Quarterly Letter

April 2011

It has been an incredible three months. Around the Middle East we have seen governments threatened, and in some cases fall, by revolutionary fervor. Japan, the world's third largest economy, has had nearly seven percent of its economy destroyed by earthquakes and a resulting tsunami. Countries such as Greece and Ireland, to name only two, face financial collapse. Developed world economies face painfully slow recoveries despite enormous government interventions. Gold prices are hitting all time highs. Oil, copper, and other commodities are also seeing their prices soar. And yet investors seem happy to bring riskier assets back in to their portfolios. It is as if there is an on/off switch for risk tolerance as money accepts almost any risk, then none, and now back full circle.

Perhaps the answer is simple: we are in a typical stock market cycle. Markets, as depicted in Chart One, tend to discount the future economic cycle. They begin to recover before recessions are over and get weaker before economic peaks. The top of Chart One also shows when various sectors of the market tend to out-perform. The chart appears correct as to where we are at the moment. We are seeing commodity related, and cyclical areas performing well. These sectors tend to be the most volatile, thus risky. The riskiest bonds are also seeing great demand which has brought their yields down to the lowest levels in six years.

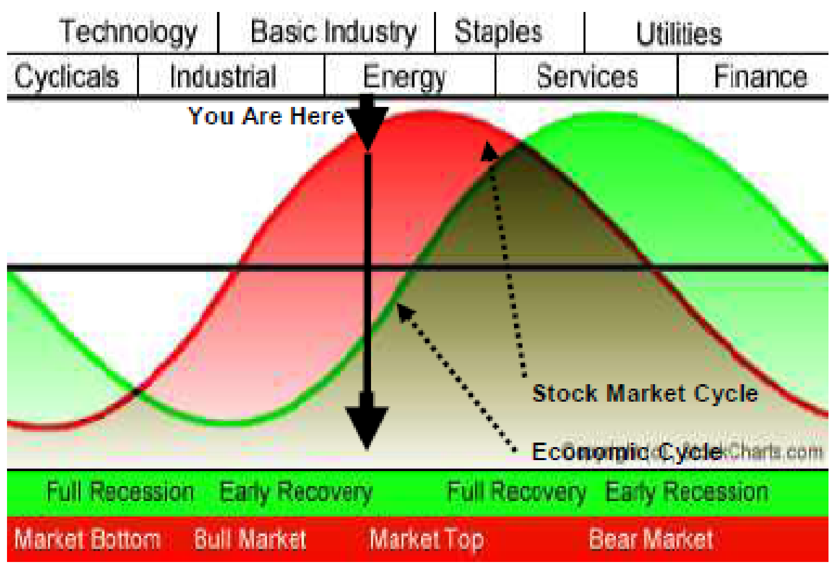

CHART ONE. courtesy of StockCharts.com and RBC Wealth Management

Unfortunately, this economic cycle seems anything but normal. Certainly things have improved markedly from the depths of the credit crisis two years ago. (Amazing how time flies!) The lower dollar has created export opportunities for many companies. Consumer spending has improved. Unemployment claims have dropped. It even appears that small and medium sized businesses, the real engine of employment growth, are starting to hire again. But other data are concerning. The real estate market, usually an early indicator of recovery, is still languishing as home prices continue to fall. Despite low interest rates, few are borrowing. Part of the reason for this is that banks are being quite stingy despite having huge excess reserves. Another reason is that consumers have taken on too much debt over the last several years. It is probably the high levels of debt for both individuals and governments that are going to make the coming economic cycles unlike what we have become accustomed to for the past few decades.

Chart two depicts total US debt as a percentage of GDP. Total debt includes personal, corporate, and government obligations. This chart stops in 2008 which happens to be the time consumer debt peaked but before the massive government deficits of the last few years. Since then consumers have paid off or defaulted on about a trillion dollars worth of debt. I estimate the total debt level for the country to now be over 375%. Federal government debt is now about 100% of GDP. Consumer obligations are now a little over 80% of GDP. What we see is that we have used debt to supplement economic growth in a major way for the past three decades which has brought debt levels to historic highs. (The 1933 blip is due to the depression but debt levels were nearly 200% of GDP before the depression.) In the past ten years we grew debt faster than in the past but in a classic case of diminishing returns less growth was realized. From the beginning of the millennium to 2008 consumer debt grew by about 14% per year, on average, while nominal GDP grew by about 5%. Unsustainable trends eventually come to an end and, as mentioned above, this one has led to the biggest consumer de-leveraging in the post WWII era.

CHART TWO. Total US debt as a percentage of GDP

As we know, the Federal government intervened in an attempt to offset lower consumer demand with its own. Chart three shows how Federal spending jumped from under 20% of GDP to 24% last year, all of it borrowed. This leaves Federal debt at about 100% of GDP, a level of government debt that has been problematic for many governments in the past and is at least difficult for us. At current debt levels a one percent rise in interest rates would cost the government $140 billion in extra interest per year. And, current interest rates are very low, as those of you who own bonds can testify. One savvy investor, PIMCO's Bill Gross, obviously thinks rates will

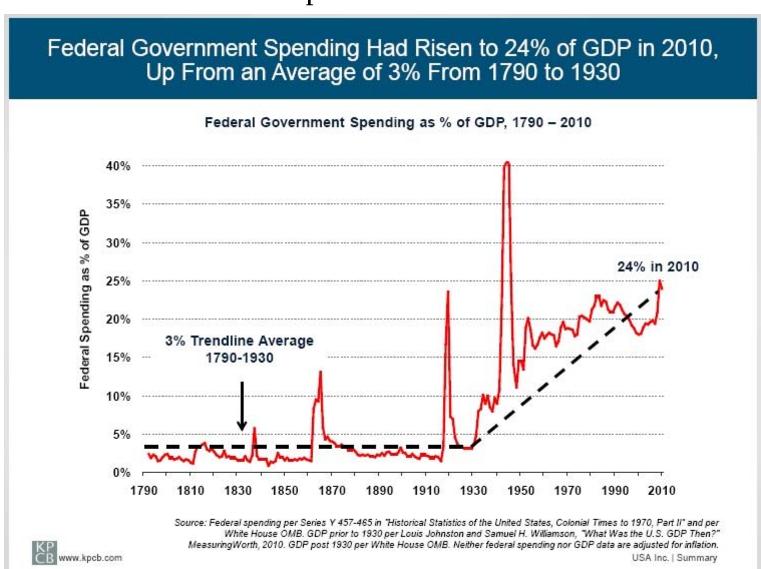

CHART THREE. Federal Government Spending

be rising. He recently sold ALL of his funds' treasury holdings. Treasury interest rate levels would need to rise about three percent to get back to average.

Like the consumer in the previous decade, the government is now growing its debt much faster than the economy is growing, at about 12% and 4% respectively. Since government revenue trends with nominal GDP it is easy to see that in the not too distant future this unsustainable trend will also have to stop. Chart four shows the Congressional Budget Office's (GAO) estimate for entitlement spending and interest expense as compared to revenue estimates. In fourteen years the two lines intersect meaning that there will be no money for anything else the government does. Obviously, the bond markets will stop loaning money to the government long before we hit that point.

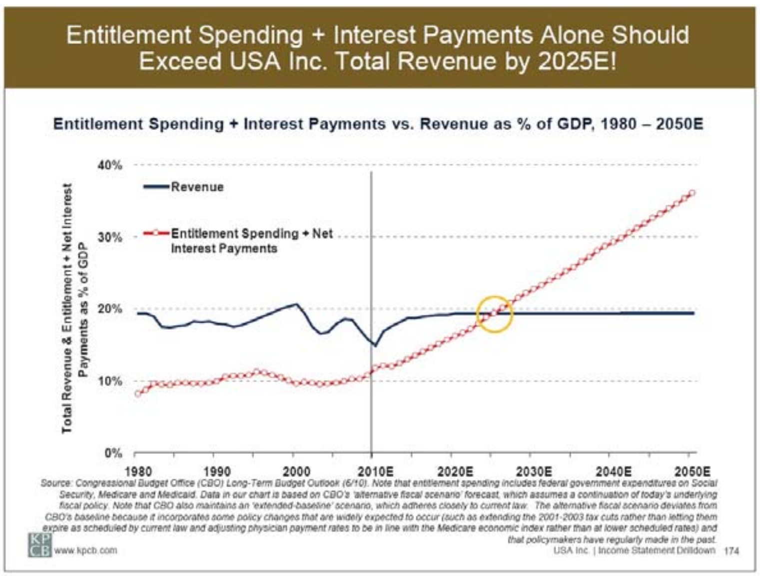

CHART FOUR. Entitlement Spending & Interest Payments

Creating inflation has been a popular way for governments to get out of debt in the past and we shouldn't dismiss the possibility of it returning to us. We know that Fed Chairman Bernanke has said he will do anything to keep away deflation and for those of us who eat and drive and heat our homes, we know he has been successful. *Monetary Regimes and Inflation* by Peter Bernholz studied inflationary periods. In eight of twelve hyperinflationary periods governments were borrowing 40% of their expenditures and had an accommodative central bank that was monetizing the debt (the others were spending less). Our government currently borrows about 40% of what it is spending and the Fed is buying up billions of those treasuries and this creates new money. The program now dubbed QE2, for quantitative easing the sequel, is planning on buying up $600 billion worth of treasuries over a nine month period ending in June. To put this in perspective, personal savings last year was $675 billion.

Going forward I expect we will experience a relatively slow growth economy while de-leveraging persists. Slower growth often leads to more volatility too so the chance of the economy falling into recession will be more likely. These forces tend to have deflationary tendencies so the Fed will be reluctant to tighten its monetary policy which increases the likelihood of higher inflation in the future.

As the recovery ages it becomes more likely that "safer" investments will work best. We have been slowly migrating stock portfolios away from those companies more reliant on economic growth and will continue to do so. For fixed income investments, we are searching for yield but want to stay on the more conservative side here as well.