<u>Outlook for April, 2012: "A Pullback?…"</u>

With equity markets posting their best First Quarter gain since 1998 (propelled by excess global liquidity), we continue to worry about the prospects for a near term pullback as well as the longer term implications of such overly loose monetary policy. To paraphrase George Santyana, "those that cannot remember the past are condemned to repeat it"! It certainly appears to us that Fed Chairman Bernanke and many senior leaders of the Federal Reserve are turning a blind eye to history.

Economic data released recently has been generally positive, with a hint of caution: The U.S. Department of Labor reported a smaller than consensus increase of 120k jobs in March – underperforming expectations in the region of 200k. In the past twelve months, the US Economy has added 1,899 thousand jobs – a pace of roughly 158k jobs per month. In terms of sectors, leisure and hospitality (+39k), education and health services (+39k), and manufacturing (+37k) were the leaders, while construction (-7k) and government (-1k) were the laggards.

The politically sensitive unemployment rate, as part of the larger household survey, dropped further to 8.2%. The U-6 measure, which we view as a more realistic picture of unemployment, also posted a significant drop of four tenths to 14.5% for March. Long-term unemployment (comprised of those jobless for 6 months or more) was mostly steady at 5.3 million, representing 42.5% of the unemployed (previously 42.6% in February). Many of the other measures including hours worked (-0.1 to 34.5 hours) and average hourly earnings (+.05c to $23.39) suggest some loss of momentum in the labor market.

The Bureau of Economic Analysis of the Department of Commerce pegged the final estimate of 4Q GDP growth at 3.0% (q/q, saar) – similar to the initial estimate of 3.0%. Sizable gains in gross private domestic investment (+22.1%), nondurable goods consumption (+16.1%) and residential investment (+11.6%) paced much of the increase. Decreases in government expenditures (-4.2%) detracted from GDP gains while the real final sales figure increased a modest 2.0%.

The mild winter and warmer than usual spring that the US has enjoyed might have something to do with the modest nature of growth expectations going forward. The mild climate could very well have pulled demand forward from future quarters, thus leading to anemic growth in the upcoming quarters. Also of note, is the significant rise in gasoline prices ahead of the summer driving season. Higher gasoline prices act like a tax on personal spending and most consumers tend to cut back spending in other areas as gasoline prices rise above $4.0 per gallon.

The Federal Reserve at the conclusion of its FOMC meeting in mid-March, did leave the Fed Funds Target unchanged at 0.0%. The FOMC also made it clear (despite a single dissenting vote) that the Fed Funds Target would be held at the 0.0% level at least until late 2014. In a nod to the improving economic picture at that time, most members of the FOMC felt that the labor market had improved somewhat and the outlook had brightened.

Our considerable worry with regard to the Fed's pursuit of full employment to the perceived detriment of price stability has more to do with the risk that the Fed will be unable to take the punch bowl away when the party really gets going. Indeed, to be kind, history is not on the side of the Federal Reserve – as there are multiple episodes of Central Bankers who thought they were clever enough to recognize the exact moment when they should remove excess liquidity.

It is true that the Fed's dual mandate of full employment and price stability (as enshrined in the Federal Reserve Act of 1913) does provide a quandary to policymakers. However, it is only the Bernanke Fed (especially since the financial and housing crisis of 2008) where full employment appears to be more of a first among equals – especially as it relates to the conflict with price stability.

Fed policymakers have also conveniently removed some of the volatile components in their measure of inflation (the famous ex-food and energy measure). The theoretical underpinnings for such an exclusion are legitimate, but as we are often fond of saying – "real people do eat and drive as well"! The FOMC remains convinced that lack of aggregate demand is primarily responsible for the under-performance of the US economy.

In the topsy-turvy world of central banking, and amidst the reality of zero bound to interest rates, the Fed has resorted to unconventional methods to stimulate demand – buying mortgages, buying government issued paper and then attempting to twist the shape of the yield curve – by selling shorter maturities and purchasing longer maturities with the proceeds.

We continue to feel that despite their assurances and perceived air of superiority, central bankers are humans first and have all the normal failings of human beings – especially when it comes to forecasting economic outcomes. Time alone will tell whether policy moves by the Bernanke Fed are appropriate given the underlying economic fundamentals: We remain skeptical that the Federal Reserve has somehow magically attained the capacity to see around the bend – as history's lessons often appear to suggest otherwise.

Farther afield, yields on Spanish government debt and those issued by some of the other peripheral European countries have started to rise again: The debt crisis in Europe continues to roll on. It has been almost two full years since the first "bailout" of Greece in May, 2010 and it is quite apparent that even Greek's problems have not been entirely solved.

In another evidence of excess global liquidity, the European Central Bank has performed two rounds of "Long Term Repo Operations" thus providing over $1.0 Trillion to European banks over a three year term. This largesse has found its way back into the government debt markets – where European Banks are happy to purchase this debt at whatever level the current yields are – as long as the yield is above their funding cost of 1.0%.

While the ECB was patterned after the German central bank ("Bundesbank"), with price stability as its sole policy remit - it has been forced, by a series of unfortunate circumstances – to act more like an instrument of fiscal policy rather than pure monetary policy. The ghosts of central bankers past are likely to disapprove of all the unorthodox moves made by the ECB's current head, Mario Draghi.

Also, the Chinese economy appears to be in the throes of a slowdown as well. The sudden dismissal of Bo Xilai, a charismatic party secretary of Chongqing, has also managed to complicate matters for the government. Mr. Bo was known for his aggressive tactics against organized crime and was also quite popular amongst the masses. His dismissal goes to show how close the powers that be in China hold their cards to their chest.

Closer to home, we are struck by some of the parallels between the internet bubble era and the hoopla surrounding the price of Apple, Inc. We do not normally spend much time analyzing the valuation of individual stocks. However, a recent news report about an analyst making the case for Apple to top $1,000 a share started us thinking: At $1,000 a share, Apple's market capitalization will be close to a $1.0 Trillion and it will represent almost 7.0% of the country's GDP!

Much will be made of this upcoming earnings season. We do think that earnings expectations appear to be reasonable going into it: As usual, we do expect to see many corporations beating lowered ("well managed") expectations, along with some spectacular misses as well. For the most part, however, we expect a "normal" earnings season. While recent price increases have pushed valuation multiples higher, we do not view the level of valuation mutiples as representing a significant risk or problem.

Commodity prices have seen some volatility lately as traders and market participants have worries about the risk of a supply disruption from the Middle East. Interest rates have also remained quite capricious, first rising on fears of inflation and then falling on fears of anemic job growth. We suspect that the low level of interest rates is also a contributing factor to the volatility.

In summary, we continue to position your portfolios with slight optimism for the future. While we worry about the possibility and risk of a near term pullback, we do feel reasonably positive over the medium to longer term prospects for financial markets. Indeed, our abiding faith in a fully diversified portfolio - that has a balanced approach to both risk and return - as the main way to attain favorable investment outcomes over the long haul remains unyielding (pun intended!).

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