

## **First Quarter Investment Commentary April 2011**

“Bankruptcies of governments have, on the whole, done less harm to mankind than their ability to raise loans.”

- R. H. Tawney, *Religion and the Rise of Capitalism*, 1926

### **The Quarter in Review**

- A massive earthquake and tsunami hit the northeast coast of Japan on March 11<sup>th</sup>. Estimates to this point are up to 10,000 dead and missing, and the cost to rebuild, including business interruption, is \$250 to \$300 billion.
- What started as a single street vendor setting himself on fire to protest police harassment in Tunisia turned into unrest in Bahrain, Libya, Yemen and Syria. A coalition of European and U.S. forces is now involved in Libya, assisting those in opposition to dictator Muammar el-Qaddafi. Oil prices have fluctuated during the last few weeks as investors attempt to decipher the impact of the unrest on production.
- Neil Barofsky, the head of the government’s TARP (Troubled Assets Relief Program), announced his resignation. Mr. Barofsky worked tirelessly on behalf of the taxpayer, and will be sorely missed.

The S&P 500 was on a bit of a roller coaster ride this past quarter. The index peaked on February 18<sup>th</sup>, only to slide below its January 1st value on news from Japan and the Middle East, then rally again to close near its high at the end of the quarter. Client portfolios lagged this index due to exposure to bonds and overseas equities, but also exhibited much less volatility than the index during this period.

### **Looking Ahead**

Commodities have been going parabolic lately, with grain prices boosted by poor harvests in Brazil and Australia, oil prices boosted by unrest in the Middle East, and many other commodities helped by construction spending in China. But, how long can this all last? The Canadian magazine, *MacLean’s*, recently had an article on the commodity boom and its effect on that country’s economy. Here is some of what the writer had to say:

But how secure should we be in assuming the commodity boom won’t turn into a bust? Not very, says Shawn Hackett, a commodity analyst in Florida who has dug into the sector’s long history of booms and busts. He analyzed the 10-year average annual rates of return for commodity prices dating back to the early 1800s. At no time have

prices risen as fast and as high as they have over the last decade without being followed by a sharp decline. "If history is any guide, we're higher than the 1980 top and much higher than the 1950 top," he says. "Unless we are going to do something right now that defies 200 years of the way the rules of engagement have been in commodities, we're due for a nasty spill."

The Oliver Wyman Group, a global consulting organization, is forecasting a recession in 2013, brought on by over-spending by commodity-rich nations and a slowing of the economy in China. A typical cycle with regard to commodities goes like this: prices rise as demand increases, new production facilities are put into place to take advantage of the higher prices, product substitution (think natural gas for oil) or slowing economic growth results in declining demand and prices, commodity producers now have excess capacity, and profits decrease.

While we wait for this portion of the boom-and-bust cycle to occur, inflation is beginning to be noticed. While there are a few economists still in the deflation camp, more people are now raising their inflation expectations. Inflation is obviously bad for most bonds, as the coupon on the bond is fixed and cannot keep pace with rising inflation and interest rates. As rates go up, the price of a bond declines. However, with stocks it is a more mixed reaction. In theory, companies will pass on price increases to the consumer, maintaining their profit margins, and may see earnings increase. However, as input costs increase and if companies are not able to pass along those costs to consumers, margins will decline and the level of earnings may not increase. Additionally, as inflation increases, so does the uncertainty about future levels of inflation, which makes stocks more risky to hold. Once investors start discounting future earnings at a higher rate, the P/E (price/earnings) ratio declines, driving stock prices lower. We will be closely monitoring this situation in the coming months.

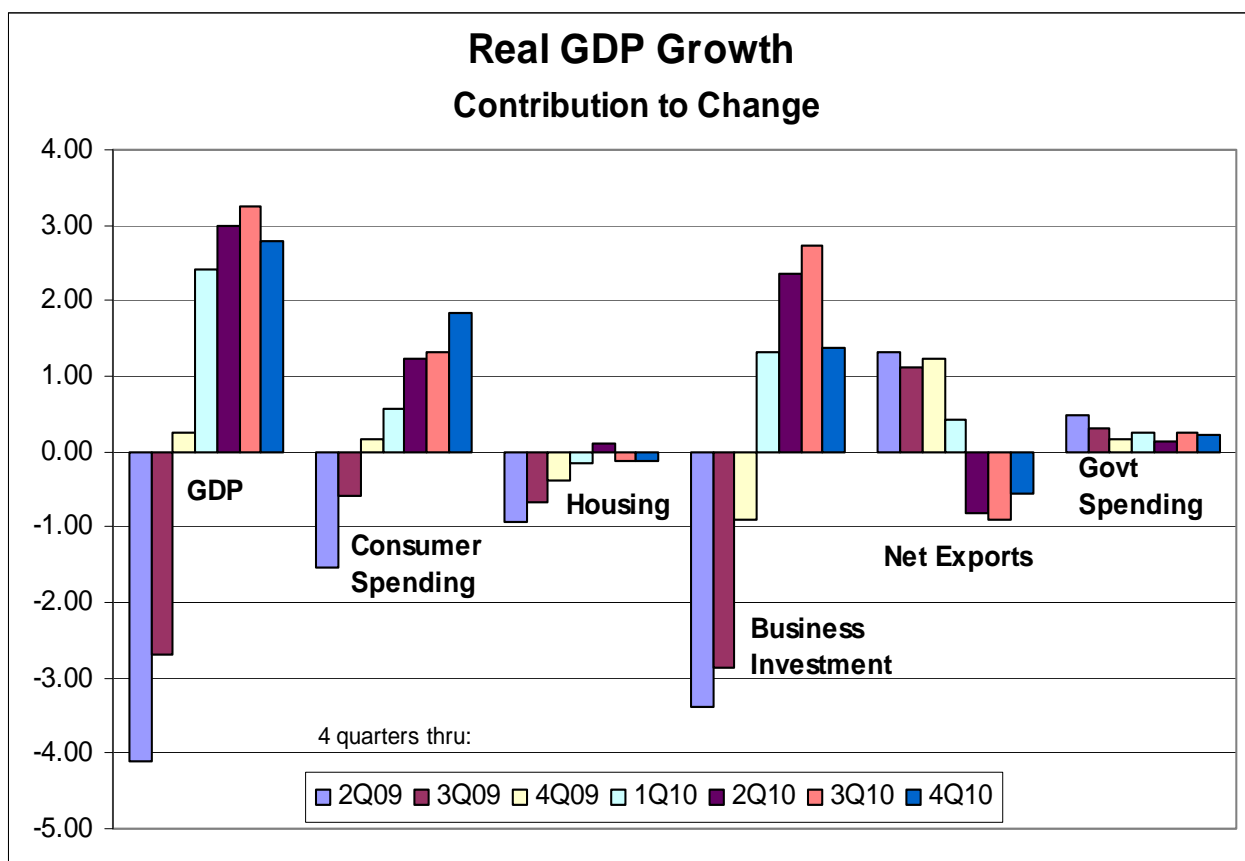
## **Economic Report**

As we mentioned in a recent Friday update, Diane Dercher, previously Senior Vice President and Chief Economist at Waddell and Reed, joined our firm as an advisor on March 1st. Now that we have a real-life economist on board at the firm, we will have an economic update section in our quarterly commentary, to offset much of the blather that I (Kevin) produce. So, here is Diane with the latest.

Despite the uncertainty that the unrest in the Middle East, the earthquake and tsunami in Japan and the debt crises in parts of Europe have imparted on financial markets and the economy, the U.S. economy is showing signs of broadening, sustainable growth.

As seen in the chart on the following page, economic growth has picked up to about its long-term trend rate near 3.0%. At first, growth came from better business investment and a significantly smaller drag from housing. Business investment has accelerated as profits have increased and access to credit has improved. This is expected to continue as equipment needs to be replaced and spending on structures is turning up.

Housing activity is still weak as inventory levels remain high and prices continue to fall. But affordability has improved and banks are not as restrictive on lending as they have been. Housing is unlikely to increase rapidly anytime soon, but it does appear the worst may be behind us.

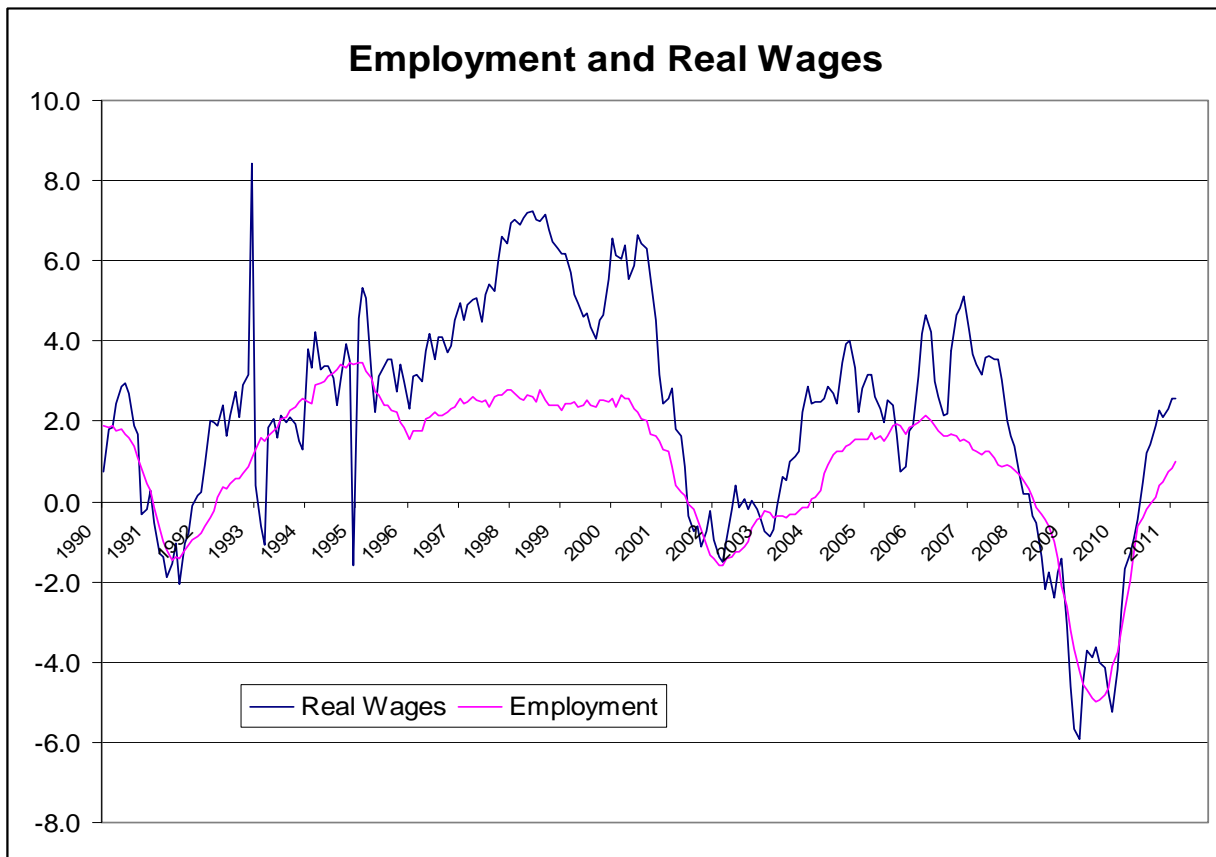


Source: Bureau of Economic Analysis, WMA

More important for a sustainable expansion to take hold is for employment growth to accelerate, thereby increasing consumers' purchasing power. This is now occurring. Increasing employment leads to improving income. As the chart on the next page shows, wages, taking into account higher inflation (energy and food costs in particular), are accelerating. While higher costs for gasoline and food are eating into consumers' pocketbooks, increasing jobs, wages and better credit access are more than offsetting these negatives.

Higher prices for food and energy, as well as other commodities, are raising inflation expectations. This, in addition to stronger economic growth and the Federal Reserve maintaining low interest rates, increases inflation concerns in financial markets. For now, inflation is not expected to spread broadly across all products but the risk of higher inflation will likely put upward pressure on interest rates.

The economy appears to be shifting from an early recovery that needed government intervention for support to a self-sustaining expansion. This is the phase when inflation remains moderate, businesses report solid profits, and employment growth improves. Anticipating higher inflation, interest rates move higher. Equities typically continue to do well in this environment.



Source: Bureau of Labor Statistic, WMA

## Closing Comments

With the addition of Diane to our firm, we now have additional capacity to accept new clients. So, if you know someone who has recently had an event such as moving to another job, retirement, loss of a spouse, or some other money event (no lottery winners, please), we would appreciate it if you would keep us in mind.

As a reminder, we will start closing our office on Fridays at 3:00 p.m. beginning the Friday of Memorial Day weekend and continuing until Labor Day weekend.

*Kevin Bruce Paul Pat Matt Diane*

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