January 11, 2011

Dear Clients and Friends,

***"There is nothing wrong with change, if it is in the right direction"***
-Winston Churchill

In our letter at the end of the third quarter of 2010, we commented that stocks appeared relatively attractive compared to bonds, and that the possible extension of Bush-era dividend tax breaks could be a catalyst for upside in equities. Congress and President Obama did eventually pass the tax cut extension, but ironically it was the more aggressive growth stocks that led the market higher in the fourth quarter, while our defensive, dividend-oriented holdings lagged over the three month period. Bonds sold off modestly during the period, though yields are still well below where they were at the start of last year despite ongoing signs of economic recovery.

The stock and bond markets are thus painting very different pictures for the year ahead. Deeply cyclical stocks in particular, such as those in the construction equipment sector, seem to be forecasting a robust global expansion, while Treasury bonds, with the 10-year Treasury yielding a mere 3.3% right now, suggest a rather ho-hum environment. Also, if things were heating up domestically as the stock market seems to think, one would expect corporate bond yields to be skyrocketing, but they are not. Bonds still seem concerned with a number of continuing headwinds, including:

- Fiscal woes in Europe facing Greece, Spain, Ireland and Portugal, among others, with Greece increasingly likely to default on its obligations despite austerity measures and financial help from other countries. This could be problematic for US multinationals with heavy exposure to that geography.
- Credit problems for municipalities in the US, where we expect a rising number of municipal defaults over the next couple of years, though we think these will center on specific, localized situations.
- The tense military situation in the Koreas.
- China's decelerating growth rate, which may be intentional as the country deals with inflationary pressures and an overbuilt commercial real estate market.
- Politics in the US, as the gridlock that the stock market prefers in the short term will not likely lead to the fiscal changes necessary to improve the country's dual deficit situation. Ultimately the US needs both tax increases and cuts in entitlements, but bipartisanship is far from likely.

With these headwinds in mind, we do not expect US bond yields to move materially higher in the near term, while recognizing that the risk to our general economic outlook seems skewed to the upside, and that we may err on the side of conservatism. (At the same time, we intend to expand our stock holdings this year in certain growth-oriented sectors, particularly the technology space where we think the rapid shift to mobile or "cloud" computing will drive a multi-year increase in tech infrastructure spending.)

Longer-term we are growing more concerned about inflation, especially stemming from commodity prices, given the growing demand from emerging economies for basic materials. In the fourth quarter we added a position in a broad-based commodities fund for most clients. While there may be periods of back-and-forth in commodities prices, we think the underlying demand for everything from fertilizer to metals will continue to strengthen over many years to come.

The basic outlook for 2011 then is cautiously optimistic for stocks, commodities and bonds, with the recognition that there will be a lot of noise along the way, as markets and economies rarely move in smooth straight lines. But as a whole, 2011 may end up looking quite a bit like 2010, at least as far as the markets are concerned.

Sincerely yours,

Mitch Schlesinger

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