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Review and Outlook

First Quarter 2011

Mid-March marked the two year anniversary of the bull market that started on March 10, 2009. Over the past two years the S&P 500 Index achieved a return of 73.2%. While quite remarkable, it is worth noting that the S&P remains well below its peak, reached in 2000; more than 11 years ago! The first quarter of 2011 was part of the most recent bull run of stock prices with the S&P 500 Index returning 5.92%. The stock prices got off to a strong start in January and February, but stalled in reaction to the amazing revolutions in the Middle East, and the tragic earthquake and tsunami in Japan. Incredibly, the market's initial move down after the tsunami was only temporary. In fact, most markets recovered the majority of lost ground within the first week following the earthquake.

The physical damage in Japan will have major global economic impacts. Japan's automotive industry was devastated and the ability of their foreign subsidiaries to maintain capacity has been compromised. This could benefit US manufacturers, at least temporarily. Similarly, global companies in the heavy machinery industry will realize heightened demand for their goods and services as Japan cleans up and rebuilds. However, the earthquake and tsunami hobbled two manufacturers of silicon wafers that account for 25% of world's supply. The wafers are the basis for the manufacture of silicon chips that are used in everything from supercomputers to smart phones to cars. A long term cut in supply could have perceptible economic impacts globally.

Oil prices are once again in the public spotlight: prices rose above $105 per barrel, leading to $4 per gallon prices at the pump. A combination of rising global demand and concern about the security of supply resulted in this rapid rise in prices. Libya is the ninth largest oil producer in the world, and most of its oil exports have been cut off. Yemen, Bahrain, Algeria, and Syria have all experienced protests. Saudi Arabia has historically been the producer willing and able to add production to maintain price stability. The Saudi government initially stated that they will make up for any lost Libyan production. If oil prices continue to rise, the world will likely apply increasing pressure on the Saudi's to keep to their word.

The most significant cause for unrest in the Middle East is the high unemployment rate of youth. Pile on rising food prices, which consume a high portion of household income, and you have a recipe for frustration. It is difficult to imagine a quick resolution to any of these issues. More likely, the Middle East will see unrest until the people experience significant change. The short term impacts related to the Middle East may be negative for investors as the markets struggle with uncertainty. Over the long run, new governments may provide significantly better growth prospects for the people of Middle Eastern countries.

Commodity prices rose dramatically over the past months. Most agriculture commodities have increased over 50% since September. Copper, cotton, gold, and silver have reached record highs. In the US, farmers have switched from food crops to cotton, putting further pressure on prices for corn, wheat, and soy beans. Devastating crop failures in Australia and Russia, demand for commodities from emerging economies that continue to increase as the world absorbs nearly 5

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billion people attempting to move from the lower to the middle class, and speculation in commodities all combined to drive prices upward. As commodity prices rise, concern about inflation increases, which spurs more speculation. As one source of inflation, commodities have generally performed well during inflationary periods.

Concerns about inflation are starting to replace concerns about deflation. However, in reality, both are occurring simultaneously. As “non–core” inflation (prices of energy and food) heats up, housing prices and real wages continue to fall. The combination hits US consumers particularly hard and will eventually curtail spending on everything other than food and energy. As of yet, most large US companies have not been hurt by rising input costs. They are often passing on higher costs to consumers in the form of reduced package sizes. More important to US corporate bottom lines are the very high proportion of profits derived from off-shore, particularly from the still rapidly growing emerging markets.

This hardly seems to be the environment in which US stock prices would perform well. However, as the world focuses on many of the geopolitical issues, governments and central banks have created one of the most attractive investing environments on record. With interest rates near zero throughout the developed world investors have flocked to riskier assets, such as stocks. Stocks seem to be one asset that offers some potential for gain, and the US is still perceived to be a safe haven in times of turmoil. Normally, money would flow to US Treasury bonds. However, Treasuries offer so little return that US stocks look very attractive. The allure of cheap money drives investors to stocks, and world turmoil drives investors to safety.

We are in a very peculiar economic environment where US corporations are prospering because of their huge exposure to international markets, particularly rapidly growing emerging markets, as the domestic society is struggling with high unemployment and rising costs of basic necessities. As long as unemployment remains uncomfortably high it is unlikely that the Federal Reserve will begin to raise rates. Money will probably remain cheap for some time. But other forms of monetary stimulus could be removed to cool down speculation in commodities and other assets. The Federal stimulus spending will end this summer. This, combined with congressionally mandated fiscal austerity, could put a real damper on any improvement in the domestic economy. The short term prognosis is not at all clear; but it was not any clearer at the beginning of this profitable quarter.

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