APRIL 2011: MARKET COMMENTARY

The last month has certainly been filled with enough crises for the year. Japan's devastating earthquake is heartbreaking as are the plights of many struggling to effect change in Libya. Oil prices are soaring and various Middle Eastern countries appear to be growing less stable rather than more so. And, lost in the background, Portugal has been threatening default. Their problems continue to destabilize other economies, possibly leading to more European economic problems.

However, after the initial shock of Libya and then Japan wore off, world stock markets have bounced back quickly ignoring additional concerns. For various reasons, this is very much what we expected and we believe that this trend will continue. In spite of the high profile worldwide trauma, positive economic trends are gaining momentum. Moreover, the pace of improvement is accelerating and is likely to continue.

The U.S. economic recovery should continue to gain traction assuming various global crises don't worsen significantly. Global growth may be adversely affected, but probably not much.

Japan isn't an engine of global economic growth and their current challenges are unlikely to cause major economic dislocation outside of the country. The on-going nuclear issues cloud the foreseeable future, but the problems appear to be lessening. Shocks to global economies are much more likely to result from supply disruptions than import declines. Japan's share of U.S. exports was only 4.7% in 2010 and merchandise exported to Japan represented an almost infinitesimal 0.4% of U.S. GDP. Supply chains will be affected, but substitutions will inevitably take place. Sales themselves are unlikely to be affected.

Unfortunately for Japan, because substitute suppliers will be found, this could slow their future recovery as they struggle to win back business. Japan's growth is expected to be flat for 2011 versus original projections of around 1.5%. If this target is accurate, global growth is expected to decline, but only by about 0.1%. Assuming this scenario unfolds, global markets will hardly notice.

In the Middle East, Saudi Arabia appears to be exercising restraint in Bahrain and Yemen. At least for the moment, Iran isn't rushing into Bahrain and tensions appear to have stabilized. Oil supply lines haven't been targeted. In Libya, the no-fly zone appears to be at least marginally successful and the international coalition appears to be moving forward rather than deteriorating. It's even possible that Libyan oil production could rebound in the foreseeable future. While the situations are obviously messy and continue to exact painful human tolls, the economic fallout appears to be fairly limited.

One notable issue that may have interesting economic and political ramifications for decades is significant changes to money flows occurring during the Middle East crises. Typically, when one Middle Eastern country experiences challenges, funds and refugees flow to different Middle Eastern countries, but the money and people stay in the region. These crises are changing that pattern. Million dollar plus real estate in London and select other cities is seeing vastly expanded interest as the wealthy flee and look to settle or diversify holdings out of the region. At a recent conference I attended, an informal poll of global asset managers revealed an unusual spike in inflows from the Middle East across various asset classes. While it's too early to know what this means for the long term, it strongly suggests that changes occurring now will be much more long-lasting and structural in nature. At first guess, it would seem greater interconnectedness and dependency would benefit growth, rather than hinder it.

In Europe, Portugal's problems shouldn't prove too damaging. The European Union and the International Monetary Fund should be able to handle Portugal's problems and prevent the rest of troubled countries such as Spain, Italy, Greece, and Ireland from sinking the European ship.

In all these instances, anything can happen and it's impossible to accurately forecast future developments or their complex interactions. However, as in most instances, we believe that panicking is likely very ill-advised and pushing ahead with an intelligent, and alert approach, makes the most sense. Problems are always here, but none of these should derail the U.S. economic train which continues to slowly pick up speed.

Several domestic issues have also been somewhat unsettling recently. While there are still various issues that cause concern, a couple of the more prominent are February's decline in manufacturing orders and the plunge of sales of previously owned U.S. homes. Housing prices hit their lowest level in nearly nine years, implying a housing market recovery may still be a ways off.

However, both of these issues appear to be bumps in the recovery road rather than changes in direction. By early March, applications for home mortgages had jumped to the highest level in three months. According to the Mortgage Bankers Association, its seasonally adjusted index of mortgage application activity, which includes both refinancing and home purchase demand, rose 15.5 %. The percentage was the highest level since the week ended December 10, 2010, and was the biggest increase since June 11 of last year.

Manufacturing data appears to be more a slowdown from previously very robust levels rather than a problem. In fact, manufacturing growth has been the leading creator of jobs in the US and the sector is enjoying fairly robust growth.

The jobs picture is largely the engine behind these improvements. Private sector job creation is picking up speed with private employers creating 201,000 jobs in March according to ADP Employer Services. These numbers generated enthusiasm and even elicited forecasts that the market may break out of its recent trading range. While the market forecasts may not be particularly meaningful to long term investors, the positive sentiment is welcome.

The housing industry is even expected to add to GDP this year and also contribute jobs gains of around 125,000. While neither gain is large, any help from this sector is welcome after the pain inflicted during the last five years. After subtracting from the economy in 17 of the past 20 quarters and shedding 1.44 million jobs, positive contributions from the housing industry will be welcome. In a further sign of growing recovery, apartment construction, and remodeling are also increasing.

Overall, in spite of all the uncertainty, we believe the US economy will continue to slowly improve and most risk based assets will benefit. Major long term issues still exist such as deficits and massive regulatory increases, but we expect the near term progress to outweigh these longer term issues in the immediate future.

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