# BRIEF REFLECTIONS

**January 31, 2011**

The year 2010 came to a close with overall strong returns in equity markets, as the S&P 500 Index rose approximately 13% and the New York Stock Exchange Composite increased 10%. All sectors of the market have risen with some of the largest gains made in small and mid-capitalization stocks. Unfortunately, the bond and mortgage markets did not conclude the year with the same euphoria, after having reversed early gains during the fourth quarter. The outlook for higher economic growth rates, the return of investor confidence, and concerns regarding higher inflation in 2011 against a backdrop of quantitative easing and the new stimulus package resulted in some profit-taking in the debt markets. We expect this dichotomy in financial markets to persist as the New Year unfolds.

On the geopolitical front, the recent upheaval in North Africa over the weekend could have the potential to diminish investors' near term risk appetite for participation in the financial markets. Investors worry that the uncertainty associated with civil unrest in the region could disrupt oil supplies from the Suez Canal and the Sumed pipeline, which together transported an estimated 2.8 million barrels/day of crude oil (roughly half the current level of global spare capacity) in 2009. These concerns have focused on the risk that instability could spread to larger oil producers in the region spiking crude prices and sending bond yields lower and the U.S. dollar higher. Much depends on how the Egyptian protests are resolved, what type of government ultimately emerges and whether the unrest spreads to other countries in the region. It is important to note that the dollar cost of oil consumed in the major developed economies as a share of economic output still remains well below past peaks.

We see these developments in the Arab world as a consequence of years of oppressive dictatorships and economic stagnation, not unlike the communist regimes of Eastern Europe that culminated in the collapse of the political framework. Despite high oil prices, the decline in sources of foreign aid has been unable to offset the demands associated with population growth. As new technologies have made regime behavior more visible to the public, the cost of repression has escalated. We view these events positively in the context that the Muslim world could endorse progressive democratic solutions that are aligned with United States interest in containing stability in the region.

Despite near term geopolitical concerns, we are encouraged that commodity markets – most notably in agriculture – are already in the process of correcting the inflationary consequences that contributed to the underperformance of emerging market equities at the start of 2011. Rising inflation in India, for example, prompted another quarter-point rate hike by the central bank last week, and the local markets are now down over 10% year to date. We view the monetary response to rising commodity prices as a healthy extension of the global economic expansion. As long as the potential oil price shock is temporary, any pass-through response in the raw commodity markets to retail consumer prices should be muted and have little effect on investor sentiment and consumer confidence.

The real GDP which was just released showed that the U.S. economy grew at a 3.2% annual rate, its sixth consecutive gain, recouping much of the losses from the past recession. It is worth noting that real final sales which exclude inventory investment rose at a torrid 7.1% rate, the fastest pace since the second quarter of 1984, with final domestic demand rising at a healthy rate of 3.4%. These numbers compare very favorably to the third quarter results which showed an improvement of growth of only 2.6% versus the previous quarter, when many economic forecasters worried about the possibility of a double-dip recession. Consumer confidence has risen coincident with rising consumption and bullish trade figures. In summary, the prospects for U.S. recovery remain encouraging as we forecast a 3.0 to 3.5% GDP growth rate this year, with relatively modest inflation at 1.3 to 1.5%. We expect 2011 to be a very positive year for overall corporate profits as well, rising as much as 10-15%, and markets should respond accordingly.

We are encouraged by early signs this year that our sector exposures and individual stock holdings have already enhanced relative returns against the broad market indices, adding several hundred basis points of relative performance over the past two months. In December, our intrinsic value bias lifted the share prices of Progress Energy and Anadarko shares with tender offers. We would expect this phenomenon to continue throughout the year, as the economic recovery gains momentum.

Peter Altman
President