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Dear Readers:

Despite turmoil in the Mid East which has caused a sharp spike in oil prices, there is growing acknowledgement that economic recovery is sustainable and gaining strength. The question is no longer whether QE2 is necessary, but when it should end; pundits no longer debate deflation having turned their arguments to the specter of inflation. Economists have been raising earnings and GDP forecasts for 2011, 2012 and beyond yet, regardless of the debate, inflation expectations remain below historic averages.

The obvious exceptions to the case that inflation is under control are rising energy, food and commodity prices:

The recent event driven surge in oil prices is reminiscent of the move in 2008 when oil peaked at $147 per barrel followed by a severe correction with prices falling below $40 per barrel. That anomalous move, like this one, was accompanied by enormous futures speculation - meaning bets on future price movement not driven by demand and supply. Saudi Arabia has adequate excess capacity to make up for temporary production shortfalls in Libya and other sources of energy such as Natural Gas are quite viable at current prices. I believe when things calm down in the Arab world oil will decline to somewhere in the range of $75-80.

Food related commodities make up about 10% of "price baskets" in developed markets and about 33% in emerging markets. Therefore, the rise in food prices, particularly grains since rice prices have remained relatively stable, has a more pronounced impact on inflation in emerging economies which still make up a smaller percentage of global GDP than developed countries. The rise in food and other commodity prices over the last year or so is muted by comparison to the upsurge from late 2006 to early 2008 (which was followed by a massive decline from mid 2008 to early 2009). There is also evidence that supply/demand imbalances for various food and commodity products should move back toward equilibrium in coming months.

A major concern continues to be the high sovereign debt levels of developed nations with debt to gdp at approximately 76% for Germany, 80% for Canada, 82% for the UK, 87% for France, 100% for the US, 120% for Italy and 235% for Japan (sourced from IMF data). Annual deficits also continue to run at unsustainably high levels. The cure is a combination of austerity, job growth and reallocation of spending from unproductive channels to productive ones. In 2010 the US spent almost $1.3 trillion on defense, non-defense discretionary and one-time discretionary items (36% of the annual budget). Redeploying that capital towards paying down debt and investing in technology, infrastructure and education - activities that create jobs - will begin to improve our balance sheet just as it did following the second world war when ratios were roughly equivalent to today.

The strong US market advance from the lows of March 2009 was initially lead by margin expansion (due to a lean business sector) resulting in faster than expected earnings growth. This was accompanied by a strong, but typical, inventory replenishment cycle which led to revenues growing more rapidly than anticipated. These factors, coupled with a reluctance to spend and hire, resulted in extensive repair to corporate balance sheets and the strongest cash position for S&P 500 companies since the 1950's.

Currently, data from the Institute for Supply Management (ISM) indicates that manufacturing activity in the US is running near the highest rate of the last 50 years. This is consistent with GDP growth rates above 4% and a likely indicator that estimates are still too low. Perhaps most importantly, this tells us that recent employment gains are likely to accelerate in coming months. I would not be surprised to see unemployment in the 7-7.5% range within the next 18 months.

Real economic output in the United States is the highest in history, as are corporate profits, yet the DJIA and S&P 500 are still well below past cycle peaks. Using normalized earnings and historic valuation ranges, the S&P 500 is at least 30% below fair market value based on 2011 earnings and there is much more substantial upside based on the forward outlook. While market volatility is rising as a result of event risk in the Mid East (and there will be other shocks in the future), the long term case for being in equities remains compelling. Things are better now than during the mid 1970's oil shock, the trauma of WW II, the great depression, or the horror of the civil war and they will be even better 5 or 10 years from now. As I have said in the past, let's continue to skate to where the puck is going.

Regards,

Terry