



Quarterly Newsletter

Second Quarter 2010

Summary- A growing sense that our economic recovery could be stronger than anticipated has lead the US Stock Market up, close to our year-end target of 1225 on the S&P 500. Inflation continues to be mild and US businesses report better than expected profits due to near record productivity gains from a lean work force. Commercial real estate is finally following residential in a bounce from deeply depressed levels. However, the real growth continues to be in the BRIC countries (Brazil, Russia, India, and China) and Asia in general, as their internal consumption for Western goods and services grows. While we will have our short-term setbacks, we are experiencing a better than expected recovery which will lead to a healthy economy in a few years.

We continue to favor stocks and bonds benefiting from BRIC growth, absolute return managers, inflation hedged fixed income and commodities bought on dips, in addition to well located commercial real estate.

US Economy- The economy grew at nearly 4% in the second half of 2009 and is now expected to grow at that pace in the first half of 2010. This is turning out to be an “average” recovery; somewhere in the middle of past recession recovery growth rates – and higher than most forecasted (including us). It was first fueled by inventory replenishments, then business-to-business capital spending and exports and most recently, by consumer demand. Profits have been high due to near record 7% productivity gains, which historically are followed by a pick up in hiring (as further efficiency gains are unsustainable). We need at least 150,000 new hires per month to keep up with population growth. Recent data shows there has been a hiring jump in temporary and household workers, which historically precedes gains in general business hiring. We continue to believe unemployment will inch down to 9% by year-end, but will take 4-5 years to reach “full” employment levels of 5%.

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While the CPI inflation remains a low 2%, our buying power in US dollars is slipping vs. BRIC and commodity based currencies like Canada and Australia (however, a weaker dollar helps our exports to these countries). We believe that the Fed can start raising rates in the second half of 2010 without impacting growth. We expect short-term interest rates to climb about 1% and the 10-year Treasury to break above 4% by year-end.

US Stock Market- Interestingly, this is the third time the S&P 500 has risen to the 1200 level. The first was in 1998 and the second was in 2004. Compared to those other periods, today's 1200 level has a lower P/E (NTM, normalized twelve month, of 14.5), higher dividends amidst lower interest rates, lower inflation and higher corporate growth forecasts. However, after the virtually uninterrupted rise from 666 in March 2009 of over 80%, we expect a near-term consolidation/correction from May through September, then a close above 1225 at year-end. Longer term, we do not see a drop below the 1000 level, and purchases on dips should be rewarded in the years ahead.

Mainstreet vs. Wall Street 2.0- The US economy still has plenty to worry about: huge budget deficits, high unemployment, toxic bank loans, high future inflation, unfriendly business policies from state and national governments, higher taxes and damaged US household balance sheets. With all this to worry about, how can the US Stock Market be going up?

Over the past 10 years, the fate of large US public companies, which are more global in scale, has detached from the fate of US economics. These multi-national companies now rely less and less on our domestic market and often make far more overseas than they do at home. These global companies increasingly look to China, India and other fast growing countries for revenue.

US corporate balance sheets are flush with over \$2 trillion in cash, lean work forces and proven domestic sales models that are being rolled out to the growing middle class of these second tier economies (India alone has more "middle class" people than the US). Large companies, (think Apple, Caterpillar, and Starbucks) unlike mainstreet, can go where the growth is and can make profits even if our domestic markets are weak.

Meanwhile, Main Street businesses that sell only domestically are still struggling at greatly reduced levels. California, Florida, Nevada and Arizona are still in recessions, and if you are in the construction business, it is a depression (unemployment over 25%). These local economies will have to wait for the trickle down effect from the healthy ones, which will take 12-18 months.

Fixed Income- The big question is: How do you find reasonable fixed income returns when interest rates are near historic lows and widely expected to rise? We have reviewed price action of various bonds during rising interest rate environments and have found the following strategies the most rewarding for various risk levels:

Conservative - The traditional "laddered maturity" municipal bond portfolio, where funds are divided up evenly between 1 and 10-12 years still works well. As the bonds mature at par annually, they are rolled into new long-maturity bonds at higher rates. This keeps income improving with no capital losses. Furthermore, tax-free municipal bonds should increase in relative value as tax rates increase in the future. Tax-free cash flow is currently a modest 3.6% for this program.

Moderate - We are building portfolios that combine inflation index strategies (targeting 6.5% above inflation), high-yield bonds (hedged to limit price volatility), medium-grade municipal bonds (believing that the economy will improve as interest rates rise), prime rate funds (floating rate coupons) and income producing commodity funds. Portfolios with these no-load income funds average 7-10%.

Aggressive – Will the state of California become economically stable in the future? If so, long term Cal GO's yielding near 6% double tax-free look attractive. 1-3 year first mortgages at low loan-to-values are available at 9-10% and become more secure if real estate continues to recover. Emerging market bonds also look attractive given their higher coupons, growing economies and hedge against the dollar.

Real Estate- Finally some good news for commercial real estate. Two leading research firms, Green Street and Moody's, independently have charts showing a valuation bottom being reached late last year and a strong rebound starting from levels not seen since 2003/4. Publicly traded REITS are up over 100% from their lows in anticipation of a rebound. While each product type and each geographic region will rebound differently, the worst appears to be over. We fully expect this year to be full of negotiations to buy self-storage properties at depressed levels and opportunities to buy into fresh "no legacy issues" real estate pools.

Taxes- According to the Tax Policy Center in Washington, 47% of Americans will pay no federal income tax for 2009, up from 38% two years ago. The federal government will spend about \$31,400 per household in 2010, yet collect only \$18,276 per household in taxes. The difference, \$13,130 or 41.8%, will be borrowed and added to our country's national debt of over \$545,000 (USA Today) per household. This debt totals over \$64 trillion vs. the total assets of all American households of \$54.2 trillion (Bloomberg). On top of this lie the unfunded liabilities of Social Security, Medicare and new "Obamacare". Taxes will need to go up considerably just to close the gap, let alone make principal and interest payments against this debt. Our government's out of control spending makes our recent over-mortgaged homeowner look tame. It is no wonder the Tea Party movement is gaining steam.

Investment Strategies for 2010- While we only see marginal gains for the US Stock Market between now and year-end, commercial real estate bought at today's prices offers a much better opportunity. Fixed income investors should benefit from the strategies described above despite higher inflation and interest rates creeping back as our economy finally picks up steam. We continue to overweight modern market neutral hedge funds with good returns, transparency and 30-day liquidity. Finally, long-term investors should consider allocating a portion of their portfolios to fast paced, yet volatile, emerging stock and bond markets to capitalize on this major shift in our global economy.

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Please join us for our Educational Series, presented by key industry leaders.

June 16, 2010 – Armored Wolf discussion on understanding world economies and markets.
4pm – 6pm in the Optivest Conference Room.

You are welcome to come to this meeting and we encourage you to bring others that might also benefit from hearing these topics. Space is limited to the first 15 people to sign up. Kindly RSVP to Traci Crays at 949-363-8686 or email traci@optivestinc.com.

We encourage your feedback on these meetings and strive to bring you value added education in the areas that are most meaningful to you. If you have other topics or speakers, you would like to hear, please let us know.

