

Amegy Bank Investment Management Markets Commentary

We are cautiously optimistic as signs of improvement emerge from a cross-section of markets and sectors of the economy. However, there continue to be developments that may keep the recent equity rally from becoming sustainable.

Signs of Improvement

There have been many signs of improvement over the last couple of months, which is encouraging. With earnings expectations and sentiment so low and negative, stock prices have been susceptible to positive surprises. Bad news hasn't been as bad as feared. Some recent improvements include the following:

- Stock price volatility has diminished from last fall
- Mortgage rates have continued to come down
- Risk aversion is losing some of its appeal as the yield on preservation of capital strategies is close to 0%, which is encouraging excess liquidity to look for a new home
- Fear may be abating as LIBOR (the rate that banks lend to other banks) is once again dropping
- Housing affordability, which tends to lead residential investment by roughly two quarters, soared nearly 50% the past seven months to a new record high
- Industrial commodities like copper are moving up, while the price of gold is staying down, despite the trillions of new spending
- The dollar is still maintaining its strength versus other currencies
- Employment losses seem to be slowing

The relative strength of emerging market countries, the technology and consumer sectors and the Nasdaq and Growth styles outperforming are more indicative of a market getting ready to move higher than one about to head lower. These are encouraging signs. However, there are also some serious items to be concerned about.

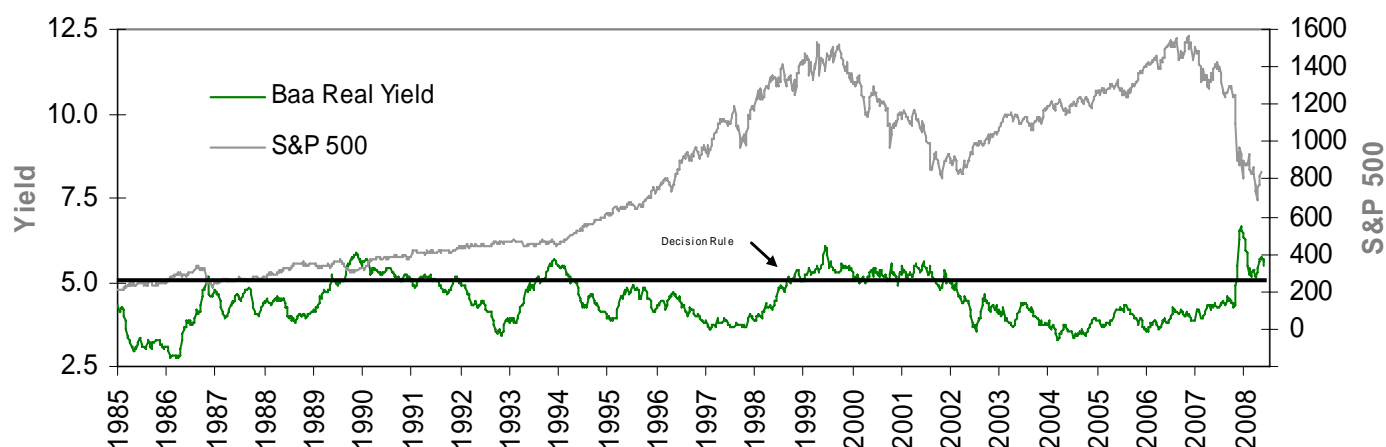
Concerns and Worries

Credit markets are not joining in - Stock and bond markets are sending conflicting signals about the prospects for an economic recovery and stabilization of the financial system. Credit markets have not joined in with the rally in equities as the spread between yields on Baa-rated corporate debt and 10-year Treasuries has remained very elevated, even as the stock market posted a furious rally from its March lows. (as seen in the following chart)

Bond investors are reflecting deep skepticism that risk has dissipated enough to justify lower borrowing costs. That message is at odds with stock investors, who believe the crisis of last fall is now waning. The worry is that history tells us that it is the bond investors who are usually right in these situations. It will be very difficult to sustain this stock rally if the credit markets do not join in.

Protectionism is increasing - Signs of trade barriers and protectionism are very troublesome and seemingly everywhere. These soft "Buy American" or "British jobs for British workers" policies will put even more downward pressure on growth. Russia imposing 25% tariffs is the latest example of these destructive policies and is contrary to recent pledges on avoiding protectionist measures. The worry is that these actions can be self-reinforcing as they lead to other sectors, as well as the risk that other countries retaliate in the same fashion. Protectionism leads to lower growth and higher costs and is starting to turn into the biggest hurdle for sustainable worldwide economic growth.

Baa Corporate Real Rates Above or Below 5%



Source: Amegy Bank Investment Management, GaveKal

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Outlook on a few topics

Political will - The Fed and others are trying to offset the amount of de-leveraging that is occurring among financial institutions, companies and consumers. This is pretty straight forward until it becomes politically unacceptable to continue. As Mohamed El-Erian (Co-chair of PIMCO) said, "We must contemplate a scenario in which the economically desirable solution is not politically feasible, while that which is politically feasible may not necessarily be economically desirable." Political fatigue of increasing deficits, "bailouts" or perceptions of the government doing too much may mitigate the economic recovery.

Cash as a catalyst - The investment community as a whole is very underweight equities with a high percentage of cash on the sidelines. There is a very big difference, however, versus the early 1980's when cash was this high, because investors could get double digit returns in cash. Today, that cash is yielding close to zero and could help explain the violent moves into equities when rallies do occur, since there is an enormous penalty for being in cash when equities do rally. Cash has turned into what some investors call a return-free risk proposition. To put things in perspective, cash as a percentage of the broad equity market value is close to 2x the amount of the levels that marked the last three bear market bottoms. There is plenty of fuel present to take the markets much higher if the right catalysts are able to release it.

The Public-Private Investment Program (PPIP)

outlook - The PPIP program may run into more trouble finding participants than originally expected. Even if the terms are attractive for participation (and they are), many potential participants are starting to believe that if they make money in the program on the "government's dime", Congress may not let them keep the money. Many of the largest financial firms have stated that they are not interested in participating with the government, given their bad experiences with the TARP program's and changing rules.

Conclusion

These are some of the most confusing times many of us have ever experienced. A diversified portfolio should provide extra stability, and our recommended strategy is to continue to invest in a diversified portfolio of various asset classes of equities and fixed income for the long term. We are here to help navigate through this difficult environment.

Regards,

Michael J. Krach, Jr., CFA
Chief Investment Officer
Executive Vice President

Disclosure Notes

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Foreign investments involve greater risks and tend to exhibit higher volatility than domestic investments.

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