

April 11, 2011

2011 First Quarter Review  
“Watch Your Step Getting Off the Boat”

We certainly had our share of market-moving news in the first quarter. The domestic financial news has generally been positive, reflecting an improving economy, while the international headlines have ranged from the revolutionary to the cataclysmic. Beyond the news events themselves, what has been surprising to many market observers is the resilience of the financial markets in the face of such events. Stocks bounced back quickly from a sharp decline precipitated by the disaster in Japan. Even the news of “another war” in Libya failed to dent the market. By quarter’s end, the S&P 500 had risen 5.4% and the Nasdaq Composite rose by 4.8%, while bonds remained unexciting with the iShares Long Term Treasury Bond ETF falling by 2.1%. Gold rose to new highs recently, gaining 1.25% for the quarter, while silver shot up 22%. Agricultural commodities rose as weather patterns endanger crops and supplies, while residential real estate remains at least subdued. It is a very mixed bag in investment and asset price action, reflecting cross currents and dislocations still present in the economy. However, the primary tailwind has been the fiscal and monetary stimuli that have been provided in “QE1” and “QE2.”

The recent action in the financial markets reflects the view that our economic recovery is on its feet and, so say the bulls, all is up for stocks (but maybe not bonds) from here. Some of the positive economic news involves rises in various indices of business activity and the recent increase in jobs created. While the numbers are not robust and there are concerns about the nature of the jobs, they are higher and point to a slow improvement in business conditions. Business activity has picked up for certain retailers and it appears the consumer is not, in fact, dead. Nominal GDP (gross domestic product) growth is increasing and it looks like a long but slow climb out of the Great Recession has developed. The rise in the financial markets reflects this more positive outlook.

After a run (up or down) in the financial markets, the question we should ask is “How much optimism or pessimism is already priced into the current market?” As always, we need to weigh the risks as well as the opportunities. It was just this time a year ago that the market was sailing along, doing very well through April, then dropped almost 15% in a little over two months. The pain didn’t end until the Fed stepped in with the “QE2” that we have heard so much about. What’s different this year is that we are near the end of that second major “quantitative easing” (i.e. money creation) as the program is scheduled to expire in June. Markets always act in anticipation of events, so the withdrawal of what has been a major source of support for the financial markets may provide a test of how sustainable this economic recovery is. Never shy about beating a metaphorical dead horse, we might say that investors may want to watch their steps as the markets get off their cruise on the QE2. Keep one hand on a rail because it might get a little slippery.

The headwinds confronting the economy and the financial markets include these: higher energy and other materials prices, continued turmoil in the Middle East and North Africa, weak gains in consumer real income (with already some dipping back into savings), low returns on cash savings, housing still in the doldrums (pressuring consumer confidence and balance sheets), supply disruptions due to Japan’s nuclear crisis in the technology and automobile industries, slowing business momentum (mostly in tech, so far), and changes in monetary policy including the end of QE2 and recent monetary tightening in China and India. Add to this the possibility for more

“sovereign debt” deterioration in Portugal, Greece, Spain, etc. and there is reason enough to believe that we may yet get another chance at cheaper prices. The market’s realization of risk can lead to our opportunity.

One investment class that has lagged in performance but which we think still represents real value is the high quality, dividend paying international companies. These companies (such as American Express, Proctor and Gamble, Bristol Meyers, Abbott Labs, Microsoft etc.) may represent the stability and income that used to be the province of the bonds of “sovereign” industrialized nations. Large multinational corporations have businesses that can transcend the problems in any one currency. They can also increase their dividends as prices inflate. Because of this, many investors view their stocks as “growth bonds” that may fare better than the value of “sovereign” bonds (including US Treasuries) in a time of rising inflation and/or currency debasement. That sounds about right to us, so we will continue to add to positions in those kinds of investments.

Since the supply of precious metals is subject to physical limitations while the printing presses and balance sheet of the Federal Reserve are not, gold and silver can provide haven for value from a declining currency. Unfortunately, they don’t pay us any income. Since energy is needed to run our economy, and prices for oil and gas will likely increase with inflation, we have also focused on some investments in the energy industry to provide income (lacking in precious metals) as well as a hedge against inflation, should it return as we expect. Since the disparity between the price/Btu of oil is dramatically higher than that of natural gas, we are investing in some natural gas companies to take advantage of a possible double whammy; an increase in the price of energy due to rising inflation and/or demand, and an even greater increase in the price of natural gas due to a shift in demand to the cheaper source. We also have the stuff here in the U.S.

Outside of the areas mentioned above, we are always looking for opportunities in special situations. For the “value investor,” a sell-off in the market is just a time when overpriced stocks rightfully go down and they hang a “sale” sign on our favorite “value” investments. We hope and would actually expect to be able to take advantage of just such a sale sometime in the reasonably near future. Until then, we intend to stay nimble and wait for the right opportunities. It is interesting to note that there have been 21 declines of more than 20% in the US stock market in the last 30 years. It is always good to have some cash to take advantage of such a sell-off. Cash is the bench that our players sit on until they are called into the game in times like those.

Your reports and statements for the first quarter of 2011 are enclosed. However, you may be scrambling to gather your tax information to prepare your returns for 2010. Always remember that, even though we include the capital gains reports in your year-end report packets, you can always call or email us and we will send extra copies to you and/or your tax preparer. Please take advantage of that since it is easy for us to do, and it can save you and your accountant the time and trouble of searching through piles of papers. Just let us know and we will help in any way we can.

Sincerely,

Claude Carmichael CFA