

TimeCapital®

Investor Advisory Services, Inc.

April 1, 2009

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Dear Client:

There was a bit of celebration as a strong performance in March took some of the sting out of a poor first quarter. The **S&P 500** still ended with a loss of 11.7% and the Russell 2000 small-cap index was down more than 15%, but that is substantially better than the 26% the S&P 500 was down back on March 6.

The big bounce over the last three weeks has made some market players hopeful that a more sustained bear-market rally lies ahead of us. We have had some productive action and the technical conditions are somewhat better, but we do not have an easy battle in front of us.

Ignoring some end-of-the-quarter window-dressing games on Tuesday, we ended the quarter with two days of pullbacks. That is perfectly healthy within the context of the rally we have had off the March lows. The challenge now is finding and holding support and building conditions to support another leg to the upside.

The big obstacle is that bear-market rallies like the one we just had tend to fizzle out quickly. Since the market topped out in 2007, we had at least half a dozen rallies that eventually failed and led to new lows. Will it be different this time? Will the bulls show some resolve and keep this market from fading?

Much is going to depend on the psychology that emerges during the upcoming earnings season. Are expectations low enough and have we priced in sufficient negativity so that when the poor reports hit - which they certainly will - that the equity markets don't roll over once again?

There was a wide divergence in markets' performance in the first three months of 2009, with results ranging from poor to middling to stellar. Shares in developing countries like China and Brazil well outpaced those from developed regions like the U.S. and Europe.

That is a marked change from late last year, when global stocks crumpled in unison and the only disparity was between different intensities of awful.

While one quarter doesn't make a trend, the divergence could be a sign that some of the fear gripping investors around the world is abating. No longer selling shares indiscriminately, investors are trying to identify which stocks world-wide will profit if a tentative economic recovery takes hold, even if the economic picture for this year remains grim.

For the 1st quarter, the Dow Jones Industrial Average was down 13.30%. The DJIA gained 7.73% for the month of March but the net result for the quarter was the weakest since the first quarter of 1939. The Nasdaq Composite finished the quarter down 3.07% and the Standard and Poor's 500 Index finished 11.67% lower.

In Europe, the quarterly declines were in tune with, or worse than, in the U.S., with benchmark indexes in Germany, France and the U.K. falling 11% to 15%.

Not surprisingly, the sector that fared the worst world-wide was financials, which had fallen 24% as of Monday in dollar terms based on a Morgan Stanley index that covers a wide swath of global stocks. Still, no sector really shone. The best-performing sectors were information technology, which eked out a rise of 0.6%, followed by materials, down 3.7%.

For U.S. investors, the dollar was a thorn in the side. The buck notched a solid advance, despite flagging at the end of the quarter. That strength cut into any profit from overseas shares and magnified any losses, since most foreign currencies bought fewer dollars at the end of the quarter.

The differing performance among global markets presents a challenge for investors. If some of the widespread selling and extreme volatility that characterized financial markets late last year returns, then markets once again could move in lockstep. If the divergence continues, then getting relative winners and losers right will become increasingly important.

As parts of the credit markets showed signs of improvement in the first quarter, investors remained wary of putting money to work as the economy buckled further and a bundle of new government programs and bailouts struggled to gain momentum. Government programs helped stabilize short-term debt markets, where companies and banks fund their most immediate and basic needs. There also was a surge of new debt raised by higher-quality, or investment-grade, companies.

But other credit markets still are mostly stuck. Lower-quality companies are shut out unless they want to pay 15% or more to borrow money, and markets for securitized debt, which are the lifeblood of the consumer economy, remain on virtual life-support. Banks and other financial institutions have received more government bailout money, yet can only raise cash with the help of government programs that either inject capital or guarantee debt.

The Federal Reserve and the Treasury introduced a number of programs in the past quarter to stimulate credit markets and keep interest rates in check in an effort to boost the economy. They increased their purchases of securities backed by mortgage loans that conform to Fannie Mae and Freddie Mac standards, made outright purchases of Treasury securities, and kicked off two programs to induce private investors to purchase securitized-debt securities to bolster bank balance sheets and spark lending to consumers and businesses.

The average 30-year mortgage rate remains low at 5%, which has induced a wave of refinancing, according to HSH Associates, a mortgage-data publisher. Despite the government's planned purchases, the 30-year Treasury-bond yield rose by nearly a percent, to yield 3.6%, from 2.8% at the start of the year as prices fell amid concerns about the effects of increased issuance to fund various bailouts. The 10-year Treasury yielded 2.7% at quarter-

end, up from 2.2% at the start.

Meanwhile, rates that companies pay to borrow for short periods in the commercial-paper market fell to less than 1% in most cases, according to Fed data. Likewise, interbank lending rates such as the London interbank offered rate remained in check, ending the quarter at about 1.2%, down from 1.4% at January's start.

But investors were still concerned about the health of banks as counterparties and about changes in the government's investment in banks and credit markets, such as when it converted some preferred shares in Citigroup Inc. to common stock and disclosed details of its bailout of American International Group Inc.

Most financial institutions still are borrowing money in government-sponsored markets, unable to untether themselves from federal support. Banks issued \$115.6 billion of debt backed by the Federal Deposit Insurance Corp. under the Temporary Liquidity Guarantee Program at low rates, mostly under 3%. In the open corporate market, many financial institutions would have to pay more than 7% to borrow.

President Obama's administration kicked off its financial-rescue efforts in February, when Treasury Secretary Timothy Geithner pushed to kick-start consumer-lending markets through the Term Asset-Backed Securities Loan Facility, or TALF. After weeks of negotiations, however, few investors signed on and only four deals were done for companies, including Ford Motor Co.'s finance arm, Ford Motor Credit Co., and Citigroup.

The plan for TALF was to bring new investors to the market for asset-backed debt, which essentially has been frozen since last summer. The program offers investors inexpensive loans from the Fed to purchase securities backed by car loans, credit-card payments, or loans to students, rewarding them with returns of 10% or more. The program was expanded to soon include securities backed by loans to companies buying business equipment, leases to auto-rental companies, mortgages and commercial mortgages, among others.

Risk premiums in the consumer asset-backed debt markets have fallen more than two percentage points since January in some cases, but investors have been reluctant to engage with the government. Investors are concerned that the government can capriciously change the rules on them.

Similar concerns about government intervention boiled up in the mortgage market, where rates have come down, but investors said the administration's plans to modify mortgage loans could cause losses on some mortgage securities. Indeed, outside the market where the Fed is a buyer for securities backed by mortgage loans that conform to Fannie and Freddie standards, there hasn't been a new deal since 2007, according to FTN Financial, a fixed-income broker dealer.

Meanwhile, for an investor contemplating his fortune from the start of the year, riskier credit markets have been a modestly positive endeavor, with junk bonds returning more than 5%, according to Banc of America Securities-Merrill Lynch. An investor in the 10-year Treasury bond, in contrast, would have lost about 3.3% in return since the start of the year.

The dollar surged out of the gate in the first months of 2009 only to stumble as the quarter drew to a close. Further obstacles could lie ahead. There are two main impediments in the dollar's path: the latest efforts by the Federal Reserve to jump-start the U.S. economy, and investors' tentative return to riskier types of assets. Both developments mean that investors are less likely to seek out the dollar as a safe port in a storm, something they have done relatively consistently since the global financial crisis intensified last year. Still, the dollar ended the quarter on a positive note. It strengthened 5% against the euro, 9% against the Japanese yen and 4% against a trade-weighted basket of 16 currencies tracked by J.P. Morgan Chase.

The dollar's gains were more impressive in the days leading up to March 18, when the Federal Reserve stunned markets by announcing that it would directly purchase U.S. Treasury bonds. The historic move sent investors rushing to sell the dollar, resulting in its worst single-day drop against the euro since the European currency was established a decade ago. The Fed's move is aimed at bringing down borrowing costs in a troubled economy, but some fear it could produce inflation in the long run, since it effectively means printing money to buy U.S. debt. Such inflation would in turn erode the dollar's value and cause foreigners to think twice about buying dollar-denominated assets. The U.S. currency steadied in the days that followed as investors digested the idea that other central banks, too, may be pushed further into uncharted territory with efforts to stimulate their economies. Like the Fed, central banks in the U.K. and Japan already are buying the debt of their respective governments.

Some currency watchers believe the European Central Bank will be obliged to do something similar. If so, that could check future dollar weakness against the euro, since both currencies would be facing roughly the same situation with respect to monetary policy. Although most experts see the potential for further weakness in the dollar in the coming months, they don't see a precipitous decline ahead. One reason: most governments aren't eager to see their currencies strengthen while their economies are in a fragile state, since it would punish their exporters. To prevent that scenario, they could take deliberate steps to weaken their currencies.

The countries that share the euro, for example, have no desire to see the euro return to the high it touched last summer, when it bought just over \$1.60. With that kind of euro strength, you would "have to turn out the lights in Europe," said a currency strategist at BNP Paribas in London. BNP is forecasting that the euro will buy \$1.45 in six months, up from \$1.3286 at the end of March. Toward the end of the quarter, there was renewed discussion surrounding the future of the dollar as the world's

dominant reserve currency. The catalyst was an unusual essay by China's central bank governor calling for the world to migrate to an alternate system in the interest of financial stability.

A move away from the dollar as the main reserve currency would likely take decades, say economists, and China's proposal probably involved a fair amount of political gamesmanship.

"Calls for an alternative reserve currency should be seen as an additional effort to dissuade the U.S. from eroding the value" of Treasury bonds through inflation, John Normand, head of global currency strategy at J.P. Morgan Chase wrote in a recent note. It isn't a "serious proposal" for change in the international financial system.

It appeared that big declines in commodities prices finally may have run their course as the first quarter came to an end. But whether it can be a sustained rally could depend on the prospects for a quick economic turnaround. The Dow Jones-AIG Commodity Index, after falling more than 50% in last year's second half, continued to slide at the start of 2009 as the global economy kept contracting. It was down 13% through March 2, before the U.S. government's aggressive plans to stimulate the economy and bolster the financial system helped rekindle depressed markets for hard assets. Escalating fears of inflation and production cuts also contributed to late-quarter gains.

Initial enthusiasm faded in light of mounting evidence of economic weakness. The index ended the first quarter down 6.4%. Gold, traditionally viewed as the ultimate safe haven in troubled times, was the hot commodity throughout the quarter. Hedge funds, pension plans and jittery individuals poured billions of dollars into the yellow metal as recession gripped the world.

Gold gained 4.4% in the first quarter, to \$922.60 a troy ounce, and at one point came within sight of its March 2008 record of \$1,003.20. Silver, which usually is more volatile than gold, soared 15% after big declines last year. Many commodities that took a beating last year posted eye-popping gains, albeit from a low base. Crude oil rose 11% to \$49.66 a barrel, and gasoline futures jumped 39%. Copper gained 32%. Agricultural products fell in the face of weaker demand and bigger crops around the world: corn fell 0.6%, soybeans gave up 2.1%, and wheat skidded 13%.

Some analysts posit that stimulus spending will eventually lead to a rebound in commodities while other analysts aren't convinced that this policy-fueled rally can continue for long. A solid recovery in commodities, they say, will require a pickup in industrial production. Even with all of the rescue plans in place, it takes time for credit markets to thaw and revive real economic activity.

There are factors that could contribute to further gains. The credit crunch has hampered mining companies' ability to open new mines. Cuts in production of oil and some base metals will affect supplies, which reduces the downside risk in many commodities prices.

Members of the Organization of Petroleum Exporting Countries have implemented reductions of 4.2 million barrels a day, or 5% of the world's total supply, about 80% of the group's pledged reductions. As oil fell below \$50 a barrel early in the quarter, the surprisingly high compliance helped stem the drop in prices. At its March meeting, OPEC decided not to seek a new cut in production targets, fearing that higher oil prices might hurt the vulnerable global economy and affect demand.

Among metals, aluminum and nickel saw the biggest production cuts in the first quarter, according to a Credit Suisse report, with mine closures accounting for 13% and 17% of their global supplies, respectively.

Future supplies also are at stake, as many producers aggressively scaled back their capital expenditures. In the U.S. alone, energy exploration and production spending is estimated to drop \$22.5 billion this year, a 40% year-on-year decline.

Every day, the depletion argument [for further price gains] becomes more powerful.

Massive stockpiling of commodities by China, a cash-rich but resource-hungry country, also has pushed up prices. In recent months, Beijing has been snapping up commodities it lacks, such as copper, oil and soybeans, and recently said it would spend an extra \$10 billion to bulk up its commodity inventories, a 60% rise from its original plan.

But some analysts warn that the hoarding isn't real demand and can quickly turn around if prices rise enough that Beijing starts to use the reserves instead of buying more in the market. Meanwhile, commodity investors have become more discerning about which commodities they buy. In contrast with prior years' heady influx into broad index funds as prices soared, exchange-traded products that track precious metals and energy accounted for nearly all of the net inflows in the latest quarter. There are a lot of different and diverging trends between different commodities. Investors are seeking more active strategies with a greater focus on individual commodity markets.

One example: As oil prices rose, higher storage levels, faltering heating demand and the risk of more liquefied-natural-gas imports put downward pressure on natural-gas prices, which closed the quarter with a 33% drop.

Our continued investment focus on Master Limited Partnerships was rewarded during the first quarter. Performance of our MLP models outperformed the S&P 500 and Dow Jones Industrial Averages by approximately 25% with a positive return of +11.49% for our Income Moderate Model as the Dow declined by (13.3%).

Our focus on MLPs that we believe will be able to continue to pay and increase their distributions over time has been profitable in an environment that appears to place a premium on stable,

income-oriented securities. Absent a significant deterioration in economic conditions from current levels or an "out of left field" tax proposal from the White House, we believe that certain MLP issues continue to offer investors compelling value with secure distributions and attractive yields.

We welcome your comments and questions and as always, appreciate the opportunity to be of service.