

## ***ECONOMIC AND MARKET OUTLOOK FIRST QUARTER 2011***

Rarely have so many impactful events occurred in one year as happened in 2010. Collectively they have already left a deep foot print on the domestic economy. Their ultimate affect, however, will continue to unfold over decades. The new Health Care Bill was signed into law in March and touched off a firestorm of protest and challenges which will last for an extended period. The explosion of the BP well on April 20th caused a total shut down of new drilling in the Gulf. Officially the ban has been lifted but new drilling has not started due to regulatory reviews of permit applications. The Dodd-Frank Reform and Consumer Protection Act, signed in May, spawned a huge number of new regulations which are still being worked out. The election brought a dramatic change to the Congressional make up far in excess of a normal mid-term rebalancing, signaling a widespread dissatisfaction with the policies of the government. Immediately after the election the bipartisan Commission on Reducing the Deficit weighed in with a broad and clearly reasoned expose of government spending excesses and suggested remedies. Very late in the year the House and Senate voted convincingly to extend the Bush era tax cuts, which themselves were enacted during an earlier recession. All this occurred during a ten month span causing one of the more volatile and emotional stock markets in recent memory.

The passionate response to dramatic news overshadowed an economic recovery which has grown sturdier as the year wore on. Industrial production increased again in November and at double digit rates over the past year. The gain in November was noteworthy with broad strength in manufacturing, business equipment, information processing and industrial subcomponents. The strength was even more impressive considering that motor vehicle output declined in that month. All signs point to a positive forecast for production in the New Year. Replacement spending, low cost of capital, and strong corporate finances are motivating businesses to invest in plant and equipment. Rising social costs, a renewed drive for productivity, and favorable returns on investment are underpinning software and information technology spending. The new accelerated depreciation allowance on business spending in 2011 adds to an already favorable outlook.

Exports are booming and have become a crucial support for the economic recovery. Net exports, i.e., exports of goods and services minus imports of the same, grew 17% in the first ten months of the year. The global appetite for American products of all kinds, from agricultural products, to metallurgical coal used to produce steel, to heavy machinery, to consumer products, is an impressive and pervasive feature of a rising standard of living in emerging countries, and a ringing endorsement of the benefits of cross border trade. A weaker dollar will continue to support a strong trend in exports. The Administration has discovered the benefits of exports in taking up the slack from a strained consumer, and creating jobs. It has announced a goal of doubling exports over five years, a goal which is unlikely to be met without more forceful leadership in bilateral trade matters, including agreements which have been languishing in the Congress for years.

While the Consumer Price Index and the Producer Price Index have been tame and roughly in line with expectations in recent months, there are some significant underlying trends worth noting. The core CPI, i.e., excluding food and energy, is no longer declining and will trend modestly higher in the coming year. This is because rents, which account for about 40% of the core and have been declining all year, appear to be rising modestly. A rising core CPI, of course, is the stated goal of the Fed in purchasing an additional \$600 billion of long term treasuries. The Fed hopes that by holding interest rates artificially low it can also lower unemployment, in keeping with its dual mandate of price stability and full employment. The core Producer Price Index also has been calm but faces significant upward pressure from prices in early stages of production, primarily commodities. All measures of inflation will be in modest upticks in the New Year, a trend which bears close scrutiny especially in view of the Fed's continuing aggressive expansive policy.

The outlook for interest rates is also going through a fundamental reevaluation. There are a number of reasons for this. Evidence that the recovery is sturdy and expanding, the aggressive stance of monetary policy and the promise of further Quantitative Easing steps if employment does not improve sufficiently, the compromise package of tax cut extensions, and a changing view of inflation have caused a directional change in attitude. Further evidence of fundamental change can be seen in the treasury market. Despite Fed purchases of treasuries the bellwether 10 year note has risen from 2.38% in October to over 3.3% currently. Net flows into high grade bond mutual funds have also ceased after ten months of strong inflows. There was a record outflow of \$2.5 billion from high grade bond funds in the latest month. In our opinion interest rates have seen their lows and will trend higher over the coming year. This trend could impact mortgage refinancings and possibly the deficit through higher interest rates on treasury offerings.

We are encouraged about the potential for 2011, and believe the stock market will be a primary beneficiary of improving growth prospects. The US economy is changing for the better, but it is not without short term and long term challenges. Corporate earnings will remain strong, supported by strength in the industrial and export sectors, and improving consumer spending as employment and incomes rise. The temporary extension of the tax cuts provides at least a two year window of stability for planning purposes. Despite the current burst of enthusiasm about the economy, however, the recovery will remain vulnerable to a strained housing market and potential disappointment in the pace of new job creation. Inflation also holds the potential for negative surprises. The sharp rise in oil prices may also negatively affect a promising resurgence of consumer spending. Long term, the rapidly growing government deficit, unfunded entitlements, and undisciplined spending by the Congress remain the most serious challenges to our country's well-being. These issues will not be addressed any time soon, and will overhang all government priorities over the coming year.

We wish everyone a wonderful Christmas Season and a happy, healthy New Year.

**Investment Policy Committee**  
**Alfred A. Lagan, CFA, Chairman**  
**Daniel A. Lagan, CFA, President**  
**December 23<sup>rd</sup>, 2010**

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