<u>Outlook for March, 2012: “Climbing a wall of worry…”</u>

Equity markets continue to climb a “wall of worry” amidst the sea of excess global liquidity. The latest fret: rising interest rates on government bonds around the world – especially as market participants worry about incipient inflation. While markets could indeed consolidate in the near term (given their substantial rise since the start of 2012), we do feel comfortable with our “cautiously optimistic” stance over the longer term.

Economic data released recently has, on balance, been quite positive: The U.S. Department of Labor reported an increase of 227k jobs in February, handsomely topping consensus estimates of around 200k. Figures for January and December were revised upwards as well (+41k and +20k, respectively) for a net gain of 61k jobs. In the February report, private payrolls added 233k as gains were widespread: Professional and business services (+82k), education and health services (+71k) and leisure and hospitality (+44k) were the main gainers while construction (-13k), government (-6k) and other services (-6k) were the laggards.

The politically sensitive unemployment rate, as part of the larger household survey, remained unchanged at 8.3%. Long-term unemployment (comprised of those jobless for 6 months or more) came in slightly lower at 5.4 million, representing 42.6% of the total unemployed (previously 42.9% in January). The U-6 measure, which we view as a more realistic picture of unemployment, edged fractionally lower from 15.1% to 14.9%. Since December 2007, the economy is still down a net 6 million jobs, having lost 8 million during the depths of the recession and recovering 2 million so far.

The Bureau of Economic Analysis of the Department of Commerce released their revised upwards their estimate of 4Q GDP to 3.0% (q/q, saar) from an initial estimate of 2.8%. For comparison purposes, 3rd quarter GDP was at 1.8%. The acceleration in GDP was driven by private inventory investment and personal consumption expenditures. Personal income ticked up slightly to +3.6% (y/y). Many of the survey data also suggest a firming in both demand as well as expectations – both on the corporate as well as consumer side.

The Federal Open Market Committee of the Federal Reserve chose to maintain the Fed Funds Target at 0.0% to 0.25% - just as they have since December, 2008. The post meeting statement released by the FOMC did suggest that economic growth appeared to be firming and “strains” in global financial markets have eased somewhat. The statement did also incorporate a new contemporaneous worry about the evolving outlook for growth: rising energy prices and their impact on actual as well as anticipated inflation.

Chairman Bernanke did receive unequivocal support from the rest of the members of the FOMC with the sole exception of Jeffery M. Lacker (President of the Richmond Fed) who thought that economic conditions did not warrant exceptionally low levels of the Fed Funds Target through 2014. In subsequent Congressional testimony Chairman Bernanke did leave the door open for further quantitative easing if conditions warranted such a move. What those conditions are is however, anybody’s guess!

Turning to commodities and their recent price increases – it is quite possible that the rate of increase in the Consumer Price Index (CPI) could easily pierce the 2.0% target that the Fed has publicized. Already, the overall measure of consumer prices has increased by 2.9% for the twelve months ending in Feb, 2012. Indeed, as price increases in crude oil and gasoline gain momentum, the overall CPI could post stronger increases thus calling into question the ultra-easy monetary policy stance.

The Federal Reserve primarily focuses on core (ex-food and energy) measures of inflation. While the theoretical underpinnings for removing volatile food and energy prices from inflation computations are well understood, it is also inappropriate to suggest that real people do not eat or drive either! Regardless of one’s position on this academic debate, it is quite clear that the Fed’s credibility is likely to be sorely tested in the months and quarters to come if they maintain their ultra-easy monetary policy stance in the face of deteriorating inflation fundamentals (remember G. William Miller’s tenure at the Fed?).

Farther afield, a new chapter has now been written in the Greek saga on debt and deficits: Over 95% of “private” holders of Greek government debt tendered to take a substantial haircut on their existing holdings of Greek debt.

While the final determination is yet to be made as we write this, it is becoming clear that the haircut might be closer 80% of the current par value of the debt outstanding.

What is also abundantly clear is that the "official" holders of Greek debt (read the European Central Bank and the various national central banks) pushed hard to exempt themselves from the same haircut – preserving the value of their holdings of Greek debt. Essentially, the "official" holders of Greek debt were treated differently from the "private" holders of the same debt – despite there being no real difference in the two kinds – thus setting a dangerous precedent. Indeed, such callous treatment of capital market rules on an ***ex-post basis***, calls into question fundamental beliefs in credit markets.

Attention now turns to the other countries in Europe with debt and deficit issues – Portugal, Ireland, Iceland, Spain and Italy. Given the policy prescriptions for Greece, it is very hard to expect the Irish or the Portuguese population to accept a tougher deal – especially if their Greek cousins got a better deal on their debt restructuring. It will be interesting to see how the next steps play out in this Shakespearean tragicomedy!

Equity markets have continued to rejoice in all the excess global liquidity since the beginning of this year – easily rising over 12% since the start of the year – the best such showing in over twenty-five years. While equity markets have climbed "too much too quickly" in the opinion of some market participants, the expected pullback has been quite elusive. Another recent worry has been the virulent rise in US Treasury interest rates.

Ten year US interest rates have seen a dramatic increase recently rising from around 1.80% at the end of January to 2.38% - an increase of 58bp in a few weeks. Indeed, history suggests that such a steep increase in interest rates is never a good thing for financial markets – especially since US government rates are used as the benchmark rate for discounting all sorts of cash flows – dividends, corporate earnings, swaps etc.

The increase has also occurred along with a steepening of the yield curve – a technical term to suggest that the longer end of the yield curve has borne the brunt of the increase relative to the front end. A "bear steepening" typically occurs as a result of worries about inflation or too much growth. We will continue to watch developments in interest rates with a careful eye – especially as it concerns their impact on other financial markets.

Earnings expectations for the current quarter (1Q2012) for the S&P500 index appear to be quite modest: Consensus bottoms-up expectations imply an increase of just 5.5% for 1Q2012 relative to 1Q2011. This compares to an actual increase of 8.0% for the previous quarter (4Q2011 compared to 4Q2010). While there have been some concerns about slowing earnings growth, valuation mutiples (currently around 14 times) remain reasonable.

Meanwhile, on the political front, the process of picking the Republican candidate for President continues to drag on – with Mitt Romney the former Governor of Massachusetts garnering the most delegates. Yet, with Super Tuesday having come and gone, Governor Romney has not been able to sew up the nomination. Many political operatives are getting excited about the prospect of a "brokered convention" – where the nominee is determined only at the convention through actual voting by delegates. This has not happened in over thirty years and if it does, we would not expect this to be a positive for the GOP's prospects come November.

The US Supreme Court is going to spend two days of hearings in April on the constitutionality of the Patient Protection and Affordable Care Act, 2010 (otherwise known as "Obamacare"). This was clearly a landmark legislation of the current Administration's term and much has been written and debated in the blogosphere about this piece of legislation. Regardless of the Supreme Court's verdict, we do not expect this to be the last chapter in this story.

In summary, we continue to position your portfolios with slight optimism for the future – reducing cash balances on hand in favor of a fully invested stance. While we still worry about the possibility of a near term pullback, we do feel reasonably positive over the medium to longer term. Indeed, our abiding faith in a fully diversified portfolio - that has a balanced approach to both risk and return - as the main way to attain favorable investment outcomes over the long haul remains resolute.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III
MBR Financial, Inc.
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

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