

INVESTMENT COMMENTARY

A PUBLICATION OF LARRY THOMPSON & ASSOCIATES, INC.

3500 Oak Lawn Avenue, Suite 240 · Dallas, TX 75219 · 214-752-5430

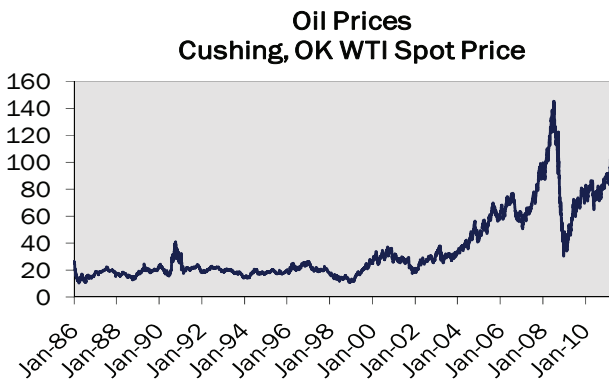
Volume 15, Issue 1

1st Quarter 2011

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity</u>						
S&P 500	5.92	5.92	15.64	2.36	2.63	3.29
Russell 1000 (Large Cap)	6.24	6.24	16.69	2.98	2.93	3.83
Russell MidCap	7.63	7.63	24.27	7.25	4.67	8.52
Russell 2000 (Small Cap)	7.94	7.94	25.79	8.57	3.35	7.87
<u>International Equity</u>						
MSCI World ex US (Developed)	3.82	3.82	11.60	-2.23	1.99	5.96
MSCI Emerging Markets	2.05	2.05	18.46	4.32	10.70	16.79
<u>Real Estate</u>						
FTSE/Nareit Equity REITs (public)	6.34	6.34	23.68	2.27	1.48	11.40
<u>Domestic Fixed Income</u>						
Barclays U.S. Aggregate	0.43	0.43	5.12	5.30	6.03	5.57
Barclays U.S. TIPS	2.08	2.08	7.91	3.93	6.26	6.63
Barclays Municipal	0.76	0.76	3.39	5.24	5.03	4.99
Barclays High Yield	3.88	3.88	14.30	12.93	9.13	8.63
Citigroup 3-Month T-Bill	0.03	0.03	0.14	0.37	1.91	2.06
<u>International Fixed Income</u>						
Citigroup Non-\$ World Gov't Bond	0.97	0.97	8.51	3.25	7.84	8.07
<u>Commodities</u>						
Dow Jones/UBS Commodity Index	4.45	4.45	28.49	-5.20	2.57	7.07

The financial markets in the first quarter once again showed a remarkable ability to overcome numerous global issues and continued their seemingly unstoppable move higher. The quarter saw major political revolutions in the Middle East, a corresponding major increase in the price of oil and a devastating earthquake in Japan, the world's third largest economy. This was in addition to the still unresolved issues of escalating debt in developed countries, rising inflation in emerging markets, and overall weak global economic growth. How can the markets continue to move higher?

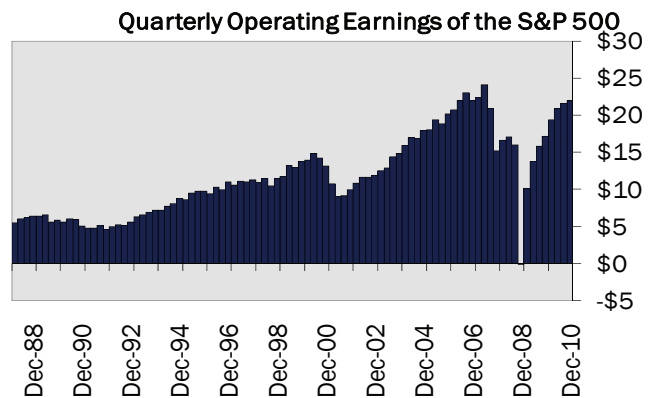
The easy answer is that while these issues are all serious, none of them have directly affected U.S. consumers, yet. The rising price of oil is beginning to affect gasoline prices, but there does not seem to be the same level of outrage as there was the last time prices were this high, which was in the summer of 2008. It may be that because we have been here before, the high prices are not as psychologically damaging. It could be that the revolutions in the Middle East are an easy scapegoat for rising prices and once the region has settled down, prices should fall. In 2008, there were no obvious reasons for the rising energy prices, with the leading three suspects being rapidly growing emerging market economies, speculation in the futures markets, or simple greed by oil & gas companies.



Likewise, as devastating as the Japanese earthquake and tsunami were to Japan, the economic damage has been largely regionally focused. It has even been debated that while short term economic growth will be much lower, longer term growth may be higher. Because the world is already awash with government debt, any additional bonds that Japan issues in an effort to rebuild may have to be at higher interest rates, a prospect that Japan will surely find unappealing.

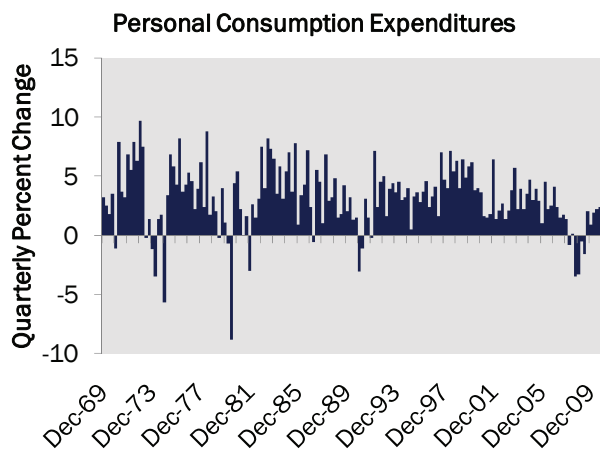
Equity investors have been very pleased with the rapid return of corporate earnings. After the largest decline in earnings most people have ever seen, earnings have recovered rather dramatically. Initially, most earnings growth grew from steep corporate cost cutting. But what appeared good for individual companies was bad for the overall economy as corporate layoffs led to a steep rise in the nation's unemployment

rate. In many cases, corporate expenses were cut so steeply that any increase in revenues had a very large impact on earnings. Today, the collective earnings of the S&P 500 are back to 2005 and 2006 levels, and not far from the all time highs seen in early 2007. Because the market level is still about 14% below its 2007 highs, but earnings are very close to their all time highs, the market appears inexpensive on a price earnings basis. While P/E ratios can be useful measures, readers should remember that stocks also appeared cheap, or at least fairly valued, at the beginning of 2008.



Recent earnings growth has been led by a return of the U.S. consumer. During the peak of the financial crisis, U.S. consumers sharply cut back their spending, sending the quarterly change in the government's measurement of personal consumption expenditures negative for the first time ever. This is important because this measurement is about two thirds of the national Gross Domestic Product measurement. After two negative quarters, consumer spending returned to positive territory and has remained positive since. While consumer spending has lagged previous economic recoveries and the growth rates are still well below historical levels, the positive increases are good for economic growth. Furthermore, because corporations have cut expenses so steeply, the increases in consumer spending have led to the increases in corporate profits mentioned earlier. Investors' favorable interpretation of economic growth, at least domestically, have driven equity prices higher, especially in the U.S.

Overseas, the equity markets have not re-



sponded as well. A declining U.S. Dollar has helped most non-U.S. equity returns when expressed in Dollar terms. However, non-U.S. equity market returns in local currency terms have lagged the U.S. markets rather dramatically. True, the Japanese markets affected the broad international returns, but Europe did little to overcome Japan's negative effects.

Investors in Europe appear to be focused on different issues than their U.S. counterparts, particularly the European austerity measures. European leaders have enacted a number of measures designed to reduce their long term debt burdens and to save several countries from needing costly bailouts. It remains to be seen if these measures will ultimately reduce Europe's debt problems in the long term, but the measures have reduced economic growth in the short term. The equity markets have taken notice and have shown preference to the U.S. markets. Here, higher corporate profits, stronger employment figures, and the lack of high inflation have convinced equity investors that the U.S. offers better short term potential.

Recent months have seen rising inflation in many parts of the world, but not in the U.S. Inflation has always been an unusual measurement that seems to affect some groups more than others. Officially, U.S. CPI has risen about 2% in the past year. Ask anyone who has sent a child to college recently if tuition increases have risen only 2% in the past year. Likewise, those who have paid any healthcare expenses will tell you that healthcare inflation is rising much faster than 2%. The reason the national rate has only risen slightly while certain aspects of our expenses have skyrocketed

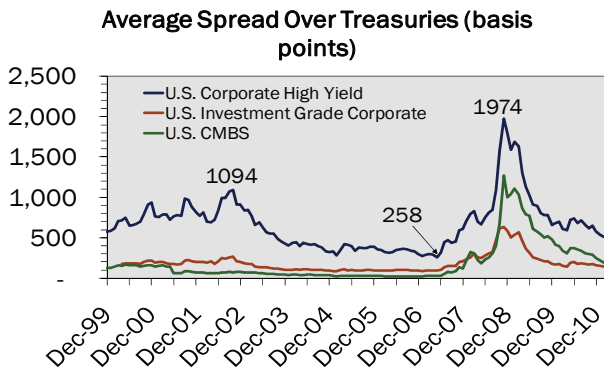
has to do with how the index is calculated. The U.S. measure of inflation puts the most emphasis on housing costs. Housing and utilities makes up over one-third of the Consumer Price Index in the U.S., but only 16% in Europe and 13% in the U.K. With the housing market continuing to struggle, U.S. inflation continues to appear soft compared to the rest of the world. While recent rises in food prices affect everyone in the world, the U.S. measurement of inflation under emphasizes the impact of food, while the European and U.K. measurements are more sensitive to food price changes.

Because inflation (and the housing market) have remained weak in the U.S., the Federal Reserve has been under little pressure to raise interest rates. Low rates should benefit the economy, make it cheaper to borrow money, and push investors out of low yielding money market funds into equities. The higher inflation measurements in Europe have already forced an interest rate hike, a 25 basis point move in early April. This move was particularly interesting given their lackluster economic growth.

While some suggest that this rate increase could make debt repayment plans of Greece, Ireland, and Portugal more costly, we believe that these countries' credit markets are largely being influenced by the specific debt circumstances of each of the countries. A 25 basis point rate hike probably had little additional impact.

The U.S. high yield debt market continues to be interesting. High yield spreads, which at one time hit close to 20% above Treasuries, fell again this quarter, ending only about 5% above Treasuries. While funds continue to enter this segment of the market, the investor profile seems to be changing. When spreads were at historically high levels, participation was largely driven by investors seeking capital appreciation. Today, with spreads much lower, newer entrants seem to be more interested in yield, particularly since U.S. Treasury rates are so low. As long as the economy continues to improve, default rates remain relatively low, and Treasury rates remain low, high yield spreads should continue to narrow. It will be interesting to see how narrow the spread actually gets. Will spreads get back to the 2.5% level that we saw back in 2007? Are income oriented buyers really

that “yield starved”? High yield bonds can be just as volatile (and less liquid) as equities and are not immune to large losses under certain market scenarios.



In conclusion, we are optimistic in the direction the economy is heading, at least in the U.S., but caution investors about taking too much equity market exposure. As we all know, the best time to purchase insurance is before we need it. Likewise, the opportune time to diversify portfolios that have imprudent equity positions is during strong equity markets. It will be too late should we experience another equity market collapse. As we painfully remember, these come with little warning.