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All values in U.S. dollars unless otherwise noted.

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**For Important Disclosures, see pages 3-4.**

## Weekly Market Monitor

Even though the major stock indices traded higher, it was a relatively quiet week on Wall Street. The economic calendar was light, and there was little corporate news other than a handful of merger and acquisition announcements. The **S&P 500 Index** and **Dow Jones Industrial Average** rose 1.0% and 0.6%, respectively, for the week.

**On Thursday, the S&P 500 quietly drifted up to a new closing high for the year and for the cycle, reaching 1,150.** Other major indices, such as the Russell 2000 (small-capitalization stocks) and Nasdaq Composite Index, also rose to new highs for the year, following very strong performances last week.

The Dow Jones Industrial Average, which has been lagging of late, has yet to reach a new high. But keep in mind, even though the Dow is made up of companies that represent diverse sectors and industries, it is comprised of only 30 stocks. The S&P 500, which includes 500 stocks, is more representative of the broader market.

On a sector basis, **Telecommunications** (+2.5%), **Financials** (+2.1%), and **Technology** (+2.0%) led to the upside this week. **Consumer Staples** (-0.7%) and **Utilities** (-0.7%) lagged other sectors.

### U.S. economic data was mixed:

- Small business optimism dropped and is still near a record-low level.
- Weekly jobless claims were a bit worse than economists anticipated but were below the previous week's level.
- Consumer confidence fell modestly in March, according to the University of Michigan survey. Economists had been expecting a modest rise.
- The bright spot, surprisingly, was retail sales. Consumers spent more than expected in February, despite the snow storms and unusually cold weather. Sales at electronics stores led other categories, rising 3.7%, which was the largest monthly gain in one year. Even department store sales rose. However, January retail sales were revised lower.

### Equity Mutual Funds: Running Out of Ammo

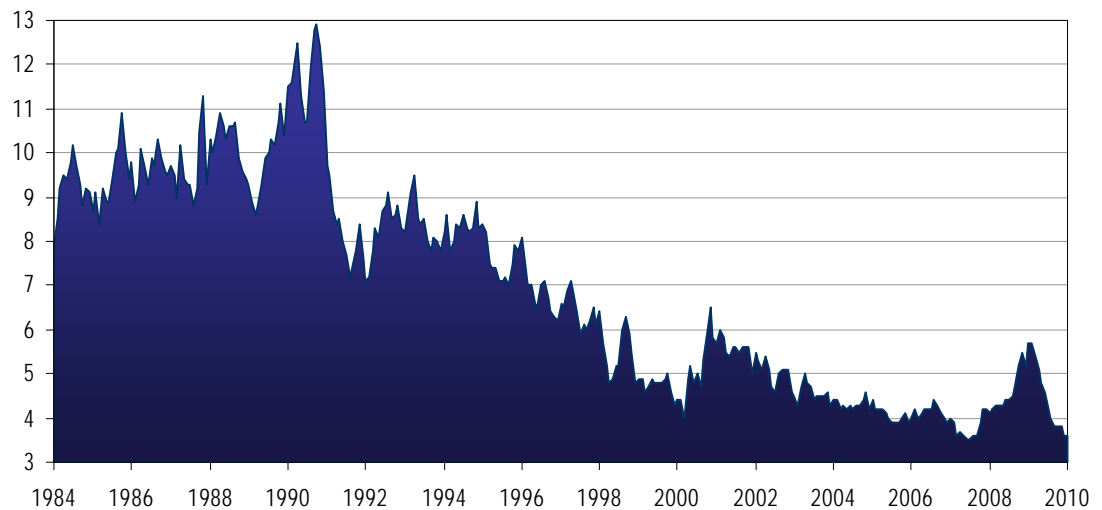
If the stock market seems lethargic at times, a contributing factor may be that mutual funds have depleted much of their ammunition.

**Equity mutual funds exhausted a significant proportion of their cash reserves during the past year.** Cash levels fell to 3.6% in January 2010 from 5.7% in January 2009, according to Investment Company Institute (ICI), a trade organization for professional money managers. That is the fastest cash-burn rate in 18 years.

According to Bloomberg, mutual funds as a group now hold the lowest cash allocation since September 2007, a month before the broad U.S. stock market indices peaked. The 3.6% cash allocation is the second-lowest level since 1984, when Bloomberg began tracking the data.

Cash as a percentage of assets should be relatively low for equity mutual funds—after all, their mandate is to invest clients' assets in *equities*, not hold it in cash. But the recent 3.6% allocation is remarkably low by historical standards, as the graph on the next page illustrates.

## Cash Allocation of Equity Mutual Funds (%)



Source: Bloomberg

**Extreme movements in cash levels and the performance of the stock market seem to impact one another.**

- **In a sharply rising market, cash levels tend to fall.** That's because portfolio managers are busy deploying cash into equities, rather than hanging onto it. Or said another way, when cash levels fall sharply, the market tends to rise. (We're not sure which is the chicken and which is the egg.)

For example, cash reserves fell from 5.4% in March 2009 to 3.6% in January 2010, at the same time the S&P 500 rallied 34.6%.

- **However, when the stock market faces extreme stress and is falling, cash reserves tend to rise quickly (which is intuitive).** When investors become highly fearful, they often pull assets out of equity mutual funds. Portfolio managers are then compelled to raise cash allocations in order to be sure they can meet redemptions. They also raise cash as they become nervous about the market during periods of stress.

This occurred when the credit bubble burst. Cash levels rose from 3.9% in October 2007 (when the stock market peaked) to 5.7% in February 2009 (right before the market bottomed). At the same time, the S&P 500 plummeted 52.6%. Cash levels also climbed sharply when the technology bubble burst.

These historical patterns and the remarkably low 3.6% cash level in January indicate to us that investors should not count on equity mutual fund portfolio managers to do the stock market's heavy lifting in 2010. Cash levels are not likely to fall much more. Portfolio managers need to hang on to a modest level of cash to accommodate transactions and a normal pattern of redemptions.

**In order for the stock market to continue to rally, the heavy lifting will need to come from individual investors, in our opinion.**

Since the credit bubble burst in late 2008, many investors have huddled in money market and bond funds. Allocations to bond funds have risen sharply.

However, since the beginning of the year, equity mutual funds have experienced *modest* inflows from individual investors, according to AMG Data. But investors have yet to aggressively shift money out of money market and bond funds and back into equity mutual funds and exchange-traded funds.

The pace of equity mutual fund inflows will need to accelerate in order for the market to move another leg higher, in our view.

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			Count	%
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