



Investment Perspective

After back-to-back years of double-digit returns in equities investors appear to have renewed confidence and enthusiasm. Since plunging to an ominous 666 in March 2009, the S&P 500 has rallied 89%. Indeed, 2010 was a positive year for virtually every asset class. The CRB index of 19 commodities posted a 17% increase, led by cotton, silver, and corn, and many metals and raw materials, notably gold, vaulted to all-time highs. Bonds, as measured by the Bank of America Global Broad Market Bond Index, increased 5% (although the specter of rising rates later in the year chipped away at returns). Real estate (measured by the Dow Jones U.S. REIT index) climbed 27%, and even the much maligned U.S. dollar index increased 1.5%, as gains earlier in the year were enough to offset a 10% drop in the second half.

For much of the past two years financial markets have benefited from a virtual perfect recipe of macroeconomic conditions: historically low interest rates, zero inflation, ultra accommodative monetary policy, massive fiscal stimulus, and a favorable political climate. These conditions helped markets weather a nasty summer downturn and, by most measures, the U.S. economy appears to have caught a second wind and is now reaccelerating. Buoyed by continued growth and demand from emerging economies, U.S. manufacturers are reporting an increase in order activity, consumer spending is increasing, and even employment seems to be improving at the margin. These factors caused many economists to revise upward their recent estimates for growth, and with the Fed's foot pressed firmly on the gas pedal and confidence improving, there is reason to believe growth may accelerate to the upside.

All this is good news, to be sure, however, there are reasons to be cautious over both the near and long term. Cyclical headwinds are emerging and threaten the relatively nascent recovery. Despite headline news to the contrary, inflation has reappeared in certain sectors, and recent data suggest input prices are up significantly. Whether producers can pass some or all of the increase in raw material costs on to customers remains to be seen. Interest rates have shown signs they may be ready to break to the upside. Indeed, after spending several months below 3.0%, the yield on the 10-year U.S. Treasury bond jumped 50 basis points in December to 3.3%, leading mortgage rates higher. Finally, the price of oil broke above \$90 per barrel, translating to above \$3 per gallon at the pump, thereby acting as an incremental tax on consumers.

In addition to these gathering fundamental economic headwinds, investors have become complacent, if not overly bullish. Sentiment readings near historical highs confirm this, as do recent option trading and volatility. To wit, market volatility declined 18% last year and now stands at 17, well below its long run average and near the level it stood last summer just before the European sovereign debt issue exploded. This burgeoning exuberance has found its way to the private sector as well: Facebook recently raised funds that value the company at \$50 billion. While this valuation may ultimately be warranted, it is estimated to be 25x revenue and is more than many companies in the S&P 500, including Boeing, Costco, Nike, and Lowe's.

Looking ahead, the most likely scenario still seems to be one of continued economic recovery and healing. Still, however unlikely it may seem, serious downside risk from another financial crisis cannot be ruled out. For now, the U.S. remains the globe's largest economy and the U.S. dollar appears to still have reserve status. This allows us to print money as necessary to fund our spending etc. However, as our debt approaches the "legal ceiling" of \$14.3 trillion, one has to wonder how long we can ignore the 800-pound gorilla. In the meantime, momentum may carry asset prices higher than most currently expect. At times like these it is worth repeating Warren Buffet's adage: "be fearful when others are greedy...be greedy only when others are fearful."

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