First Quarter 2011 Investment Commentary

One Picture Speaks a Thousand Words – Chinese proverb

When you write an investment newsletter, graphs are very useful to help explain the facts, particularly when the issues are very complex. Starting with this quarter, I am kicking off a new era for my investment newsletter. In doing my part to get this economy going again, I purchased Adobe Pro software (normally $300 retail, I bought it online for $159, further proof that the web is a global deflationary phenomenon). Adobe Pro will allow me to make one very important upgrade to my newsletter. In my day job as a portfolio manager and research analyst, I have to read and digest volumes of data and written materials and these reports often come with graphs that help me to understand and interpret the facts. With the assistance of Adobe Pro I will now be able to cut and paste graphs from other pdf files and create my own pdf files for sending out to my interested readers. With Adobe Pro, I will now be able to supplement my investment commentary with graphs that will hopefully make my investment newsletter more interesting for you to read and understand.

Inflation

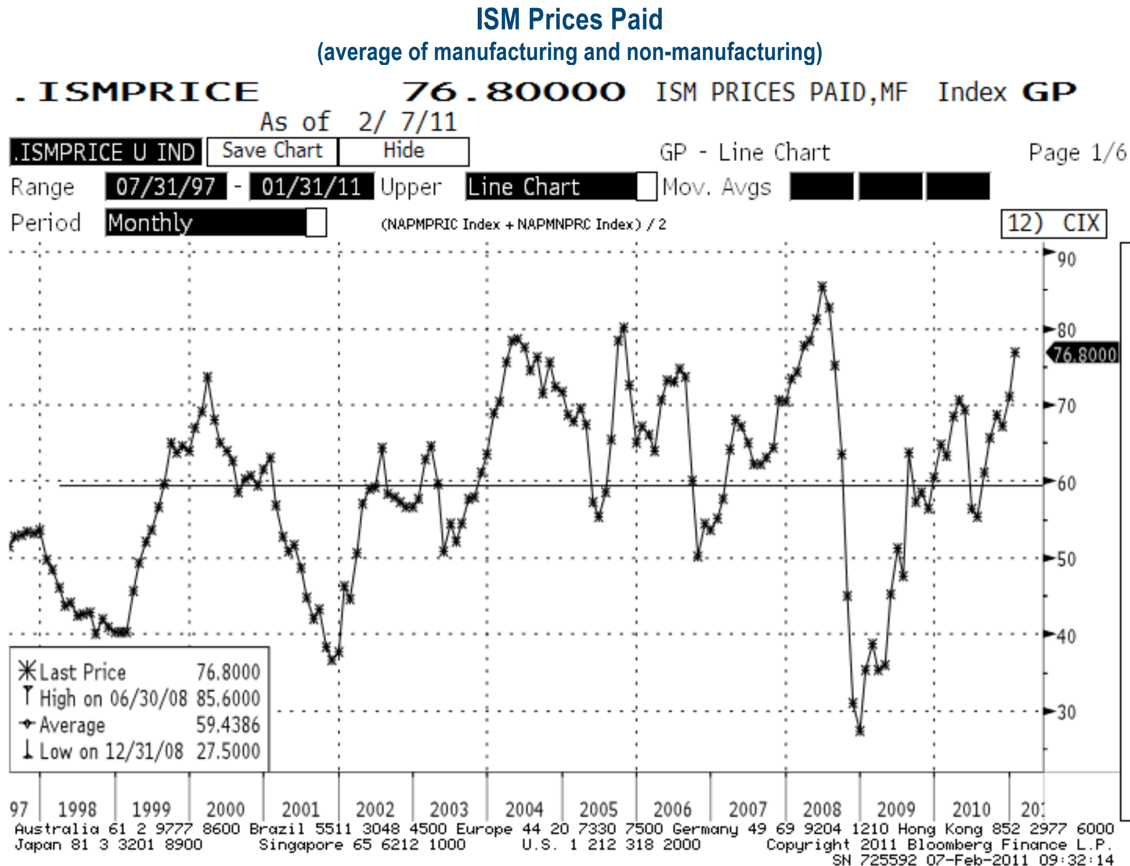
The US economy has been in a low inflationary (even deflationary) environment for a long time, certainly in things we want. Electronic devices such as handsets, TVs, and PCs are a classic example of declining prices but with greater features. But there is a notable change in the inflationary environment for the things we need. Even though the web has been a major deflationary force that has benefited consumers tremendously for over a decade, we all know that there is another side to the inflation story today. Gas prices are at $3.60 a gallon and food prices have increased considerably because corn, wheat, and soybeans are all up 50% or more over the past year. Cotton is up over 100% and so it will cost more to buy clothes. In short, we are all feeling more inflationary pressures in our family budgets. So we know our pocket books are getting squeezed from inflation but what does that look like from a price level perspective?

We now have a way of visually seeing inflation on a real time basis thanks to those ingenious geeks (a respectful term) at MIT. MIT collects daily the price data for 5 million individual items. The database begins in October of 2007. While the annual inflation data (not shown) is still roughly 2.75%, the daily (shown below) shows a recent acceleration.

You are probably looking at that chart and saying, yup, that pretty much sums up how I feel I am getting squeezed right now. Notice the recent steep acceleration. This recent uptick coincides with the large increases we have seen over the past 6 months for gas and food.

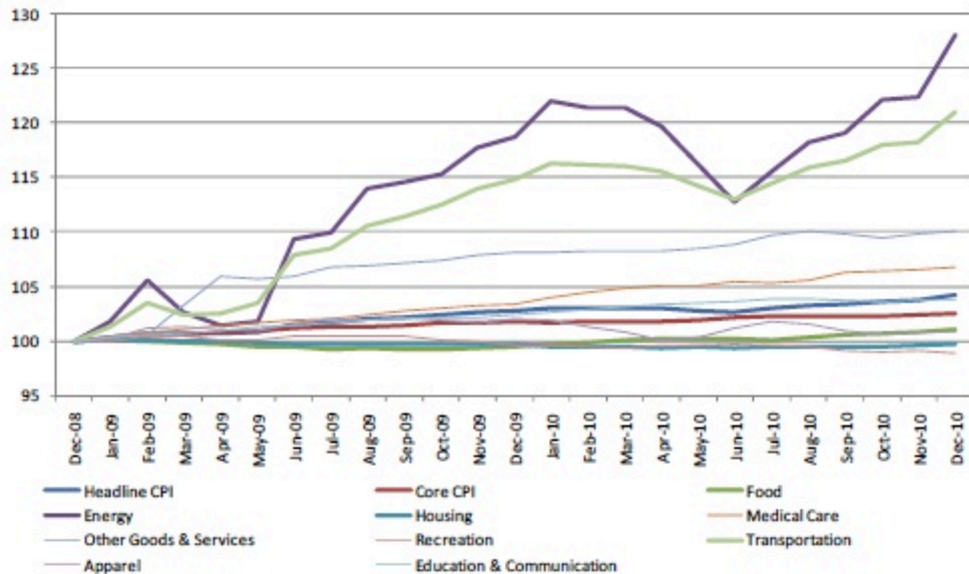
Why do we start paying higher prices? Our current Federal Reserve monetary policies (near zero interest rates and Quantitative Easing I & II) are a root cause (and a complicated issue I won't get into here) but generally speaking consumers pay higher prices because the manufacturers and service providers start to see price increases in the raw materials and labor used to produce the goods and services they provide to you as a consumer. They have to make a profit too, right? The following graph captures an ISM survey of both manufacturers and non-manufacturers in terms of the prices they pay for their input costs. Similar to the MIT chart, you can see input prices bottomed in early 2009 and have risen from there including a steep climb since mid-2010. These graphs

capture what all of us now experience with cost increases for the items we need everyday to live.



The Bureau of Labor Statistics calculates the Consumer Price Index (CPI). The chart below plots some of the components of the CPI. The two lines well above the rest of the pack over the past two years are food and energy inflation. These costs are soaring, up over 20% in two years. Those on the low end of the income scale or retirees on fixed income are disproportionately getting hit by rising energy, food, and healthcare costs. These cost increases hurt everyone else too but in particular they hit the low/fixed income consumers where these costs are a much higher percentage of income. We are in the Have and Have Nots economy and this inflation data helps to explain why public sentiment and mood is so sour at this time. It also explains why public food stamps assistance is very high and why food pantries are desperate for donations. As an aside, emerging markets consumers face a similar situation, as food, energy, and transportation costs are approximately 60% of consumer income. Some of the political turmoil and unrest you see in certain countries is due in part to the rapid rise in food and energy costs those consumers are also experiencing. The masses will live under despots as long as they are well fed. When they are not, watch out. Think French Revolution.

Unweighted CPI Components (December 2008 = 100)



Note: Housing and Transportation components shown above each include their respective energy components (approximately 10% and 29% of Housing and Transportation, respectively). For illustrative purposes, Energy is also shown as a separate item.
Source: Federal Reserve Bank of St. Louis.

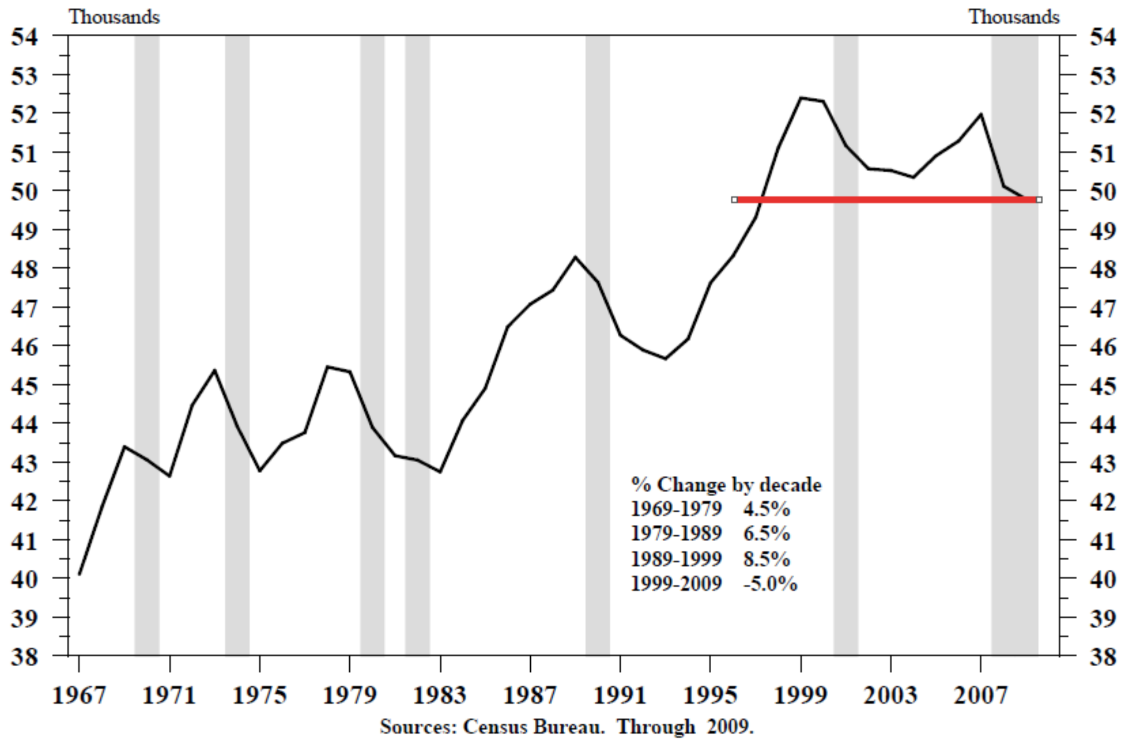
The Big Squeeze

As we see in the above graphs, we are experiencing inflation in the basic goods and services we need to live. Companies have an income statement where revenues are offset by costs and the difference is profit. Profits get squeezed when costs go up faster than prices are increased. But corporate profits are doing quite well now, so that tells you that companies have been successful in passing along higher costs to their customers and protecting their profits.

How is this profit picture looking for the US consumer? Not so good. We also have an income statement. It's our wages plus other income minus the expenses we pay out to buy things to live. The profit for an individual is savings, which is extra income we have available to invest or spend on discretionary goods or services. What happens when our wages become stagnant and our expenses go up? We draw down our savings or investments to cover the gap in order to maintain our lifestyle or we trade down.

The income picture look for America is very challenging. The following two charts capture some broad income measures for the US economy over longer periods. As shown in the top chart, real median household income peaked in the late 1990s, about the time of the stock market bubble peak (everyone was a brilliant investor then). As of today, median real income (in economic jargon real is defined as nominal-inflation) is at the same level today as it was in 1996. In other words, the median person in America is

earning no more today than they were 15 years ago. These two charts help to explain why the American Dream has turned into a not so pretty reality.



The next chart captures somewhat different data on wages but tells a similar story. In the last decade, average hourly earnings peaked in 2006/2007, about when the economy peaked and before we the Great Recession hit. Despite the modest recovery we have had in the economy over the past eighteen months, hourly wages continue to decline. This is another big reason why corporate profits continue to do well. Companies have seen a recovery in their revenues and have passed on price increases, but they have not yet had pressure to increases wages because unemployment remains too high. So the US consumer is bearing the full brunt of this weak economic recovery and rising prices. Is this good for the US economy? Of course not. The US consumer generates 70% of US GDP growth and with the US consumer squeezed from a combination of stagnant wages and increasing costs, US real GDP growth is likely to be muted until either real wages start to increase or inflationary pressures recede. Relief looks to be very far away on the horizon.

CHART 1: THE WAGE-LESS JOBS RECOVERY – BIG SLOWDOWN IN EARNINGS

United States: Average Hourly Earnings: Production 7 Nonsupervisory: Total Private Industries
(year-over-year percent change, $/Hour)

Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Debt – another dirty four letter word

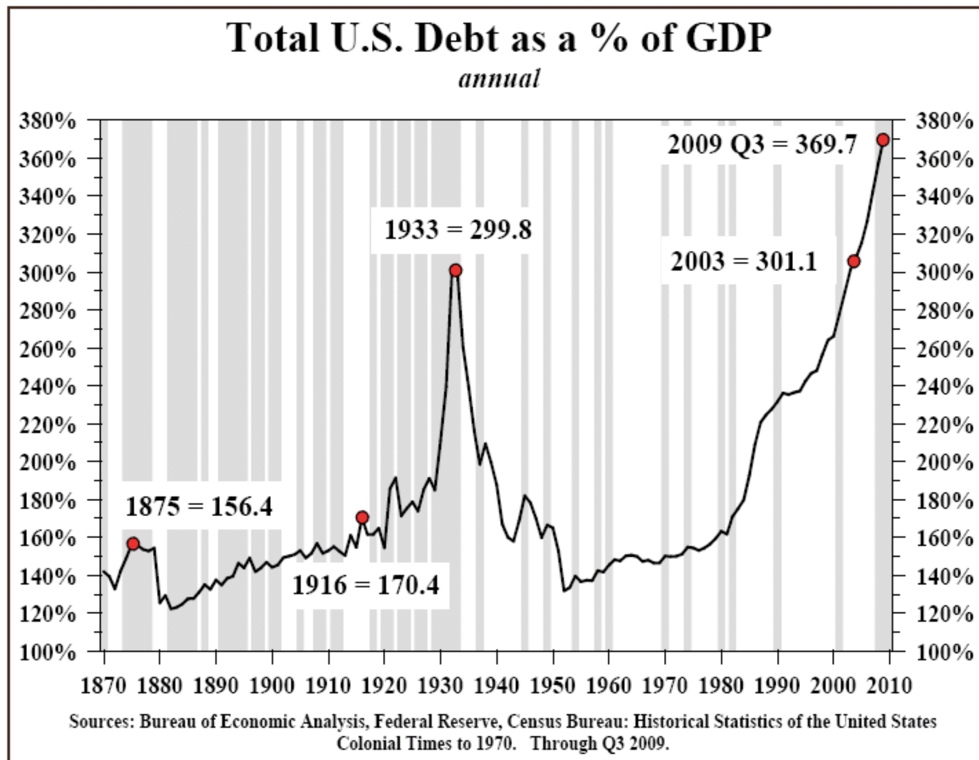
Another major factor that is an overhang on US GDP growth is debt. Simply put, debt has grown to such a level that it is acting like a brake on growth and a big reason the US economy is having trouble generating more than 3% GDP growth per quarter. There are two graphs that can help to put the US debt situation into perspective. This first chart below captures 3 categories of debt including private (corporations and individuals), government, and bank debt. As you can see, the first decade of the new century can be defined as one of the US going on a debt binge. We're talking Animal House here. Total debt grew by 11% per year from 2002 to 2010. Why was debt growth so large? Because money was cheap and readily available due to the Fed policies of keeping interest rates too low for too long. When interest rates are low, borrowers have a major incentive to take on debt because the interest payments are artificially low. During this decade, many Americans used their house value increases to take on more debt, refinancing at lower rates or taking out cheap home equity loans to spend on housing upgrades, cars, vacations, second homes, etc. Banks did the same thing and we now see governments around the globe drowning under too much debt. Collectively, this debt growth has created a massively over leveraged economy such that we must now pay the piper and pay down the debt. In short, Dean Wormer has shown up and Delta house is getting expelled. How do we deleverage this system? Consumers must save more and pay off our credit cards and loans. Governments have to make budget cuts and/or raise taxes. Banks have to cut back on lending in order to cover losses on loans made during the past decade. In aggregate, what this all means is lower GDP growth until we get our

debt situation under control. No easy solutions remain to this issue and that is why you see the level of societal acrimony at all time highs. Payback's a bitch.

Total Global Debt (Left Axis) and Global Debt/GDP (Right Axis)

Source: IMF Global Financial Stability Report; IMF World Economic Outlook; Moody's Country Credit Statistical Handbook; BIS; CIA World Factbook; Hayman estimates.

I am not even sure I need to bother to comment on the next chart below. Just ask yourself one important question. Is this sustainable?



Gaining a better understanding of the big picture

Let's face it, without an extensive financial background or education, investing is a difficult endeavor for the average person to be successful at. The one thing that constantly amazes me is how many people actually think they can win at the investment game with limited experience when the professionals themselves have a difficult time consistently winning. This is all the more true during this current era where complex global macro risks are defining the current investment environment and will for the foreseeable future. I try my best to distill these complex issues into the simplest form I can without losing the whole picture but it is challenging to do well because our current situation is very complicated. Other experts have been at it longer than I and it is not often that you can find a writer that can make complex economic/investment topics easier for the average person to understand. To that end, I am recommending a new book from a writer I personally enjoy reading on a weekly basis. The book tackles the complex issue of our global debt crisis and what it will mean to you, your kids, our country and why you should care about the fate of Greece, Ireland, and Portugal. It is titled The End Game and the author is John Mauldin. The book is now on the NY Times Best Seller list. I am reading the End Game while testing out my daughter Sydney's Kindle (there is a generational message here that the first person in our house that has a Kindle bought with her own money is Syd). If you are intimidated by these complex global issues, but want to understand them better (trust me, you do), I highly recommend this book. Force yourself to become more knowledgeable about this topic, and you will better understand how and why it impacts your life. And you will become a more informed investor as a result. I am not going to lie to you. The End Game is a lot drier than the scintillating Kathy Ireland autobiography I read each night before I go to bed but the world is a serious place and the toga party is over. It's time for all of us to sober up.

First Quarter Market Commentary

February 6th would have been the 100th birthday of Ronald Reagan. Reagan was known for using humor in his speeches to get important points across. Abraham Lincoln was the king of using humor to make a point but Reagan did a good job too. One of my favorites lines Reagan used related to the question of the role that government should play in our lives and the economy. We know Reagan was a conservative and a believer in less government and so he used to warn those who believed that government could solve all of our nation's problems by using the tag line, "We're from the government and we're here to help."

Ronald Reagan's birthday resonated with many Americans this year because of the start of his Presidency is similar to the situation in the US today where government has again become too big in our daily lives and economy and international turmoil is on the front page daily. Reagan was elected during a time when Americans were fed up and the public mood today is similar. In 1980, we had a significant recession underway and the Iran hostage situation and failed rescue attempt added to our nation's woes. History does not rhyme but it often repeats and 30 years later (yes, 30!) we find ourselves in difficult economic times, certainly the worse since that 80-82 recession and America's standing on the world stage is under siege.

The major international event during the first quarter that added to our current woes was the Middle East powder keg. Egypt, one of the more stable countries in the Middle East, saw major political upheaval and the eventual overthrow of the Mubarak regime. The political unrest in Egypt spread, with Algeria, Yemen, Libya, Bahrain, Tunisia, and Syria all showing spreading unrest. In Libya, a civil war has started that has drawn in NATO forces. The Middle East upheaval is all about the desire for more freedom and let's face it, the governments being forced out are some of the worse violators of human rights in the world. However, since the Middle East sits on top of most of the world's oil supply, oil prices have skyrocketed by $25 per barrel since mid-February and we are now seeing very high gas prices here in the US as a result of these events.

A second major event was Japan's earthquake and tsunami. Beyond the sad human toll, the Japan earthquake added a nuclear plant meltdown scenario to the world's list of problematic events. Even though Japan is an island and only about 10% of world GDP, there certainly will be a global impact from this event. For example, the global supply chain will be impacted by the shutdown of Japanese plants from earthquake damage as the power grid in Japan has taken a big hit, losing approximately 10% of its output. US auto plants will experience periodic shutdowns in the months ahead due to shortages of parts manufactured in Japan. So, the Japan situation is going to impact our GDP in some way but the magnitude of the impact is still unclear.

What the Middle East and Japan earthquake/tsunami situations show is how events elsewhere can have an impact on our fragile economic recovery. Even though the US economy and job market are showing a grinding improvement since last summer, there still remains very large and global related macro risks that can become important factors

to us here in the US and could easily knock our recovery off course. For now, investors are discounting the major macro risks and the market is showing its resilience to negative news headlines.

For the first quarter, the S&P 500 returned a solid +5.9% for the quarter. However, gains from the stock market were quite narrow, with only two S&P sectors out of 10 outperforming the broad market. Unsurprisingly, given energy and commodity price increases, the Energy sector was the big winner, (+16.3%) with Industrials (+8.2%) the only other sector to outperform the S&P 500. The riskier small cap segment of the stock market as measured by the Russell 2000 Index also had a strong quarter, returning +7.9%. Value stocks modestly outperformed growth stocks during the first quarter with the Russell 1000 Value Index returning +6.6% while the Russell 1000 Growth Index returned +6.0%. Commodities and precious metals continued to move higher as the price of oil, gold, silver, corn, soybeans, and cotton all increased during the quarter.

Developed international markets continue to lag the US markets, mostly due to the Japan earthquake effect. The MSCI EAFE Index returned +2.7% for the quarter but Japan was down -5.8%. Europe performed slightly better than the US, returning +5.8%, helped by the strengthening Euro. The MSCI Emerging Markets Index returned only +1.7%, as slowing growth and inflationary pressures in key markets such as China and India and political/social turmoil in the Middle East weighed on returns.

Fixed income investments had a mixed first quarter. US Treasuries are facing pressure from budget deficit woes and rising inflationary expectations while corporate bonds remain the better place to be in fixed income as corporate profits remain strong. The broad US fixed income index, the Barclays Aggregate Bond Index, returned +0.4%, held back by the lagging performance of US Treasury bonds. Long-term Treasury bonds returned -1.0% for the quarter compared to +1.1% return for investment grade corporate bonds, +0.6% for mortgage-backed bonds, and +3.9% for high yield bonds. Due to Fed's current policy of maintaining short-term rates near 0%, money markets continue to offer no return opportunity to investors.

Summary

During the first quarter, the market returned nearly 50% of what I thought the market could potentially return for all of 2011. The market managed to do this despite several major unexpected events occurring that gave investors reasons to become more cautious. Instead, by early April, the Investors Intelligence bull-bear survey recorded the lowest bearish reading since late 2007 when the market began its major correction. As you may recall from January's newsletter, I identified four big picture issues that, depending on how they played out, could have significant influence on how the market performed during 2011. These included a sovereign debt crisis contagion, China economic growth and inflation, Federal/state budget deficits, and investor complacency. We can see from the bull-bear readings in the II survey that investor complacency remains high despite recent global events that add more uncertainty to the outlook. On the sovereign debt crisis front, Portugal recently joined Greece and Ireland in requesting a bailout (reported

to be $129B) so the sovereign debt crisis remains in play. A $100B billion here and a $100B billion there and eventually you are talking serious money. Watch out for Spain because if that one goes next, there is going to be a major market correction. In China, inflation pressures remain (their inflation rate is over 5%) and the China Central Bank is aggressively raising interest rates to try to get its inflation under control. As a result, the economy is showing signs of slowing down although China GDP growth is still at high levels. Why does China matter? Because China represents 20%-25% of world GDP growth. So, the China inflation/slowdown factor also remains in play. In the US, the Federal government flirts with the threat of shutdown and our current fiscal year budget is six months overdue. This is the type of scenario that occurs when you have massive budget deficits and difficult choices must be made. The problem of course is that politicians don't want to make difficult choices and face voter wrath. In the states, Wisconsin and Ohio passed legislation to reign in the power of public unions and to get control of their budget deficits. Both actions have been met with significant public discord. California still has a $15B budget hole it is struggling to close. So the Federal and state fiscal mess issue remains in play. Given that all of these issues remain in play, the rest of the year should be one heckuva wild ride.

Are we having fun, yet?

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