

Investment Commentary

March 7, 2011

A tug of war is taking place in the markets, with crosscurrents of good economic reports on the positive side and a continued rise in oil prices from the conflicts in the Middle East on the negative side. Last week, US equities were up modestly, with the Dow Jones Industrial Average rising 0.33% to 12,169, the Nasdaq Composite advancing 0.13% to 2,784 and the S&P 500 adding 0.10% to close at 1,321.

As we near the end of the first quarter, we thought it useful to review our predictions for 2011 and where we stand. While it is still early in the year, overall our predictions are on target.

- 1. US growth accelerates as US real GDP reaches a new all-time high.** We continue to believe that US GDP growth will accelerate and come in at roughly 3.5%. More importantly, we believe the components of growth will be higher quality than last year, with increasing evidence of real final sales rather than inventory accumulation, as the economy exits recovery and heads into expansion.
- 2. The US economy creates 2 million to 3 million jobs in 2011 as unemployment falls to 9%.** Friday's employment report was encouraging, with 192,000 jobs added in February and the unemployment rate falling to 8.9%. This leads us to believe there is more positive news to come, particularly as the lead indicators for jobs continue to show positive momentum.
- 3. US stocks experience a third year of double-digit percentage returns for the first time in over a decade as corporate earnings reach a new all-time high.** Markets are off to a pretty strong start in 2011, notwithstanding the difficulties in the Middle East. Earnings continue to come through better than expected and our belief is that they will hit a new all-time high in the third quarter.
- 4. Stocks outperform bonds and cash.** It is early in the year, but if stocks are up at all in 2011, they will outperform cash, which we expect will post a near-zero return this year. Meanwhile, bonds struggled until the Middle East disruption and flight to safety took place. So the jury is still out, but we have reasonable confidence that our prediction will ring true and stocks will also outperform bonds for the year.
- 5. The US stock market outperforms the MSCI World Index.** So far this has been the case, though a lot will depend on Europe and to some degree Japan. Our view is that continued good economic growth in the United States will lead to strong earnings growth, which in turn will lead to a US stock market that outperforms.
- 6. The US, Germany and Brazil outperform Japan, Spain and China.** Spain has performed well coming out of the doldrums of last year, so while we are behind on this prediction, we still believe it will ring true. Germany, given its ability to export, as well as manufacture and handle its fiscal affairs, and Brazil, with the development of its middle class, should perform better than China, with its inflation problems, and Japan, which will be impacted by secular problems.



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7. **Commodities and emerging market currencies outperform the dollar, euro and yen.** Commodities are off to a good start this year in most cases. One currency is in our favor at the moment. Emerging market currencies come from countries that have faster growth and less debt, which is a pretty powerful combination against the developed world and supports our longer-term view.
8. **Strong balance sheets and free cash flow lead to significant increases in dividends, share buybacks, mergers and acquisitions (M&A) and business reinvestment.** Again, it is early in the year, but all the signs point to strong free cash flow and strong balance sheets leading to all of the above. So far, so good.
9. **Investor flows move from bond funds to equity funds.** This has happened in spades so far this year, and our belief is that this trend continues, though perhaps not at the pace we have seen. Still, after a long period of flows in the other direction, we think investors will continue to reduce their fixed income allocations while adding to their equity positions.
10. **The 2012 Presidential campaign sees a plethora of Republican candidates while President Obama continues to move to the center.** Certainly the President appears to be moving in this direction, at least in words and to some degree in deeds. This was evidenced by the extension of the Bush-era tax cuts, although he did not have much choice given the election. No credible Republicans have yet announced a Presidential run thus far, but we believe many will in the months to come.

In summary, most of our predictions are on target. While expected gains from equity markets for 2011 (low double-digit returns) may not be that different from last year's expectations, we do believe the risks have moved from the downside to the upside. The cyclical recovery will continue, but at a less-than-normal pace due to the structural problems the developed world continues to face.

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