



Economic and Market Outlook - 2nd Quarter 2011

From its inception, the New Year has witnessed its share of tumultuous events. It is not feasible to discuss the outlook for the economy and the financial markets without reference to these extraordinary occurrences. Each in its own way could have long lasting significance for the world economy.

It is no exaggeration to say that the entire Arab world of the Middle East, governed mostly by hated despots, is aflame in a geopolitical tsunami which holds potential for both great peril and benefit for the U.S. economy and our national security. Early in January Tunisia erupted in widespread demonstrations following the self immolation of a street vendor in protest of high unemployment and lack of opportunity. In a very short time the dictator of 23 years was forced to abdicate. Within weeks protests in Egypt forced the President of over 40 years, Hosni Mubarak, to resign. Inspired by the events, Bahrain, Iran, Syria, Yemen, and Libya erupted in violent protests against their repressive regimes. In every one of these countries it is the young who initiated and led the demonstrations. Educated, unemployed, frustrated, and seeking a future, they are faced with lack of opportunity and endemic government corruption. They are not terrorists or mercenaries. It defies the obvious to think that these and neighboring countries will return to their former ways of governing. For the U.S. and its European allies the obvious danger of war and upheavals in the region is the disruption to the supply of oil. While the U.S. has diverse sources of oil, Saudi Arabia in particular is a major supplier and any cut-off would have serious economic consequences. Hopefully the threat to our dependence on oil supplies from the region will, finally, force the adoption of a sensible domestic energy policy to provide for the country's economic and national security. This happy ending has eluded us since the first Arab boycott in October, 1973.

Other dramatic shocks weighed heavily on the financial markets in the first quarter. The tragic earthquakes in New Zealand and Japan and sudden return of the debt crisis among euro countries added to the nervousness and heightened volatility. Aside from the terrible human cost, the massive quake in Japan shut down vast swaths of Japanese industry. As a major supplier of industrial and technology products the tragedy is most certainly damaging to global growth in the near term. Assuming that the nuclear plant is brought under control soon, reconstruction and rebuilding will start immediately and on a massive scale. It may provide incentive to stimulate Japanese economic growth, which has been under achieving for years. The financial crisis in Portugal is further indication that the problems of the heavily indebted nations of the euro zone have not been cured. The recent approval by European Finance Ministers of an enlarged permanent crisis fund is a step in the right direction but probably not enough to satisfy the capital markets.

The cumulative affect of these disturbances will be felt in the new quarter, and individual companies may find themselves very challenged. However, the United States economy is getting stronger and broadening out. Cumulatively, these events may slow but will not upend the recovery, and some damaging results may prove temporary. Most important to our economic outlook the labor market is slowly but steadily improving. The economy added new jobs for the sixth consecutive month in February and unemployment fell to its lowest level since April 2009. New jobless claims have declined in 5 of the past 6 weeks giving confidence that the underlying trend in labor market is in the right direction. In tandem with a brighter outlook for labor, income levels are also increasing. Wages and salaries rose 4.4% year over year in February compared with 3.8% in January. The rising trend is not lost on the consumer. Personal spending rose a healthy 0.7% in February with particular strength in automobiles. Thus far consumer spending has not been impacted by rising gasoline prices.

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The factory sector continues to show no evidence of a slowdown. Building on strength as 2010 drew to an end, manufacturing industrial production continued its robust expansion through the first quarter. The rising tide of production was corroborated by the various Federal Reserve monthly regional surveys which registered large gains. Replacement spending, low cost of capital and strong corporate finance are motivating businesses to invest in plant and equipment. Rising social costs, a renewed drive for productivity, and favorable returns on investment are driving software and technology spending. Corporate America reported an aggregate \$1.7 trillion dollars in cash on its balance sheet at year end, and profits are rising. With the new temporary accelerated depreciation allowance in full force this year the manufacturing sector is leading the domestic economic revival.

Interest rates especially for Treasuries benefited from the flight to quality as volatility rose to near record levels in the quarter. The Federal Reserve has reaffirmed its very aggressive monetary policy, and has pursued the purchase of an additional \$600 billion of open market purchases of Treasuries. This program will end by June 30, 2011 and should not be renewed. Thus far the quantitative easing program has not benefited the housing market, which remains stuck in mire. Still, housing affordability is very high and the market is close to stabilizing. In our opinion interest rates will rise over time as the financial markets price in a stronger economy and stability in housing becomes apparent. Inflation levels remain non-threatening, but will experience a modest uptrend as import prices continue to increase and consumers gradually become a little more accepting of higher prices.

The most serious problem facing our economic health is the rapid increase in the nation's debt which has surpassed all acceptable levels of soundness. This issue is the gorilla in the house, and all other worries and uncertainties are small by comparison. There are indications that some leading legislators recognize and are willing to address the problem, but broad support and leadership by the Administration is tenuous at best. We can only hope that a long term solution emerges from current discussions. Absent this overriding concern, we view the U.S. equity market as fundamentally cheap and believe it will respond to rising earnings and attractive valuations as the economy continues its expansion.

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March 30, 2011

