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Market Resilience

Year-to-date, major markets have weathered ups and downs to a point that domestic averages, international developed, and international emerging markets are locked in a race for dominance. At this writing, U.S. markets are ahead 8.52%, while the MSCI EAFE as a measure for developed markets is up 8.77% and emerging markets have gained 5.22% YTD. This is not bad, of course, as all these markets have digested political unrest in the Middle East and North Africa, some increased worries about the persistent Euro zone debt issues, and the aftermath of the quake and tsunami in Japan. In addition, markets must contemplate the impact and likelihood of higher interest rates, higher inflation and higher taxes, at least in the U.S. This represents a pretty full plate for investors to digest, and markets have become increasingly tentative as we head into the balance of the year.

In the U.S. much is being made of the anticipated end of the Fed's quantitative easing efforts and what, if any, might be the economic impact on this phase of the recovery and hopefully, on an expansion that has strength and staying power. This question is very important for economic activity in the U.S. and for the rest of the world as well. Again, in order for stocks to do well, the business cycle needs to continue to expand and drive earnings growth, which over time will ultimately do the same for stock prices.

So, what about the stimulus that has been in the mix here for some time – the so-called QE I and then QE II? In November 2008, at the height of the financial panic, the 10-year Treasury yield fell to almost 2%. QE I came along and yields moved up to almost 4%. When this phase of the Fed's exercise ended in March of 2010, yields promptly fell to around 2.5%. In November of 2010 the Fed began QE II and yields again moved higher. This raises the question of what might happen when this phase ends. The answer is that nobody knows for sure, but we can all probably agree that markets, rates, currencies, commodities and on and on, have been discounting this event for some time. A skeptic or cynic might therefore answer that (a) we already know, and/or (b) not much.

Keep in mind that when the Fed was considering a new phase of easing, the financial crisis had long since past, the U.S. economy had begun to recover, and the Fed was very concerned that Japanese style deflation could be in the offing. While Chairman Bernanke never actually forecasted deflation in 2010, there is some agreement among economists and Fed watchers that he feared

deflation could ensue and once established, would be very difficult to escape. In the time since, markets in the U.S. are higher, the dollar is lower, Treasury yields are higher (not lower), commodity prices have soared, and the U.S. economy is still recovering and expanding, albeit at a very tentative pace.

All of the above looks pretty good in retrospect – higher markets and a recovering economy- but some of this has the look of some years ago when the Fed was accused of conducting policy with the express purpose of injecting life into equity markets. Mickey Levy of Bank of America wrote a great piece in March detailing the numerous benefits of QE II over the short term, but highlighting the costs of excessive monetary accommodation. The lower US dollar stimulates exports, but reduces domestic purchasing power and the excess supply of dollars has contributed to higher commodity prices that have pushed up global production costs. Inflation pressures have increased in emerging nations where food occupies a greater weight in some inflation measures and upward pressures here may well take some time to subside.

Indeed the biggest risk is no doubt higher future inflation rates and inflation expectations. Leverage is still the order of the day – certainly in terms of sovereign debt and central banks as well. In economic and monetary terms this represents some form of a catch-22: when and if central banks begin to wind down the size of their bloated balance sheets, representing an element of monetary tightening, the results will not be good for the recovery or the staying power of the expansion. On the other hand, should central banks delay addressing the process of deleveraging, the fires of future inflation are fanned and inflation expectations will rise.

This brings us to the point of how policy makers will face the dilemma of all the debt that was created in the aftermath of the financial crisis of 2008. The answer to this question is... very carefully, and glad that others have this huge task and responsibility.

In a sense, all of the above represents the bad news. The good news is that markets, in their constant march of discounting future events have already adjusted for much of this. Valuations are very reasonable, both here and in international markets. In the US, price earnings ratios are about 14 times estimated 2011 S&P 500 earnings. Earnings, the much-watched part of this fraction and perhaps the ultimate reward, have been rebounding and continue to be the highlight of this recovery.

Over the next few years, the likely outcomes are that either exogenous events or policy missteps cut short the recovery, causing earnings to suffer and markets to weaken. The second would be a period of continuing very slow growth, and perhaps somewhat higher inflation and interest rates, limiting market returns. The last outcome would be the world extracts itself from the severe downturn of 2008 and economic recovery accelerates to a pace more resembling previous cycles, and markets celebrate on the upside. Not surprisingly, we feel the second outcome is more likely – periods of slower growth and, over this period, more muted output levels and market returns. Not the end of the world, and in view of the very impressive returns for calendar 2009 and 2010, not an unreasonable scenario for investors after the calamity of 2008.

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