

TFC Market Update

March 7, 2011

Revolution, Oil, Inflation, and Bernanke's Strategy (What Will the Financial Markets Conclude?)

Just as the global economic recovery was moving into an expansionary phase, events in North Africa and the Middle East intrude to force a full reassessment of the probable outcomes. At this point, how the geopolitical situation will resolve itself is, no doubt, a matter of futile conjecture. But it's still useful to remember that whoever takes control in whatever country will need the oil revenues to finance its governing activities; so keeping the pipelines open will continue to be of paramount importance. In virtually all the countries in play, there exists no indigenous economic base. In fact, if you exclude oil production and add up all the residual value of the goods and services produced in the 17 Middle East and southeast Asian Muslim countries, their combined GDP is no greater than that of Finland's—the world's 54th largest economy. Oil revenues (petrodollars) drive the machinery of military and political control. At \$105 per barrel today, the price of oil has barely exceeded the growth of inflation since 1983. Our economy since the oil embargo of 1973 has become much more energy efficient. Unless a return to the peak price of \$151 of early summer 2008 is in prospect, our nascent economic recovery should continue, although probably at a somewhat diminished pace.

For the global economy, as important as the price of energy always is, the big questions today for the equity markets remain: 1) When will we reach a *self-sustaining* economic recovery?; 2) When will we no longer need the monetary and fiscal stimulus of the past few years?; and 3) Can we free ourselves of the onerous government involvement in the daily lives of those who create the jobs in our economy? We will leave to our political class, and the Federal Reserve Board, the responsibility to settle these conflicting issues; hopefully, in a more civil and constructive manner than has been the case these past few years.

The Fed's (Bernanke's) Game Plan? (Approaching a Monetary Policy Inflection Point?)

The Fed's monetary policy strategy may be revealing itself in its actions of late. It appears that the primary objective of Bernanke's QE2 Treasury bond purchase program is to hold interest rates in check at present "crisis" levels, while providing cheap liquidity for the stock market to regain or exceed its previous peak levels.

The Fed's bet is that as stocks gain ground, the wealth effect will improve investor sentiment and a more confident consumer will ramp up spending patterns. In today's benign inflationary environment (i.e., weak labor-cost-push backdrop), this course of action may work over the short-term. Longer term, managing inflationary expectations will be critical. This approach also has an obvious political objective for the 2012 elections. If QE3 were to materialize, the motive behind this easy money campaign would become all too obvious.

As the remainder of the year unfolds, one needs to carefully analyze the Fed's language in its bi-monthly post-meeting announcements. If unemployment begins to abate and the monthly hiring numbers begin to accelerate sooner than anticipated, Bernanke may have to allow interest rates to move back up to more normal ranges (e.g., 3% for short maturities, 5-6% for long-dated bonds). But for the moment at least, the Fed's accommodative monetary policy posture favors a fully invested position in equities.

Non-Trivial Minutiae (Sad, But True)

One of the well established tenets of investor behavior is the tendency to chase performance; buy the fund with the best return numbers, engage the manager with the most recent top ranking. Jack Bogle, Charlie Ellis and other experienced market observers have suggested a contrary approach; periodically move money to last year's worst performers! Proof-positive of the validity of this latter suggestion is the recent announcement by Morningstar that "nine of the top ten individual stock funds over the past 24 months (i.e., since the market trough of March 2009) have bottom-rung, 1-star ratings by Morningstar." Past performance is no guarantee of future return. It's a useful indicator, but much more needs to be considered in selecting a fund for inclusion in one's portfolio.

Should you have any questions or comments, please let me know.

Best,

A handwritten signature in blue ink, appearing to read "J. Joslin".

James L. Joslin
Chairman, CEO & CCO

JLJ:sf