Q1 2011 Commentary

"Today you can buy an iPad 2 that costs the same as an iPad 1 that is twice as powerful," he said."You have to look at the prices of all things."

New York Fed President, William C. Dudley on inflation

"I can't eat an iPad,"

Anonymous audience member

We are often asked why we and many other authors of economic newsletters seemingly feel compelled to offer some quotation at the top of their commentary. Perhaps we struggle with how to open the letter and hide behind some cute quip. As many of the quotes have come from members of our Federal Reserve, we prefer to think of it as a window into their insights and what we may expect from subsequent monetary policy. Or maybe we just can't resist idiotic comments when we see them. We suspect it may be a little bit of all of these. As the expansion of the Fed balance sheet from QE2 winds down in the second quarter just as consumer concerns of erupting food and energy costs escalate, we foresee more and more headlines addressing whether QE2 morphs into QE3. As we have seen how difficult it is to understate the impact that the Fed can have on asset classes, we expect this to be a determining influence in the direction of the markets for the balance of 2011.

The global economy enters the 2nd quarter emerging from one of the most shock-filled periods in recent history. Mostly peaceful, social networking-fueled uprisings in Tunisia and Egypt were followed by much more violent, military involvement in Libya and the devastating earthquakes and tsunami in Japan. Despite these events and the human and economic toll, the markets survived, even thrived during the opening months of the year and rebounded from a 7% global decline during the opening weeks of March. For the quarter the S&P 500 returned 5.9% while the Dow Jones Industrial and Nasdaq averages were up 7.1% and 4.8% respectively. International indices performed less well but still positively with the MSCI EAFE index of developed nations up 3.4% and the MSCI Emerging Markets index up 2.1%. With continued growing uncertainty in the Middle East and North Africa regions helping drive up the price of oil; sovereign debt fears in Europe remaining in the headlines; and the human and economic tragedy in the world's third largest economy; the markets unrelenting march forward with the best first quarter in over a decade has been truly astounding.

Though suspect of its durability, we noted in our annual commentary the increased optimism in the cyclical recovery of the U.S. economy. Ending 2010 with consumer spending and confidence strengthening, we suggested the prospects for stronger than expected employment growth might fuel a cycle of increased demand, credit extension and a modest pace of economic growth into early 2011. Indeed, we have now seen jobless claims break below 400K for seven of the last eight weeks. As layoffs decrease, we have experienced the long awaited rebound in private payroll growth that has averaged over 159K per month for the first quarter of the year. We feel this may actually be understating the job growth as the Household Survey (which samples a broader yet smaller base and does a better job of picking up new businesses) has averaged over 375K monthly jobs. In a little over a year since last February we have created over 1.5M new jobs and since November alone, the unemployment rate has declined from 9.8% to 8.8%.

This job growth has been led by manufacturing with an almost 20% increase over the last year. The ISM (Institute of Supply Manufacturing) index has now risen from a cycle low of less than 35 in 2008 to over 60 (a reading over 50 indicates an expanding economy) for three straight months, the highest quarterly level in over 28 years. This continued strength in production extended the inventory accumulation and export strength of prior quarters and led to an improved GDP growth of 3.1% in 4Q 2010 while fostering consensus expectations of a 4% 1Q 2011 and full year gains of 3.5%-4%.

A rising stock market has been the primary source of an increase of about 20% in Household Net Worth for the U.S. consumer since the recession lows of 2009 though still about 10% below the levels of 2007. When combined with the extension of the Bush-era tax cuts and the additional stimulus of the 2% payroll tax reduction for 2011, consumer confidence as measured by the Conference Board and University Of Michigan Sentiment surveys soared to 3 year highs in January. Though still at historically low levels, small business confidence as measured by the NFIB (National Federation of Independent Businesses) index has risen from a range of around 88-90 over the last 2 years to a recent level in excess of 94. As the large majority of new jobs are created by these entrepreneurs, this is critical to a sustainable recovery.

U.S. corporations have managed their businesses exceedingly well during this recovery and have enjoyed exploding profit margins taking S&P earnings back to levels near 2006 highs. With full year 2010 operating earnings of $84 and a 2011 consensus estimate in excess of $97, many analysts argue that U.S. stocks are actually no more expensive now following a near doubling of 2009 panic lows.. For corporate America, the lessons of the summer of 2008 are not easily forgotten and they have strategically locked in very high levels of long term debt at generationally low levels. This has the benefit of reducing interest expenses and bringing their liquidity ratios of cash and short term assets to the highest levels since 1956 thus protecting themselves for the inevitability of higher rates.

However, our operative words in our prior comments have been *cyclical recovery* and we still expect that we are in the early stages of a long term post-financial crisis. Currently we are seeing troubling signs and increasing headwinds that are leading us to maintain our original thesis that the economy will be challenged in the second half of 2011. Recent economic data have slowed and may best be described as choppy. While the ISM indices are very strong we must remember that they are diffusion indices which give us direction but not degree. Industrial Production levels may have reached a plateau over the last 3 months while construction spending has declined at more than a 16% annualized rate in the last 3 months. Japan is 5% of U.S. exports and 8% of global GDP. Even a small global supply chain disruption arriving at the same time that China's central bank attempts to slow the pace of economic growth may have a pronounced impact on export growth. At a time when our recovery is more dependent on high growth emerging markets for exports, surging commodity costs are leading these central banks and governments towards policies to slow growth and contain food inflation which is far higher in developing countries.

While commodity costs represent between 40%-60% of the median income in these emerging markets, food and gas have now risen to 22% of our wages and salaries, a level rarely seen in the U.S. While the 2% payroll tax cut is estimated to add $60B to disposable income, it is estimated that a $1 rise at the pump is a tax in excess of that level. With West Texas Crude now approaching $110/barrel, we have already seen the national average for regular gas rise to over $3.65 cents per gallon which is up from $2.63 last August. With food costs also at very elevated levels, a sustainable recovery would require increased wage growth. However, the improving jobs reports have not translated into wage increases and we fear the labor and capacity slack that we have often addressed will continue to retard income growth. Real work-based wages and salaries have declined in 5 of the last 6 months and the year over year trend in real average weekly earnings gains has now declined from 1.5% to 0.5%. Wage disparity has been increasing for decades and appears to be accelerating. Real median income in the U.S. is actually at levels of 1995 showing no increase in 16 years! The impact of rising food and energy costs is a regressive tax that impacts lower and middle income households far greater than upper income households. It is therefore of no surprise that the improved confidence seen in January imploded in the face of the international news and the impact of rising gas prices. The Consumer Confidence index declined from still historically low 72 to a reading of 63.4 in February with low income households showing the lowest reading since March of 2009.

Declining consumer sentiment is also a strong concern for a housing market which appears to be approaching new cycle lows. The positives for housing are continued low mortgage rates that combined with declining prices have created the highest affordability levels on record. While new home sales and housing starts that are at or near historic lows makes headlines, we view this as positive news. New homes compete with the incredible oversupply of existing homes and anything that controls supply will improve that imbalance. However, while new home prices have now declined nationally to a median price of $202,100 they are still at a 30% premium to the $156,100 median for existing homes. This is in contrast to a historic average premium of 15% indicating further declines would be in store, a disincentive for homebuilders to break ground. The most recent level of existing home sales showed a month over month decline of 9.6% to an annualized rate of 4.88M (down over 40% from levels of 2005).

LPS Mortgage Monitor reports that although delinquencies are slowing, the end of the foreclosure moratorium and an additional wave of ARMs (adjustable-rate mortgages) set for a spring reset are increasing the current rate of foreclosures and the likelihood of increased distressed supply hitting the market. Indeed, 39% of February sales were distressed properties with 33% all cash transactions, both records. This is placing further downward pressure on prices. The Case-Shiller 20 index of home prices is now down for 7 consecutive months (at an 8% annualized rate of drop) and within 1.1% of the cycle lows set in April 2009 and almost 32% down from the peak in 2006. Core Logic estimates that the number of homeowners underwater on their mortgages increased in 4Q 2010 to 23.5%. This was before a 1Q decline of about a 3% threatening another 2.4M homeowners who have less than 5% remaining equity.

The pressured consumer has now slowed spending momentum and the 4% annualized rate of spending seen in the 4Q of 2010 has slowed to an estimate of about 1.5% in the first quarter of 2011. As the consumer represents almost 70% of GDP, our estimate of Gross Domestic Product is now tracking closer to 2.5%. While there may be some weather impact in this declining trend, the real wage pressures, rising costs and declining confidence will continue to weigh on spending. The fading of stimulus from QE2 combined with the fiscal headwinds of declining spending and further budget cuts from State and Local governments place further pressure on continued growth.

Quietly, we have also noticed a slowing of corporate profits. With corporate profit margins very near an all time high and profits relative to GDP at a historic high of 12.7% versus a long run average of 10.5%, we feel that margins have most likely peaked. Even though national corporate profits (the broadest picture of U.S. profits) are up 11.4% year over year, they are down at a 2% annualized rate over the last 2 quarters. In fact, the last quarter was the first decline in eight quarters and dropped at a 10% annualized rate despite positive headlines. We are now slowly seeing downward revisions to GDP growth along with corporate earnings all while the market marches onward. Higher energy costs, rising input costs and declining consumer confidence remain the biggest risk to continued growth and we view the consensus estimate of $97 in S&P 500 earnings and 3.5% to 4% 2011 GDP gains to be an unlikely best case scenario. Simply put, earnings are at high risk of not meeting expectations and this is not a good combination for an already extended market.

We have noted for the better part of the last 18 months that determining the inflationary direction would be the key determinant to investment positioning and returns over the next few years. For much of this time, we have argued that deflation is the primary risk and that inflation was a greater longer term concern. Since the commencement of QE2 in

September, the huge run up in bond yields and commodity prices have made the argument that we are wrong. Import prices are up 6.9% over the last year with export prices up over 8.6%.. Headline inflation has moved up from a 1.1% rate of increase annually to the current 2.2%. As a matter of fact, we do believe that it may even hit 4% sometime over the summer as we anniversary deflationary numbers. Even removing food and energy from the calculation, the core CPI has moved from 0.6% at year end to over 1.1% and with rents (Owner's Equivalent Rent is 23% of CPI calculation and 40% of the core) inching higher may hit 2%. The argument that the Federal Reserve and William Dudley espouse is that this is a transitory increase confined to the commodity space that will plateau and even moderate. Increasing productivity, excess capacity, and flat wage growth all indicate that this is not sustainable inflation but rather an increase in relative prices.

We continue to agree with this position and feel this to be an inflationary spike within a deflationary post-financial crisis. We are often asked what would make us change our position. The tremendous expansion of the Federal Reserve balance sheet is given as the main reason for the inevitable inflation. However, M2 (money supply) has grown at barely more than a 4.5% annual rate through March. The Velocity of M2 still stands at or near the lowest levels in the last 40 years indicating no turnover or lending of these reserves. In fact, we continue to see the expansion of the excess reserves on bank balance sheets. We would need to see a strong pick up in wages and increases in the velocity of money to have greater concerns. We do not see this currently but will be vigilant and alert for any changes.

Whether that is correct or not, however, is really beside the point. The audience member is really right. For now, there is a clear increase in prices of basic necessities at a time of high unemployment and no wage growth. Rising food and energy prices may be the tipping point for an economy that has been stimulus fueled. We have to ponder what the next move by the Fed might be. Most economists feel the economy to be moving along and 70% in a recent CNBC poll indicate the view that there will be no QE3. In a time of exploding global deficits, the political will for further intervention is fading. (As we write this the European Central Bank just raised interest rates possibly indicating the long period of extraordinarily easy credit may be coming to an end). The liquidity bid of the Fed (Bernanke put) will disappear. The impact on stocks, bonds, gold, commodities and volatility along with confidence may be very unpredictable. We anticipate that while there will be no immediate QE3 we may be sitting here at the end of the second and third quarters pondering when it does start.

The next few months are critical to see if the economy is able to stand on its own two feet. With markets priced for very attractive outcomes, we continue to recommend a defensive posture and believe the focus on defensive quality companies as the best value and investment in such an environment.