1st Quarter 2011

What a Pleasant Surprise!

The S&P 500, after two of the strongest back to back quarters in history, continued to drift higher in the first quarter of 2011. Most major averages experienced gains of 2 – 7% and the news flow on the economic front continued to be "slightly better". So what was the surprise?

If we had lined up 100 people on January 1 and asked them where the market would be on April 1 if the U.S was bombing Libya, there was a coup in Egypt and Japan experienced the worst nuclear disaster since Chernobyl, what do you think they would have said? Our guess is 100 out of 100 would have stated that the market would be MUCH lower. Yet all of those things did happen during a single three month period and the market went UP! How can that be?

Jobs and Profits

Ultimately stock prices follow profits, if valuations are relatively constant, and the first quarter was a shining example of that. Last quarter we talked about how company management teams continue to do an excellent job managing their business and maximizing profits in a slightly improving economy. In spite of all the scary news from around the world, the news in the U.S. continued to have a "slightly better" tone. Earnings reports from the 4th quarter and expectations for earnings in the 1st quarter continued their trend higher and outlooks have continued to improve for the remainder of 2011. Those solid results and better expectations cause investors to allocate capital to stocks which causes higher prices.

A new development for the U.S. markets is that we are beginning to actually see some job growth. If an investor tried to put their finger on one critical component that affects investor psychology more than any other it would likely be the unemployment rate. That number is still WAY too high, but the trend is moving in the right direction. Clearly if more people are getting jobs, that will lead to spending and a cycle of positive outcomes throughout the economy. This is precisely why we referred to the extension of the tax cuts as "the game changer" in our last letter. If companies have this new found savings, in the form of tax rates that stayed the same when they had high confidence they were going to go up, they are more comfortable spending money. We are hearing from companies that they are not aggressively spending money, adding staff etc. But, company management teams are telling us that they are willing to invest in shorter dated projects that have a high return on investment. Further, in many cases, for the first time in several years companies are willing to replace employees who leave and even slightly grow their head count by hiring new people. That is a seismic shift in psychology from six months ago.

An even more important shift in psychology that we are hearing is that "most" people are not near as concerned about losing their jobs as they were six months ago. If people feel their job is safe, they are much more likely to spend money on things they want/need that they have put off buying for awhile. This new spending makes companies feel more comfortable spending money and adding jobs and the spiral continues, which creates an expanding economy. This is economic theory clearly happening before our eyes. The resilience of the markets in the first quarter was surprising and impressive.

The "Not so Hidden" Threats

What about all those bad things we know about? The issues related to national debt levels, weak housing, European debt restructurings, Middle East violence, budding inflationary threats etc…. They have not gone away but they have gone off the radar screen for now. The government has succeeded, so far, with "kicking the can down the road." The strategy of worldwide leaders has clearly been to try to push off the inevitable long enough for the economy to improve and help make those problems easier to solve. To state it another way, "to fake it till you make it". So far the strategy appears to be working. Will it continue is the Trillion dollar question! One can only speculate but it is safe to say that eventually the piper will have to be paid and there will be some serious pain that is endured. But for now, the markets are choosing to not focus on those negatives and choosing to focus on the positives that do exist.

The intriguing thing about the first quarter was how the markets shook off the really scary news and, while volatile for a few weeks, continued its' march higher once the news flow tapered off. Will the markets continue to be able to do so as we have more news from Europe, the Middle East and Washington regarding the potential government shut down? That depends on whether the market can pass "the next big test"!

The Next Big Test and the Wild Card

What is the "big test" the market is going to face in April and May? Earnings! We are beginning to hear from companies the results for the 1st quarter. These announced results are critical to the continued health of the market. Some fear has begun to creep into the psychology of investors that the market may have fully discounted the earnings growth. It will be imperative that companies not only match expectations but to affirm that the outlook for the remainder of 2011 is consistent with the models that analysts are using to project results for the rest of the year. Analysts will be closely listening to conference calls for clues related to capital spending, hiring plans and end user demand for products and services.

The "Wild Card" we see in the market is inflation, and the corresponding threat that higher interest rates would create for this bull run. Inflation is percolating under the surface but so far is not showing itself dramatically in government statistics or company earnings reports. The inflation hawks in the Federal Reserve are beginning to talk about the need to raise interest rates but, so far, the consensus in the markets is that the Fed will not likely raise rates before year end. If that outlook begins to change in the market and/or the Fed surprises the market with a rate hike, investors could potentially run for cover.

One thing we feel very strongly about is that long term interest rates are going to go UP and potentially go up a LOT. We encourage every client to contemplate how that scenario might impact their situation. We have been planning for this possibility in all fixed income accounts we oversee but we would love to discuss your situation with you, if we have not already done so.

We are very pleased with the strong start we have had in 2011 and look forward to the remainder of the year. Please let us know if there is anything that we can do for you. We appreciate the confidence you have in us!