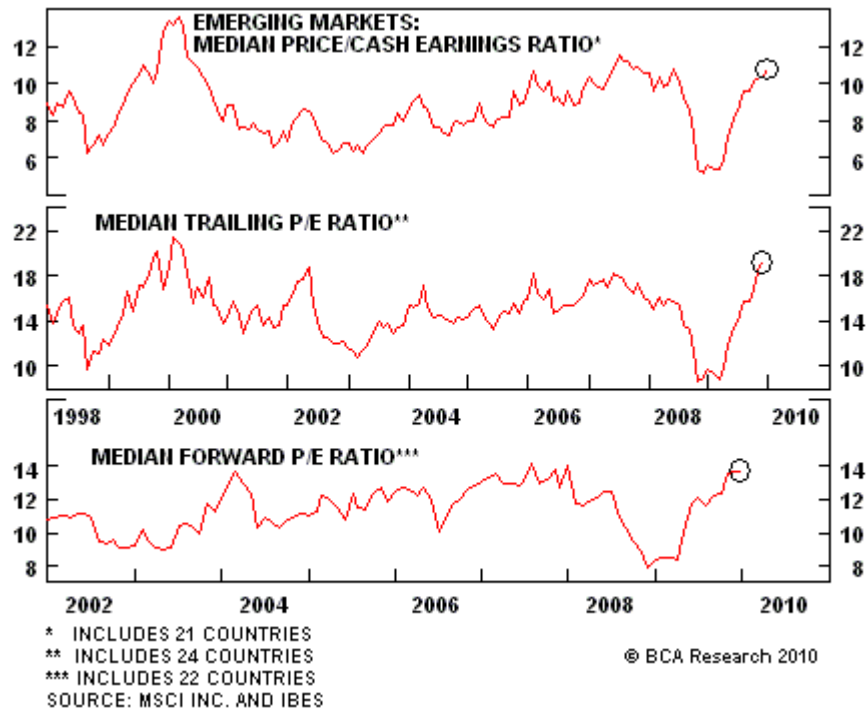
Suppose the European Union bails out Greece? Markets would likely respond positively on the news. But then who bails out Italy, Portugal, or whoever else may be next? This is not clear.

Also of significance, in our view, is that emerging market economies are showing some signs of slowing down. Everyone is aware that the Chinese authorities are trying to cool things down, and we believe that is the appropriate action, but we are surprised by how little attention the leading indicators of emerging markets have received as they begin to weaken.



Source: StrategasRP

Emerging market valuation appears to be full, that is, the cyclic recovery appears to be priced in.



As our clients know, we are secularly bullish on emerging markets and commodities. It is well known that the majority of the world’s marginal growth over the coming decade is believed to come from emerging Asia, Latin America, and to a lesser extent Eastern Europe. However, tactically (over the next 3 to 9 months), there are probably better areas to allocate new money, in our view.

## *Positioning*

With all the global crosscurrents, how does one position a global portfolio? As the title of the piece goes, we believe currently finding the right footing in the global market place is “tricky”. On the one hand, many of the positive forces that helped drive risky assets higher through much of 2009 are still in place, i.e. low interest rates, abundant liquidity, and better earnings than expected. On the other hand, the above mentioned issues appear to be escalating and it is not yet known to what duration or magnitude these issues will affect global economies and financial markets.

Clearly, a stronger U.S. Dollar is at the heart of the recent market shake-up. We have allocated a portion of clients’ equity allocations to securities that rise with the U.S. Dollar (and falls when the dollar falls) as a way to hedge some of our reflation themed positions. The calls for “quality” stocks to outperform have been around since the credit contraction began, but we believe the quality trade will actually outperform this year. The BSC Global Strategy’s international stocks should benefit as they are focused on large

companies with higher than average dividend yields. Domestically, we have increased our exposure to healthcare as earnings are coming in stronger and the sector has lacked meaningful participation in the March rally to date.



We think there are a couple of key indicators to watch that would suggest that the recent correction is morphing into something more sinister.

- ✓ 1) Credit Spreads – *still supportive of stocks (widening spreads would be bad)*
- ✓ 2) U.S. Leading Economic Indicators – *still rising at an increasing rate*
- ⚠ 3) Market Breadth – *not good, but not bad (majority of stocks are below their 50-day moving average, but above their 200-day)*
- ✓ 4) Interest Rates – *10-year treasury yield below 4%. Fed on hold.*

Fixed income allocation remain invested in high quality securities and have less than benchmark duration (or interest rate sensitivity). The risk this year is for higher yields, in our opinion.

As of now, we are in the correction camp, but will adjust client portfolios as conditions dictate. We continue to believe flexibility is key.

Thank you for your interest in Blue Shores Capital.

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