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Market Commentary

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Off to a Good Start

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Investors came into 2011 feeling constructive about the outlook. Forecasts of market performance expected the Standard & Poor's 500 to rise about 10% after a strong performance in 2010. The economy was projected to grow 3%, unemployment was thought to decline modestly and interest rates were likely to rise a bit but stay low, with inflation remaining tame. All of this was reflected in various measures of market sentiment which were at varying levels of optimism ranging from mild to extreme. Since by now we all have learned that the best time to buy stocks is when investors are despondent, savvy professionals were cautious in January, expecting a correction at least or perhaps a downturn lasting until the weather warmed.

If you believe as I do that the market was put on earth by God to make fools of the greatest number of people, it would not be surprising to you that stocks rallied throughout the early part of the year. The fundamental background was positive. Retail activity was firm, automobile sales were surprisingly strong, fourth quarter earnings were mostly beating expectations, the European credit crisis was dormant for the moment, state and local governments were making an effort to control expenses and initial unemployment claims were trending downward. There were some negatives: the Federal budget deficit was running at an unprecedented \$1.5 trillion rate and the United States was likely to run up against its debt ceiling by March. Inflation was beginning to become a serious problem in the developing world, casting some doubt on the potential profitability of companies operating in those markets. Political upheavals in Tunisia, Egypt, Libya and Bahrain raised the issue of stability in that critical oil-producing region. The January unemployment report came in at 9.0%, but that was more because of people dropping out of the work force than new jobs being created. As we moved into February investor optimism remained undaunted and those who were cautious began to buy again, recognizing that it was futile to "fight the tape." Mutual fund buyers who had shunned equities in favor of bonds during 2010 bought more common stocks in January than in any month since 2003.

In February the economic background was mixed. Inflation, which had not been a problem because wage increases were rare and home prices were not increasing, suddenly became a concern as both consumer and producer prices rose more than expected. President Obama presented his budget and those looking for significant progress in reducing expenditures were disappointed. It appears that few in Washington are willing to make cuts in defense, or in Social Security, Medicare, Medicaid and other entitlements. Every budget hawk seems to focus on the discretionary component of the budget, especially foreign aid, earmarks, the Department of Education, etc. The entire discretionary component is 29% of the budget, so if all of these items were cut to zero, the budget deficit would still be over \$1 trillion. It is clear that we are not going to make major progress in fiscal restraint without making adjustments in a wide range of previously sacrosanct programs. To do this Congress would have to reduce some benefits important to their constituents and run the risk of not being re-elected.

While most Americans recognize that we cannot run trillion dollar deficits indefinitely, few seem willing to make the sacrifices that would be necessary to bring expenditures more in line with receipts. For the past 60 years the United States government expenditures were about 20% of Gross Domestic Product (GDP) and tax and other receipts were about 18%, resulting in a 2% gap. Today expenditures are running about 25% of

GDP and receipts are 16%, for a 9% gap. We have been fortunate that foreign lenders who have financed this gap have been willing to buy our Treasury bills, notes and bonds at historically low interest rates, but I do not believe we can count on this condition lasting forever. If we need a crisis to address this problem seriously, a sharp rise in interest rates might cause Congress and the electorate to recognize the need to make some serious program adjustments.

Looking at some troubled areas of the economy that may be improving, housing stands out. The January report on housing starts shows a significant rise, primarily because of multi-unit construction. As the economy improves, those with jobs feel more secure, family formations increase and housing demand steps up. As a result of low interest rates and the decline in house prices over the past few years, affordability has been on the rise, but it is only now beginning to become apparent in transactions. If the trend continues, this could be an important positive for the economy. Mortgage delinquencies are declining, but the overhang of homes for sale remains large. If home prices do improve at all, they are likely to do so gradually.

But there are other important signs of strength. The Institute for Supply Management purchasing manager indexes for both manufacturing and services are showing remarkable strength and exports are contributing to the growth of the U.S. economy as the developing world buys more of our goods. The consumer continues to spend. Although consumer confidence has been relatively flat, real consumer spending is back to pre-recession levels. Capital spending continues to exceed the levels of previous cycles as companies seek ways to improve productivity. The dark side of this is that much of the new equipment enables companies to reach their production and service goals with fewer workers, so unemployment remains high. I do expect the unemployment rate to decline this year into the mid-8% range, however.

Overseas, recoveries are taking place everywhere. Real growth in the Euro zone was almost 2% at the end of last year in spite of the financial problems in the southern tier countries. Real growth in Japan at the end of 2010 was almost 5%, helped partly by deflation there. This was substantially above the levels achieved earlier in the last decade. Industrial production is strong almost everywhere and retail sales have recovered sharply from the recession, but they have fallen back recently in Japan. Housing is weak across the globe. By now almost everyone recognizes that the engine of growth is shifting to the developing world, but some problems are emerging there as a result of rising commodity prices. Food is an important component of consumer prices (over 30% in China and Brazil and 47% in India) and pork and grains are surging. In India, for example, wholesale and retail prices have been increasing at an 8%–9% rate and the government has increased interest rates in an attempt to dampen economic activity and prices. As a result projected real growth is expected to decline from close to 9% to the 6%–7% range. A similar inflation problem exists in China, where the government is taking even more aggressive monetary steps to control prices. Perhaps Vietnam is too small to be important, but prices there are increasing more than 20% and the base lending rate is only 9%. The result of all of this monetary restraint is that the performance of the equity markets of the emerging countries has been lagging behind Europe and the United States. It may not be here just yet, but I think a buying opportunity is developing. China has already begun to do better.

One of the worries at the beginning of the year was that the financial crisis in Europe would reemerge. I was hopeful that a combination of austerity measures, higher taxes and growth would be combined with transitional aid from the International Monetary Fund, the European Union and Germany to provide a period during which the stress could be reduced. I was also encouraged by the lack of public protest against the measures various governments were taking to bring their budget deficits and overall debt into line. Recently there have been reasons to be concerned. Angela Merkel's political party lost an election in Hamburg, which was a setback for her. Merkel's leadership is essential to the workout period for the weaker economies and to fill that role she must maintain her political strength at home. Interest rates on the 10-year bonds of Portugal, Ireland and Spain have risen recently, reflecting increased uncertainty, and credit default spreads are rising. I remain optimistic about Europe for the intermediate term but this is a situation that requires monitoring.

One area where some good news is appearing is the financial condition of state and local governments. After dropping to a problematic low at the end of the recession, personal income receipts at the state level have

been increasing. Even New York City reports that tax revenues have been coming in \$2 billion higher than projected three months ago. While there are still severe problems in a number of troubled states like New York, California, New Jersey and Illinois, I believe the situation is improving. I do not see similar progress at the Federal level.

There is considerable controversy over whether the apparent strength of the United States economy is a result of the QE2 monetary easing program. Many believe that much of the money the Fed injected into the economy went into the stock market. There are plenty of Bernanke critics around who will argue that the economy was starting to recover on its own and the second round of easing was unnecessary at best and dangerous at worst. After all, adherents of Milton Friedman believe that inflation "is always and everywhere a monetary phenomenon," but while the recent reports on the consumer price index are showing a rise, we are a long way from what we experienced in the 1970s. In my view you need wages and housing prices to be rising for inflation to become a problem. House prices are still declining and it is doubtful that wages will rise significantly with the unemployment rate at 9%; it was 6% in 1974 when inflation was becoming a severe issue.

The Federal Reserve began QE2 last fall because the prospect for passing another fiscal stimulus program seemed dim based on the temper of the populace, questions about the original Obama stimulus program and the Republican shift in Congress. Monetary easing was the only tool left in the box to deal with the problem of persistent high unemployment, and the current easing is likely to continue until we see the jobless rate drop comfortably into the 8% range. At that point the Fed may begin tightening, but should we be so fearful of that? Looking at past cycles, according to Strategas Research, the Standard & Poor's 500 gained an average of 15.6% in the twelve months before the first tightening and 4.8% in the six months before tightening began. Even after the first tightening the S&P gained 8% in the first six months and 3.7% in the first year. What matters most is economic momentum and earnings growth. If the United States economy is going to grow at 4% or better in 2011 and not slip back into recession in the following year, then the likelihood of the market continuing to deliver positive performance is high. Excessively bullish sentiment will surely produce periodic pullbacks, but in the 84 years since 1926 the S&P 500 has risen more than 10% 48 times, more than half the time, and with the present favorable outlook I think 2011 will fall in that group.

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