COMMENTARY 2011 Q1

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At the end of 2010, we saw continued reasons for cautious optimism, but also felt that volatility was likely to remain high. In view of the alternatives, we felt it best to stay largely invested. For the first quarter of 2011, the S&P 500 managed to gain 5.4%, despite the escalation of tensions in the Middle East, the largest earthquake recorded in Japan and related tsunami and the continued sovereign debt stress across Europe. Even with all of these situations, this has been the best first quarter return for the S&P 500 in more than 13 years.

For the first six weeks of 2011, the S&P 500 moved up almost 7%. As turmoil broke out in the Middle East, oil prices rose 15% from the middle of February to the first week of March. Then on March 11, the earthquake and tsunami struck Japan and the market retreated back to where it began the year. Towards the end of March, sentiment again turned and the S&P 500 managed to be flat for the month. The return for the market was mostly driven by two economically sensitive sectors: energy up 17% and industrials up 8%. No single sector had negative performance for the quarter.

Domestic Backdrop Continues to Show Signs of Recovery

Although we were somewhat surprised by the strength the market exhibited in the second half of March, we did see a number of positive developments during the quarter that helped to drive this performance. Corporations continue to show signs of strength, as evidenced by improvements throughout the quarter in surveys measuring key variables such as hiring and capital investments. Several key data releases support this positive outlook, with robust results from indicators such as manufacturing activity and retails sales, to name just a few.

Consumer confidence echoed these views, having reached a 3-year high in the quarter and settling at a level firmly above the lows of the recession. Employment numbers also continue to show improvement, although the rate of improvement remains tepid and wage growth has been weak.

Unexpected Macroeconomic Developments Could Hamper Growth

As we have highlighted in previous commentaries, the market continues to wrestle with a number of large longer term macro concerns. Many of the positive data points we highlighted above were generated during periods before the Middle East unrest and the Japanese earthquake and resulting tsunami. Given these added pressures, we will need to watch statistics closely for signs of deterioration.

Throughout much of the Middle East people have assembled to demand change in their countries' governments. In several instances, dictatorships have been swept aside, but there are issues that need to be confronted. Violence in some of these countries has resulted in supply disruptions. Disruptions and fear have driven up the price of oil. No one really knows what governments we may see or how friendly they will be toward U.S. interests and global economic stability.

The situation in Japan continues to unfold and there are important investment implications as a result. Most critical, major capacity to produce components and finished goods has been shut down and is disrupting supply chains around the world. In addition, reconstruction in Japan could create demand for materials and capital goods. Funds for this will have to come from somewhere, and this may put pressure on U.S. Treasuries since Japan is the third largest holder of these financial instruments.

The complications at the Fukushima reactors may have broader implications. Energy generated by nuclear facilities may shift to other alternatives. This may drive up the demand for natural gas globally. It also means that around the world, nuclear energy is going to be scrutinized. Some plants may be taken offline for brief periods for inspection or retrofitting and others may be closed permanently. Proposed new plants are likely to cost more and some may never be built.

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Expect Increased Market Volatility through the Remainder of the 2011

While no-one has a crystal ball predicting what will happen, it appears more likely that we will be dealing with higher priced fuel than previously thought. It appears that the U.S. Administration has become more interested in the idea of energy independence, though we have yet to see what sort of impact this may have. As a greater portion of consumers' discretionary spending disappears into the gas tank, our outlook for the consumer is less certain. Recent surveys suggest that consumers are becoming concerned about the impact of gasoline price increases.

Another big issue for the balance of the year will be the direction of interest rates since the Federal Reserve's quantitative easing program is scheduled to end in June. Housing statistics (which may have been affected by bad weather) are already showing signs of strain with the number of new houses currently being built at the lowest level on record. The Fed continues to be committed to holding down interest rates to support the housing market and broader economic activity, but that will only work as long as unemployment stays at its current levels and they can continue to assert that inflation is benign. Further, the Fed is not the only player who can impact rates, as the Chinese and Japanese hold significant positions of U.S. Treasuries. China is trying to slow its inflation. Recent comments also suggest that the Chinese are interested in reducing their trade surplus with the U.S. which could result in less demand for U.S. Treasuries. The events in Japan and their need to rebuild could mean that a portion of Japan's Treasury holdings would be sold. Given all of this, the Fed may discover that it needs to engage in more quantitative easing.

Inverness Counsel remains focused on growth and valuation metrics to drive our core strategy. We identify those investments we believe position client portfolios to successfully navigate the current market environment. Our long-term themes are: (1) Companies that should benefit from building or renovating global infrastructure; (2) Companies that are positioned to capitalize from strong growth in emerging markets; (3) Companies with stellar balance sheets that are focusing on compelling growth opportunities; and (4) Companies that should benefit from higher commodity and fuel prices and perhaps a weakening dollar.

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