

# Capital Markets Commentary

## 1st Quarter 2010



In the first quarter of 2010, the U.S. stock market continued to post positive returns. This was the fourth consecutive quarterly gain, as investors continued to buy stocks and shun money market investments, which continue to yield virtually nothing. The S&P 500 Index gained 5.4% in the fourth quarter, and the Russell 1000 Index gained 5.7%. In fact, this was the best first quarter gain in the S&P 500 Index since 1998.

Changing the trend seen in the fourth quarter of 2009, value equities significantly outpaced their growth counterparts, as the Russell 3000 Value Index returned 7.0% vs. 4.9% for the Russell 3000 Growth Index. This pattern of value outperforming growth was evident across market capitalizations. The Russell 2000 Value Index returned 10.0%, the best performing segment within the U.S. stock market in the first quarter, and was significantly better than quarterly gain of 7.6% for The Russell 2000 Growth Index. In the mid cap arena as measured by the Russell Midcap Indices, value stocks outpaced their growth counterparts with a return of 9.6% vs. 7.7%, respectively. So-called “mega cap” value stocks gained more than their growth counterparts, as the Russell Top 200 Value Index gained 5.6% versus the Russell Top 200 Growth Index’s gain of 3.5% in the first quarter. From a market capitalization perspective, small cap stocks outperformed mid cap equities, which in turn outperformed large capitalization stocks. Respectively, in the first quarter The Russell 2000 Index returned 8.9%, The Russell Midcap Index gained 8.7% and The Russell 1000 Index returned 5.7%.

Continuing the trend displayed in 2009, The NASDAQ Composite Index outpaced The S&P 500 Index in Q1, as shown in the chart to the right. Technology stocks remained among investors’ favorites, with their transparent business models and consistently high levels of relative profitability.

What a difference a year makes! A year ago, many equity investors were ostrich-like, heads buried in the sand and eschewing stocks. Now we’re back to some of our society’s favorite pastimes: keeping up on scandalous celebrities and appalling athletes, watching heroic efforts of the Olympics and “March Madness” as well as clutching the latest news on adhesive automobile accelerators. Not to mention enjoying higher stock market valuations and greater account market values when we investors read our statements.



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Source: Bigcharts.com

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### Stock Market Sector Performance

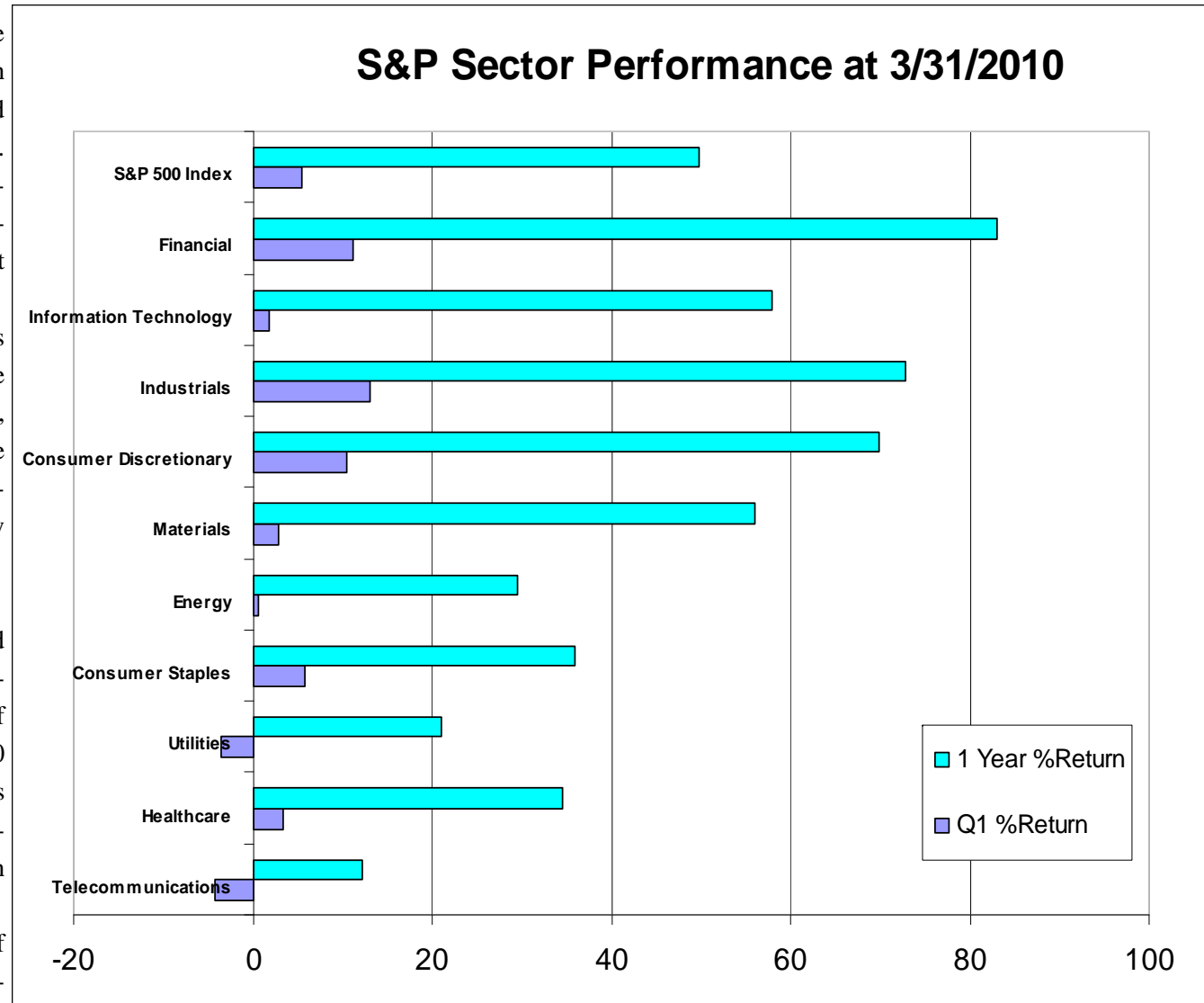
First quarter sector performance shows eight out of ten stock market sectors in the S&P 500 Index posted gains. Utilities and Telecom were the two negative sectors in Q1. On the other hand, Industrials, Consumer Discretionary and Financials were the three leading sectors, each up more than 10% in the first quarter.

In the last 12 months, all ten sectors have posted gains. Telecom and Utilities are again the lagging sectors, while Financials, Industrials and Consumer Discretionary have posted gains of more than 60% in that time-frame. Of course, this rebound follows a very tough stretch in 2008 and early 2009.

### Market Volatility

Stock market volatility, as measured by the CBOE Volatility Index, or VIX, continued to decline in the first three months of 2010. The VIX began the year near the 20 level, and despite spiking up to the upper 20's in February, it ended the first quarter at approximately 17. This level was last seen in mid-2008.

A similar pattern exists in the level of volatility in the CBOE NASDAQ-100 Volatility Index, or VXN. Too, VXN is at a level that has not been seen for about two years. Market volatility, in other words, has returned to a state of normalcy, following the terrifying tumult experienced in the capital markets over the last 18 months.



Source: S&P

### Domestic Economy and Unemployment

The first quarter is likely to show GDP growth of approximately 3%, or about half the 5.6% rate witnessed in the fourth quarter of 2009. That level is in line with the 3.0% GDP growth forecast for 2010, based on a February 2010 survey by the Federal Reserve Bank of Philadelphia. The previous survey indicated a consensus prediction of 2.4% GDP growth in 2010.

Unemployment is showing signs of bottoming, but the outlook for sustained job growth is still quite murky. The national level of unemployment stood at 9.7% in the most recently released data, down slightly from the 10.2% high seen in October 2009. This 9.7% unemployment figure translates to a total of 15,000,000 Americans out of work. An additional 2.3 million workers were not counted as unemployed, but instead were classified as “marginally attached to the labor force” because they had not searched for work in the last four weeks preceding the employment survey, according to the Department of Labor. Of these 2.3 million marginally attached workers, one million of these individuals were classified as “discouraged workers,” defined as those no longer seeking employment because they believe that there are no jobs available for them.

Furthermore, the duration of unemployment for many has been quite long: 6.5 million workers have been unemployed for 27 weeks or longer, or 44.1% of those unemployed. Adult men were more likely to be unemployed than adult women, with unemployment levels of 10.0% and 8.0% respectively. Looking at unemployment within each state in the Union, the worst employment conditions were in Michigan, with 14.1% unemployed, Nevada at 13.2%, Rhode Island at 12.7%, and two states reported 12.5% unemployment: California and South Carolina. Three states reported a level of unemployment that was below 5%: Nebraska, North Dakota and South Dakota. (Source: U.S. Dept. of Labor)

### U.S. Fixed Income Markets

By and large, the domestic fixed income market returns were negative in the month of March, but still managed a positive quarterly return for the first quarter. The Barclay’s Capital U.S. Aggregate Index declined by 0.1% in March, but gained 1.8% in the first quarter. Inflation-protected securities, as measured by The Barclay’s Capital U.S. TIPS Index, gained 0.1% in March and posted a quarterly gain of 0.6%. The U.S. Treasury yield curve steepened slightly in the first quarter, as the spread between two-year and 10-year Treasuries increased from 270 basis points at 12/31/09 to 281 basis points at 3/31/10.

The high yield market continued to make significant gains in the first quarter, as the ML High Yield Master Index gained 4.9%. This demonstrates how high yield debt returns can often be more closely tied to equity market performance than to the return of the Barclay’s Capital U.S. Aggregate Index.

On a separate note, the major ratings agencies announced that they would be revising or recalibrating their ratings for municipal bonds, and the net result would be an increase in ratings for several states and other municipal bond issuers.

### Russell U.S. Equity Index Performance

As shown in the table to the right, value outperformed growth across the board in the first quarter, reversing the previous quarter’s trend. The best performing segment was small cap value, which more than doubled the return of large cap growth in the first quarter. Midcap stock returns were very close to those of small cap stocks. (Source: Russell)

**Q1 Russell U.S. Equity Returns (%)**

	Value	Blend	Growth
Large Cap	6.8	5.7	4.6
Mid Cap	9.6	8.7	7.7
Small Cap	10.0	8.9	7.6

### Non-U.S. Equity Markets

The performance of non-U.S. equities in the first quarter was mixed, and lagged that of the U.S. markets. The EAFE Index was essentially flat in the quarter, posting a 0.2% gain. The strongest performing developed markets in U.S. dollar terms were several Northern European countries: Finland, up 10.7%, Denmark, which returned 9.2%, and Sweden, which gained 7.2%. On the other hand, the weakest performing markets were three of the four so-called “PIGS” — Spain lost 15.6%, Greece, down 13.2%, and Portugal, which declined by 10.3% in the quarter.

Looking at performance in the emerging markets in the first quarter, The MSCI Emerging Markets Index posted a small gain of 2.1% in dollar terms. The best performing markets were Thailand, Hungary, Egypt and Colombia, each gaining 10% - 12%. The markets with the worst performance in dollar terms were Taiwan, China and Brazil, each losing 1% - 4% in the first quarter.

### Residential Real Estate

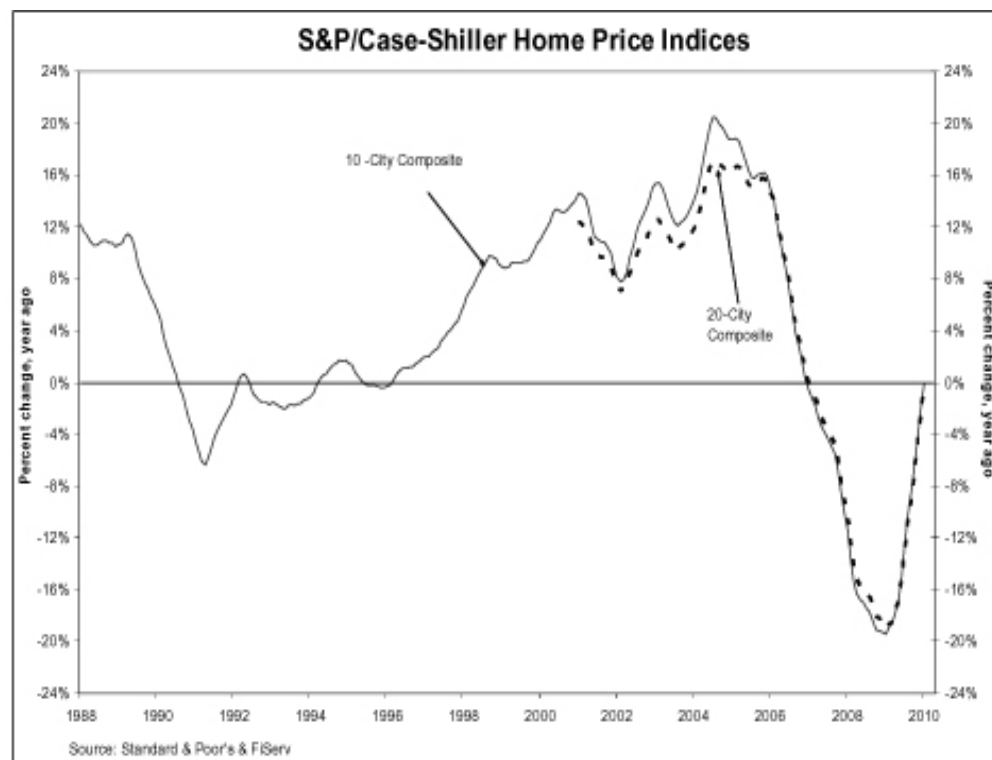
U.S. home prices continued to struggle. Based on the S&P/Case-Shiller 20-City Home Price Index statistics released on 3/30/10, home prices dropped by 0.4% in January 2010. Only two of the 20 areas showed increases from December 2009, Los Angeles and San Diego. In that same monthly timeframe, Chicago and Seattle each lost 1.7%

Looking at one-year performance, some metropolitan areas have fared much better than others: the strongest gains were experienced in San Francisco, up 9.0%, San Diego, up 5.9%, and Dallas, up 4.1%. On the other hand, real estate continues to languish in areas such as Las Vegas, down 17.4%, Tampa and Detroit each down 7.4% in the last year. In fact, Detroit is now 28% below price levels seen in 2000. In aggregate, however, year-over-year prices are down only 0.7%. This is the closest to a positive print since January 2007, as shown in the chart to the right. However, there still remains a massive inventory of unsold homes across the United States.

### Commodity Prices

The broad-based CRB Commodity Index dropped by approximately 6% in the first quarter, reflecting a generally downward trend in the level of commodity prices. This follows a gain of 32% in The CRB Index in 2009. Gold was essentially flat in the first quarter, ending near \$1,100 per troy ounce.

However not all commodities were in a downtrend in the first quarter of 2010. For example, the price of crude oil gained several dollars per barrel in the first quarter, moving from \$79 to \$83. Furthermore, The Core Consumer Price Index was up 1.3% on a year-over-year basis in the most recent (February) report. It should be noted that the “Core CPI” figure, commonly quoted as a proxy for the level of inflation, eliminates the volatile food and energy components. Some would argue that the Core CPI figure understates the “true” level of inflation, since most of us still need to eat and to fill up our vehicle’s gas tank.



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Edited by James Kitchens, CFA

## Index Returns Since 2001, Sorted From Best to Worst

INDEX	ASSET CLASS
Russell 1000 Value	Large Value
Russell 1000	Large Blend
Russell 1000 Growth	Large Growth
Russell Midcap Value	Mid Value
Russell Midcap	Mid Blend
Russell Midcap Growth	Mid Growth
Russell 2000 Value	Small Value
Russell 2000	Small Blend
Russell 2000 Growth	Small Growth
MSCI World Index	Global Equity
MSCI EAFE Index	Int'l Equity
Barclays Aggregate Bond Index	Intermed. Bond
Merrill Lynch High Yield Index	High Yield Bond
Balanced (60/40)-Rebal. Annually	Balanced
Citigroup 3-month T-bill	Cash Equiv.

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 YTD
14.0%	10.3%	48.5%	23.7%	14.0%	26.9%	11.8%	5.2%	56.3%	10.0%
8.4%	1.7%	47.3%	22.3%	12.7%	23.5%	11.6%	1.8%	46.3%	9.6%
4.5%	-1.9%	46.0%	20.7%	12.7%	22.3%	11.4%	-20.7%	40.5%	8.9%
4.1%	-9.2%	42.7%	20.2%	12.1%	20.7%	9.6%	-26.2%	37.2%	8.7%
2.5%	-9.6%	40.1%	18.3%	10.0%	20.2%	7.1%	-28.9%	34.5%	7.7%
2.3%	-11.4%	39.2%	16.5%	7.1%	18.4%	7.0%	-33.8%	34.2%	7.6%
-3.7%	-15.5%	38.1%	15.5%	6.3%	15.5%	6.1%	-36.9%	32.5%	6.8%
-5.6%	-15.7%	33.8%	15.3%	5.3%	15.3%	5.8%	-37.6%	30.8%	5.7%
-5.6%	-16.2%	30.0%	14.3%	4.7%	13.4%	5.6%	-38.4%	28.4%	4.9%
-9.2%	-19.5%	29.9%	11.4%	4.5%	11.8%	4.7%	-38.4%	27.2%	4.7%
-12.5%	-20.5%	29.8%	10.9%	4.2%	11.2%	2.2%	-38.5%	20.6%	3.7%
-16.5%	-21.7%	28.2%	8.3%	3.9%	10.7%	-0.2%	-40.3%	19.8%	3.4%
-20.2%	-27.4%	19.3%	6.3%	3.0%	9.1%	-1.4%	-41.5%	19.7%	1.8%
-20.4%	-27.9%	4.1%	4.3%	2.7%	4.8%	-1.6%	-43.1%	5.9%	0.9%
-21.2%	-30.3%	1.1%	1.2%	2.4%	4.3%	-9.8%	-44.3%	0.2%	0.0%

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