

THE SEARCH FOR TRUST

During this highly religious time of year, the search for financial trust has become ever more difficult. Following the ides of March, the Fed introduced quantitative easing (QE), the direct purchase of \$1 trillion of government securities over the next six months, commencing the last week of March. At the end of the month, the Financial Accounting Standards Board (FASB), bending to regulators and financial industry lobbyists, watered down its FAS 157 mark-to-the-market ruling now referred to as FAS 157e. Many investors have now come to refer to the FASB as the "Fraudulent" Accounting Standards Board. The irony of it all is that the new accounting rules will make it more attractive for banks to keep the billions of dollars of toxic assets on their books because the rule states that banks can use their own judgment on asset values as long as there are no willing bidders to set a market price.

As the President traveled globally, selling his stimulus plan, the best that was produced by the G-20 Summit was a reinforcement of the International Monetary fund (IMF) with a \$1-trillion recapitalization. There is irony here as well as the IMF will be a more independent spotlight on the Washington/Wall Street corridor. After all, Washington legislatively created the crisis and many investment bankers swam alongside and played a central role in building the bubble, taking ever-larger gambles (leverage) with the explicit backing of government through co-opted industry regulators. Along the way, the banking and securities industries became top political contributors and now they are using their influence to prevent the appropriate reforms. Government appears unwilling to act against them and, instead, this administration would appear to be using the confusion and chaos to significantly increase the size of government in many non-financial areas.

The month of March saw a market reversal as the impact of the FASB change and the Fed's new (QE) policy were recognized. Equities finished the first quarter with the Dow Jones Industrial Average down 12.43% but it rose 7.93% in March. The S&P 500 fell 10.98% in the quarter while rising 8.76% for the month, while the NASDAQ Composite lost

only 3.1% for the quarter, being up 11.02% for the month. Fixed income was best represented by Barclays Capital Municipal Bond Index, which was up 4.20% for the quarter and a minimal 0.2% in March. The Barclays Capital Government/Credit Index was off 1.28% for the quarter but up 1.10% for the month.

TAXABLES

The Fed's QE policy announcement created the largest single "up" day ever in the Treasury market, with a stampede to cover shorts by mortgage players, adjusting their convexity for quarter-end statement purposes. Before the Fed announced the program, the 10-year note traded above 3% on March 18. The yield plunged 0.50 percentage points initially and dipped to as low as 2.49% on March 19. By month-end, the 10-year yield had retraced to a level of 2.69%. The best-performing sector was the US TIPS index, followed by US nominal Treasuries and US Agencies.

Barclays Taxable Indices	PRICE (%)	CPN (%)	TOT. RET. 3/09 (%)
Aggregate	1.00	0.39	1.39
Government/Credit	0.70	0.40	1.10
US Governments	1.50	0.31	1.82
US Treasuries	1.87	0.31	2.18
US Agencies	0.58	0.32	0.89
TIPS	5.65	0.19	5.84
Credit	-0.60	0.53	-0.07
Corporate	-0.97	0.56	-0.41
Credit Aaa	0.64	0.36	1.01
Credit Baa	-0.54	0.63	0.08

During the month, we took profits in TIPS and added to our corporate holdings with PepsiCo, Pfizer, Shell, and UPS. Additionally, we have attempted to stretch the maturities of our Treasuries to pick up income and to use short Ginnie Mae pass-throughs for front-end curve needs. It is our ongoing belief that system-wide credit deterioration continues with deleveraging and credit contraction. This systemic credit risk is now extended by the revised FAS 157e with its lack of transparency and balance-sheet creditability. Inflation and any weak dollar concerns are conversely minimized by the synchronized global downturn and the greater depth of the European problem, particularly in Eastern Europe.

TAX-EXEMPT/MUNICIPALS

During March, the Fed's commencement of QE also helped stabilize the high-grade municipal market. Rates became marginally lower and curves steeper after a very strong January and February. The market remains bifurcated with high-grade new issues being well received while spreads remain at historically wide levels in the secondary market, especially for states with the most depressed real estate markets like FL and NV.

Although municipal issuance declined 14.8% in March (\$37.3 billion vs. \$43.8 billion in 2008), this reflects last year's rush to refinance auction rate issues into traditional money market floaters. Fixed-rate issuance was actually up 19.5% and included the \$6.4-billion California GO offering, which became the fourth largest municipal bond sale on record. YTD issuance is now only 1.9% lower than 2008: \$83.8 billion vs. \$85.4 billion.

Barclays Tax-Exempt Indices	PRICE (%)	CPN (%)	TOT. RET. 3/09 (%)
Municipal Aggregate Bond	-0.39	0.41	0.02
10-Year Municipal	-0.86	0.39	-0.47
California Exempt	-1.16	0.41	-0.75
New York Exempt	-0.41	0.41	0.00

As shown above, California markedly under-performed the national market although the state GO offering was increased by more than 50% given the demand. The New York index tracked very close to the national although the GO curve showed some spread widening given the budget outlook.

OUTLOOK

Trust and confidence in the overall financial structure are at all-time lows. Belief in financial statements is crucial for any asset price increases to occur. As discussed in our quarterly Investment Commentary, this Great Recession is unique because of the synchronized global downturn not experienced by Japan or during our Great Depression of the 1930s. To expect government to solve problems principally initiated by government itself will only further complicate the outlook. All politicians have job security as their uppermost priority and can never be expected to make the hard, long-term choices. Our expectation, therefore, is for this cycle to be extended and deflationary, and to challenge many widely accepted portfolio structures. Our asset-allocation analysis as of March 31 points out the fallacy of stocks for the long run. For the past 10, 20, and 40 years, the total returns from bonds have exceeded or equaled those for common stocks on a gross return basis, and when adjusted for risk, the case becomes even stronger. Finally, in an era of deleveraging and the consequent squeeze on corporate profits, dividends, and stock buybacks, the principal contributors to past equity performance will continue to extend their decline. The distrust of

conventional portfolios, 70% concentrated in equities, will grow as "mission control" and survival become paramount objectives, and stable and secure income the only tool to accomplish these objectives. In an environment of balance-sheet distrust, why would any investor consider a junior or subordinated capital position when one could be the owner of senior debt and receive returns up front – equivalent not only to the past history of equities but also to the prevailing consensus for sector-return expectations of stocks going forward?

MARKET HIGHLIGHTS*

Foreign Money & Bond Markets	2/28/09	3/31/09	US \$ Tot. Ret. (%)
3-mo. LIBOR BP Fixing	2.04938	1.64875	N/A
ML UK Gilt 10+ Index	4.25	3.98	4.63
3-mo. LIBOR Yen Fixing	0.63750	0.60313	N/A
ML Japanese 10+ Index	1.76	1.83	-1.53
Currencies	% Change		
British Pound (US \$ per pound)	1.4318	1.4324	0.04
Japanese Yen (yen per US \$)	97.575	98.96375	1.42
Euro (US \$ per euro)	1.26686	1.325049	4.59
Commodities			
Gold Comex Spot (\$ per oz.)	942.35	919.15	-2.46
CRB Future Com Pr. Index	211.57	220.40	4.17
W. Tex. Int. Crude (\$ per bbl)	44.76	49.66	10.95
Equities	US \$ Tot. Ret. (%)		
S&P 500	735.09	797.87	8.76
DJIA w/ Income	7,063.00	7,609.00	7.93
NASDAQ	1,377.84	1,528.59	11.02
NIKKEI (TOKYO)	7,568.42	8,109.53	6.56

*Source: Bloomberg

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