

January 2011

“Looking Back at 2010”

While most people were out celebrating the New Year in grand style, I spent my New Year's Eve having a movie marathon with my 11, 8 and 4-year old kids. As we were choosing our seven movies at Blockbuster, I stumbled across Dr. Dolittle. To my kids, Dr. Dolittle means Eddie Murphy, but we watched the classic version starring Rex Harrison and my kids loved the pushmi-pullyu scene. That is the scene with the two-headed llama and the song “I've never seen anything like it.” That's exactly how I feel looking back at 2010.

After strong total returns in 2009, the market also delivered solid returns in 2010. In bonds, the Aggregate Bond Index (representing the broad investment grade universe) had a 6.54% total return in 2010 after a 5.93% total return in 2009. All spread product contributed to the 2010 performance with healthy positive excess returns (returns above Treasuries) delivered by corporate bonds with 229 basis points of excess return followed by mortgage-backed securities with 225 basis points of excess return. In stocks, the S&P 500 Index had a 15.1% total return in 2010 after a 26.5% total return in 2009. Consumer Discretionary stocks (up 28%) and Industrials (up 27%) were the leading sectors for 2010.

But, low Treasury yields was the real story in 2010. In November, a \$35 billion 2-year note was auctioned at an all-time record low yield of 0.44%. That's about as close to zero as you can get. What's even more dramatic was the incredible demand as the bid-to-cover was 3.70. This means that total orders for the new notes were 3.7 times the total volume of the amount auctioned. In other words, the government received \$129.5 billion in orders. Normally, a bid-to-cover for a Treasury auction is closer to 2.5.

The 2-year note was not the only story. Looking out on the yield curve, even the 10-year Treasury reached an amazingly low yield of 2.38%. This is very near the 2.07% low yield set during the “Financial Crisis” in December 2008.

By now, people have read numerous stories about one of the main factors causing yields to decline — “quantitative easing (QE)”. As a recap, QE is generally when a central bank creates money which it uses to purchase assets, raising the price and lowering the yield of those assets. The first quantitative easing (QE1) consisted of the government purchasing \$1.25 trillion in mortgage-backed securities and \$175 billion in agencies from November 2008 to March 2010. Because unemployment has remained stubbornly high, the government chose to implement a second round of quantitative easing (QE2) in November 2010 by purchasing \$600 billion in Treasuries.

We were never true believers that QE1 and QE2 would be successful at keeping interest rates low for any reasonable time period. For this reason, we kept our duration (interest rate exposure) generally below the market by remaining significantly underweighted in Treasuries in favor of 15-year agency mortgage-backed securities and high quality corporates.

GH&A

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What a difference a month makes! As the economy has shown some moderate improvement, 10-year Treasury yields have risen over 100 basis points to a recent high of 3.52% in mid-December. Many in the “don't fight the Fed” camp are surprised by the increase in rates in the middle of the Fed's QE2 buying program. We aren't! We were more surprised by the artificial overreaction to the QE initiatives and the 2.38% low yield in October.



Source: Bloomberg, GHA Research

Thus, the recent back-up in rates has provided an excellent opportunity for those of us who have been short duration and underweighted in Treasuries to reload by buying them at these lower prices. We will be writing more about our outlook in our next letter. For now, because of the stubbornly high unemployment rate, over the near term we expect rates to trade in a narrow range with a bias lower. But as I look back at 2010, “I've never seen anything like it in my life!”

*“I've been around;
I could tell you stories
That would quite astound you;
I'm not a fool!
I went to school!
I've been from Liverpool to Istanbul, Istanbul.
I'm no fool!
And anyone will tell you
That I'm sharper than a knife,
But I've never seen anything like it in my life!”*

Dr. Dolittle 1967 Film Soundtrack

Gilbert Andrew Garcia, CFA
Managing Partner
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A copy of our Form ADV, Part II is available upon request.
FIVE HOUSTON CENTER 1401 MCKINNEY ST., SUITE 1600 HOUSTON, TEXAS 77010 PHONE: (713) 853-2322 FAX: (713) 853-2308

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