



INVESTMENT COMMENTARY

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Selected By **WEALTH MANAGER** Magazine As One Of America's Top 500 Advisory Firms

MARCH 28, 2010



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INDICATORS POINT TO LIMITED BUT SUSTAINABLE GROWTH

THINGS ARE GETTING BETTER, BUT THERE IS A LONG ROAD AHEAD

The first quarter of 2010 comes to a close with equity markets moving higher and an overall sense the economy is slowly recovering from the worst slump since the 1930s. The economy is still very fragile, but economic growth, while still slow, appears to be on a sustainable path. Credit markets are much improved and most indicators are pointing up. But this is not to say everything is rosy or bright. There are large structural issues still unresolved. Record high unemployment, elevated sovereign debt levels, and a depressed housing market are all adding a certain level of anxiety to the markets. Uncertainty regarding changes in the tax code, national energy policies, and a final version of health-care reform have investors and employers feeling apprehensive.

THE ECONOMY IS SLOWLY RECOVERING FROM THE WORST SLUMP SINCE THE 1930s.

Equities We remain generally bullish on stocks. Earnings have been better than expected as corporate America has done an excellent job of controlling costs in hard times. The latest retail sales data reflects the consumer is stronger than expected, and that spending is more impacted by stock prices than home prices. Long term prospects for the equity markets are bullish, but a major correction (10%-15%) due to profit taking is possible. We would not interpret such a correction as a reflection of market weakness nor would it curb our long-term optimism. Interest rates should move up as economic growth stabilizes, but at the present time we see no significant short-term increase in inflation. Treasuries are not attractive on a total return basis, and we currently prefer investment grade corporate and high yield bonds. With inflation expectations low there is no need to have a big hedge in commodities, however investors should maintain a 5% - 7% hedge in commodities.

AT THE PRESENT TIME WE SEE NO SIGNIFICANT SHORT-TERM INCREASE IN INFLATION

We prefer to hedge with agriculture, which we see as having the most upside, but we still view energy along with base metals and precious metals as useful for hedging. We like emerging market currencies. Higher growth and lower debt loads than the U.S. make emerging market currencies a good hedge against U.S. deficit problems. The Canadian dollar and Australian dollar are strong, but investors should keep in mind these currencies are highly correlated with commodity prices and hence offer little hedging benefit against the U.S. dollar.

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Housing Analyzing the housing market brings to mind Yogi Berra's famous quote, "This is like déjà vu all over again." First we had to face an avalanche of foreclosures due to the sub-prime mortgage debacle, and now we are confronted with a replay from a growing wave of pending foreclosures due to record-high unemployment. It is estimated there are about 5 to 7 million homeowners who are seriously delinquent (missed *at least* three monthly payments) on their mortgage and are in danger of slipping into foreclosure. Investors fret that as these delinquent properties fall into foreclosure, and add to the supply of homes-for-sale, they will further degrade housing prices. This *shadow market* (delinquent loans which lenders expect to eventually be foreclosed upon) is a growing concern to real estate analysts. While government and private-lender programs have been designed to aid homeowners in modifying their existing loan payments, there is little hope for homeowners who can not even make a reduced mortgage payment due to extended periods of unemployment. The truth is, for the long-term unemployed homeowner, there is little hope on the horizon. The vast majority of these shadow market properties will eventually go into foreclosure. Meanwhile, banks have slipped into a "foreclosure paralysis" whereby they are allowing the shadow market to grow unchecked because they do not want to further depress home prices by swelling the existing market with even more foreclosed properties. Aggravating the situation is the fact that many of these shadow market homes are located in the same areas which were hit hard by the sub-prime mess and now suffer very high unemployment rates - Arizona, Nevada, California, and Florida.



CURRENTLY, 5 TO 7 MILLION HOMEOWNERS ARE SERIOUSLY DELINQUENT ON THEIR MORTGAGE

Analysts are beginning to point to this shadow market as a possible reason for the recent data which shows that while certain markets are experiencing an upswing in home sales they are showing at the same time a corresponding drop in home prices. A recent analysis by J.P. Morgan Chase highlights the long-term impact this new glut of foreclosures will have on real estate in certain regions of the country – by the end of 2012, 39% to 50% of home purchases in Phoenix, AZ will still be foreclosed properties. And even in a market as vast as Los Angeles, foreclosures will still account for 28% of all sales over two and a half years from today. What makes J.P. Morgan's grim analysis so plausible is the simple fact that the only way to salvage most of these shadow market properties from foreclosure is with a robust jump in employment – and unfortunately, most economists do not see much job creation for the next few years.

IN CERTAIN LOCALITIES THE HOUSING MARKET WILL STRUGGLE FOR YEARS TO COME

It is difficult to make blanket statements about real estate nationwide because so much of it is local and dependent upon various regional factors. The Federal Reserve will stop purchasing mortgage-backed securities at the end of this month and the home buyer tax credit is set to expire at the end of April. The Mortgage Bankers Association expects mortgage rates will move up about one point by the end of 2010 as a result of the Fed's action, and realtors are unsure how sales will be impacted when the home buyer tax credit expires. While there are many signs of growing stability in many regions of the housing sector, the data would seem to indicate some segments of the housing market may struggle for years to come.

Jobs Persistent long-term unemployment remains a significant problem and will act as a drag on economic growth. Government and private economists, including White House economic advisors and Treasury officials, are all predicting unemployment will remain somewhere in the mid to high 9% range for the remainder of 2010 and linger near 8.5%-9% in 2011.

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State Budget Woes And while it looks like the worst is over for private sector job losses, it may be just the beginning for state and local workers. To put it mildly – many state and local government budgets are nearing an unprecedented crisis whereby they are unable to balance their budgets without sizeable layoffs. A recent survey by the National Association of State Budget Offices reports that even with the infusion of stimulus funds, 23 states have already resorted to layoffs and another 16 states have used furloughs in an attempt to close budget gaps. Unable to increase revenue due to depressed property values, record-high unemployment, and dismal sales tax revenues – states are now forced to cut their payrolls, and many state budget officials admit they are entering uncharted territories when it comes to the drastic magnitude of the impact. It is estimated that for fiscal year 2011, states will face a \$180 billion dollar budget gap. The Center on Budget and Policy Priorities estimates that without any additional federal aid, states will implement budget cuts that will cost nearly 900,000 private and public sector jobs in 2011. An official from the CBPP said it is not accurate to describe the current budget crunch as a revenue shortfall, but actually should be described as a revenue collapse. He went on to say, in proportional terms, there has never been a drop in state revenues like we are seeing now.



MANY STATES HAVE MOVED FROM “REVENUE SHORTFALLS” TO A CRISIS OF “REVENUE COLLAPSE”

States are scrambling to raise revenue anywhere they can and at least five states have gone so far as to announce they plan to delay payments of tax refunds to residents in an effort to help stretch limited state funds. Vertex, Inc., which tracks data on state and local sales tax, reports U.S. sales tax rates have hit the highest rate since Vertex began to collect data in 1982. Vertex counted 649 new or increased sales tax rates during 2009. Investors should remain vigilant as record-high federal, state, and local debt levels may work to undermine economic stability.

Global Investment Outlook Greece’s debt problem and the deteriorating relationship between China and the U.S. regarding the yuan will probably continue to dominate the news. The Chinese government has ratcheted-up the rhetoric by insisting the yuan is fairly valued and any decision regarding their currency is a sovereign matter and none of Washington’s business. More and more, statements issued by Chinese officials have a snarky tone that implies Washington has no room to criticize China, and should instead concentrate on “the safety of dollar assets.” While U.S. officials are not yet proposing a hardball policy, there is growing pressure for the government to take some type of action. With the global economy still in the earliest stages of recovery, any hint of tariffs or protectionist policies could have terrible implications. The greatest concern for investors is the speed at which any escalation in a tit-for-tat trade skirmish could roil markets. Investors need to keep a close eye on government actions and statements which may indicate a further eroding of relations.

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In contrast, as fast as the Chinese currency situation may change, chances are the debt crisis currently engulfing Greece will drag on for years and years. France and Germany are still at odds about how to proceed with a rescue plan. France backs a European solution while Germany is favoring an IMF led package of aid. If push comes to shove, Germany will most likely dictate the terms and details of the bailout. Greek officials are already grumbling about Germany's "cult of austerity" and their fixation on debt. The German government is insisting on steep budget cuts, tax increases, and drastic changes in social benefit programs such as state pensions and retirement plans before any bailout is approved. With all the uncertainty regarding fiscal budgets in Portugal, Ireland, Italy, and Spain, the euro may very well weaken against the U.S. dollar, and growth in the EU countries could be stunted.

SUMMARY



- **Long-Term (5-6 years) U.S. equities could double**
- **Significant, short-term correction possible in U.S. stock market due to profit taking after substantial gains since March 2009 low**
 - **Slight underweight in foreign and emerging market equities**
 - **Maintain target weighting in U.S. equities**
- **Overweight investment grade corporate bonds vs. Treasuries & Agencies**
 - **Overweight high yield bonds**
 - **Continue to build position in real estate**
 - **Intermediate U.S. Treasuries attractive for hedging only**
- **Inflation Protected Treasuries (TIPS) attractive as long-term holdings**
- **Agriculture commodities remain attractive. Energy, base metals, and precious metals have limited upside, but still remain useful for hedging purposes**
- **Emerging market currencies should appreciate in relation to the U.S. dollar**
 - **Euro should be weak relative to U.S. dollar**
- **Covered call writing (selling call option contracts against equity holdings) very attractive for hedging and generating additional income**
- **Global financial crisis abated but economic growth will be modest in coming year**
 - **Greatest risk to investors in coming months is global government debt and instability in the currency market**

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