FBB Capital Partners

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Dear Clients and Friends,

Stocks were generally higher in the first quarter of 2010, led by the financials and the more cyclical industrial and consumer discretionary sectors. Defensive areas such as the utilities, energy, and staples all lagged, as stock investors expanded their appetite for risk at the expense of safety. Healthcare stocks were up modestly on average, despite much hand-wringing over newly passed health insurance reform legislation. While the ultimate economic effects on the healthcare industry and broader economy will not be fully understood for years, the new laws may prove beneficial to many health care companies as they find their customer base suddenly expanded.

We commented in our January letter that we believed stocks were in fair value territory, neither cheap nor expensive, and that further upside would be relatively muted compared to the recovery we saw in 2009. Little has changed to our view, with an improvement in the corporate earnings picture being the key driver thus far, though the headwinds (taxes, deleveraging) and tailwinds (rising operating profits and dividends) have both accelerated recently.

The fixed income area saw higher volatility during the quarter, but bonds finished the quarter largely where they started it. This was true even as the Federal Reserve took the first step in what we think will be a long, slow march toward higher rates, by hiking the discount rate charged to banks by a quarter of a percent. An astonishing $350 billion flowed into bond funds in 2009, more than the previous 5 years combined, and one of the reasons bond yields remain as low as they are, even as bond risks might be on the rise. We continue to shop very selectively for bonds, looking for those with relatively higher yields to provide some downside protection should bond flows reverse.

"We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle."

- Winston Churchill

On a broader basis, federal and municipal budget deficits are likely to continue to grow – not only because of health care expenses, but because entitlement programs in general continue to balloon. For example, two weeks ago the CBO announced that Social Security will be underfunded by payroll taxes in the current year; previously it did not foresee such a shortfall before 2016. That is problematic, and it supports our view that taxes will need to rise significantly, to cover ongoing spending needs. Higher taxes will probably not bring the fragile economic recovery to a complete halt, but are likely to at least slow the recovery's pace.

Two of the indicators that we continue to watch closely are employment and housing. While the unemployment number remains high at 9.7%, the number of first time jobless claims has been moderating. Though employment is often a lagging economic indicator, the initial claims number is often watched as a leading sign of improvement. The problem for jobs is that factory utilization remains very low, and a meaningful improvement in end-demand is necessary before businesses begin hiring *en masse*.

The decline in home prices also appears to be moderating in several regions of the country. The most recent Case-Shiller housing report showed that the 20-city index was off only 0.7% for the 12 month period ended January 31, 2010 making it the smallest price decline in the last three years. Washington D.C. metro area prices actually appreciated 3.5% for the same period. Groundbreaking on new homes remains anemic, which we view as a positive as it gives existing homes less competition, and keeps excess inventory off the market.

So, the bottom line is that we are seeing modest improvement in these important indicators, despite the potential for growing headwinds over the remainder of the year. We would not be surprised to see higher volatility in the financial markets in the coming months, but are encouraged by the strength in corporate profits.

Sincerely yours,

Mitch Schlesinger

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