The Good, the Bad and Uncertain

So much going on in the marketplace today. Top that off with the potential impact of the 3rd year of the election cycle and you have markets being pulled every which way.

Recently the financial media has been focused on the end of QE2, the process by which the Fed has been minting new funds to buy back U.S. Treasuries to pressure interest rates down. While they have been successful in driving rates down, the additional borrowing has put additional strains on the rising debt limits the legislature must continually approve. Regardless of whether the Fed officially ends QE2, as of June 30th it will not end the Fed’s Treasury buying spree as they will continue to repurchase Treasuries using the proceeds of maturing mortgages they had taken over in the financial crises. This is likely to continue to moderate interest rate levels, but will it still be enough to drive economic growth as many believe it has to this point?

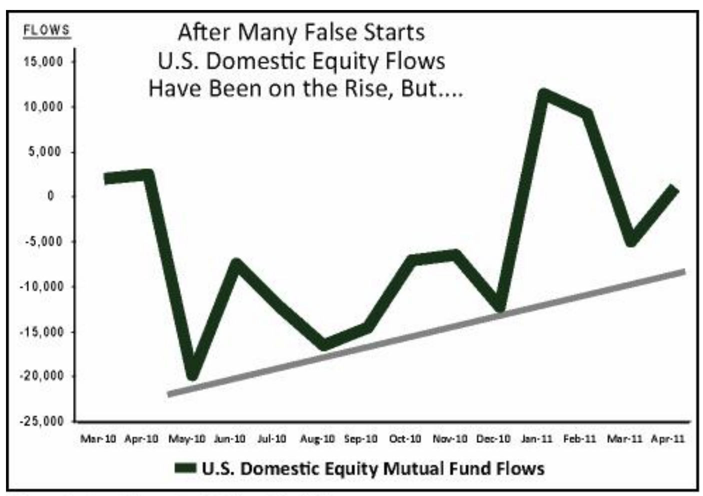
Also in the news and very much related to the QE2 story are commodities. Energy, metals and soft commodities have all gained due to economic stimulus, weather conditions and the forces of easy money in the marketplace. As QE2 has dramatically lowered borrowing rates speculative forces have piled into traded commodities and drove prices up. We are seeing at least a short term reversal of this trend now.

While commodity trading has been around for many years, traditionally, much of the trading was to hedge physical commodities. Recently measures of commodity activity point to an increase of speculation. Several markets and in particular silver had seen parabolic rise until a dramatic pullback just weeks ago. In one week, the price of silver fell from it peak at $48 to a low near $33 per ounce. Silver has a much smaller marketplace than gold and tends to be less liquid and therefore more volatile. Investors should be cautious before venturing too heavily into this volatile metal.

As we have discussed at times in our newsletters, investments dominated by traders carry more risk as there is little focus on company attributes that can create a margin of safety for the investor. The stock market has been heavily populated with traders in the recent past and has seen its share of volatility. Even though the market has risen dramatically since 2009 it was not until just several months ago that investment flows into U.S stocks (funds) rose above outflows. Fearful investors had been putting record amounts of money into bonds even though yields have been pitifully low. Could it be investors now see the need to grow their assets and have finally been plunging back into U.S. stocks?

Well known analyst, Jeremy Grantham of Grantham, Mayo and Otterloo (GMO), while having concerns about the market as we do, sees U.S. high quality stocks as one of the best places to be within the entire global marketplace. In his recent newsletter he commented “ boring blue chips start to win as investors get nervous but can’t bring themselves to stop dancing.” The fundamental attractiveness of these (high quality) stocks for price and growth may be the driving force behind renewed investor flows a feature that has begun to help our portfolios positions as well.

While we applaud the new flow of funds from investors, it may be wise to maintain some caution in the short term as too much investor optimism can lead to an over-bought market ripe for a correction. Global financial conditions, political election and re-election forces, monetary stimulus, and fundamental valuations are all shaping the risks and opportunities in the market. We believe owning quality companies while being nimble within the portfolio can enable us to successfully navigate forward. We suggest you continue to evaluate the risk exposure levels you feel comfortable with.



Source: Investment Company Institute through April 2011

We would be happy to assist you with any questions you may have about allocation and diversification.

James G. Tillar, CFA, Steve Wenstrup