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Financial Markets Perspective

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PROSPERITY BEGINS AT HOME

Government austerity measures both in the U.S. and abroad and a rise in government regulations and administrative red tape are threatening to undermine the functioning of a free global economy. The key word here is FREE, and although lawmakers make rules that restrict our freedom, the entrepreneurial spirit of American entrepreneurs finds a way around those increasing regulations. Innovation has always driven America to the forefront of creativity and economic expansion. From Evan's steam engine to Morse's telegraph, Drake's oil well, Strauss blue jeans, Bell's telephone, Eastman's camera, the Wright Brother's airplane, Ford's Model T, Birdseye's frozen foods, Estee Lauder's cosmetics, Walt Disney's world of entertainment, Wilson's xerography, Boyer's DNA cloning, Turner's 24 hour news network to more recent notables such as Gate's PC operating system, Job's iPhone/iPad, Brin & Page's Google and Zuckerberg's social media that has connected millions of people around the world. And this list is to name but a few!! Innovation has given us the opportunity to change the world every day and to reward those pioneers who come forward and make a difference in our lives. By ignoring the challenges, competition, regulation and naysayers, American visionaries are changing the world—for the better! As a result, standards of living have improved and will continue to improve both in America and across the globe.

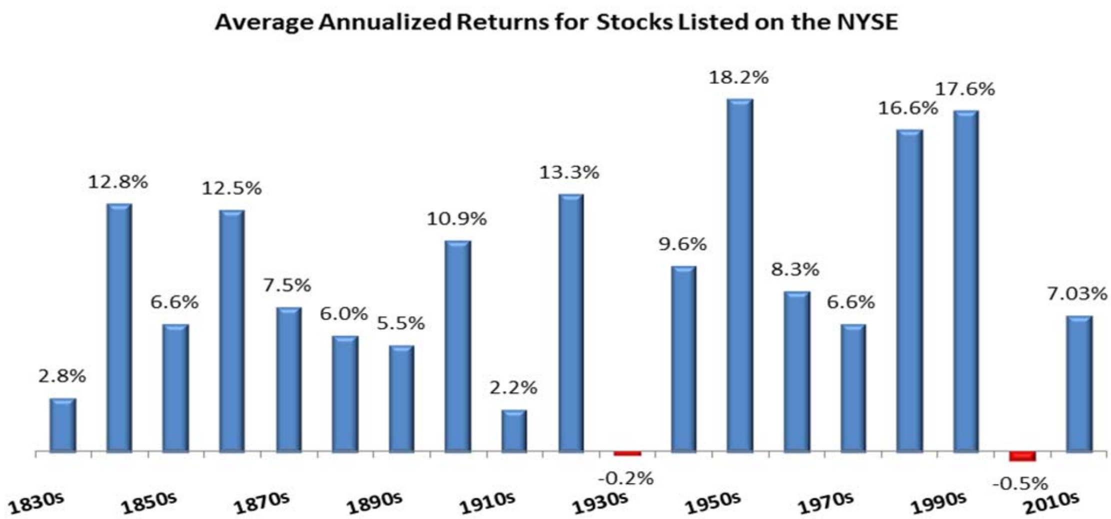
In 1974, OPEC imposed an oil embargo that pushed the U.S. into energy dependency that resulted in double-digit inflation and economic lethargy for the decade of the Seventies. Due to this dependency, there began an enormous shift of wealth to the Mideast as higher oil prices and increasing oil imports made Arabs richer and Americans poorer. As the Arabs spent those U.S. dollars on infrastructure and imports from Europe and Asia, Americans struggled with rising prices and falling standards of living (think of Detroit). Contrast the picture of the Burj Khalifa (the highest building in the world in Dubai) with downtown Detroit, once the global hub of automobile production that has effectively fallen into bankruptcy due to the loss of American dominance, and you have an accurate picture of this wealth transfer.

On a brighter note, the International Energy Agency (IEA) predicted that North American oil production will dominate world-wide supply growth over the next five years. Growing production from hydraulic fracturing aka "fracking" and other technologies that can access once-inaccessible reserves have changed the energy dependence picture. Consider that in 2010 60% of all new oil and gas wells worldwide were being hydraulically fractured. As of the end of last year, 2.5 million hydraulic fracturing jobs have been performed on oil and gas wells worldwide with more than one million of them in the United States. Once again, homemade American innovators are about to put an end to our dependence on foreign oil. These discoverers are creating jobs that contribute to economic growth and prosperity at home. Oil output is not the only beneficiary of fracking. Natural gas is considered in abundance and low prices have prompted utilities to shift from coal and oil to natural gas fired facilities. Trucks and automobiles are also converting to natural gas and the U.S. is becoming an exporter of liquefied natural gas, a true reversal in our energy dependency.

This renaissance of the American economy is reflected in the rise of the U.S. dollar. Once thought to be headed for oblivion, to be replaced by the yen or the Euro as the world's reserve currency, the dollar has strengthened as the U.S. returns to being an export powerhouse. The strong dollar--for decades following World War II--was a sign of economic strength but also served as an economic umbrella for those countries that suffered the most from the war. For example, in 1969 the Dow Jones Industrial Average was 1,000 as was the Nikkei, the Japanese stock market equivalent. By 1989, the Nikkei reached 39,000+ while the Dow only eclipsed 10,000. Cities in Japan, Germany and Korea emerged from the war stronger than ever and the U.S. lost prominence culminating in our failure to recover our hostages in Iran during the Carter administration. As a result of both a strong currency and a lax trading policy, the U.S. almost lost the reputation of world leader. Fortunately, a change in economic direction took place beginning in 1985 as characterized by President Reagan's "Morning in America" theme that brought us back from the economic precipice that could have relegated us to a second-rate world power. Reagan was a visionary who brought prosperity back to the United States of America and gave the freedom to entrepreneurs that resulted in the information technology boom of the Nineties.

Even after the Y2K-related meltdown and the 9/11 terrorist attacks, Americans showed their resiliency as reflected by a strong rally in financial markets and a surge in economic activity. Unfortunately, government's interference in the mortgage market through Fannie Mae and Freddie Mac and legislation known as the Community Reinvestment Act (CRA) provided the wherewithal for the creation of the real estate bubble that almost unwound our financial system. The quick response by the Federal Reserve to provide a safety net under the tottering financial industry allowed the U.S. to escape from this meltdown and move on to better times as the second decade of the twenty first century began.

Over the past eighteen decades, the U.S. stock market has disappointed investors in only two of those eighteen decades—the 1930s and the 2000s. The following exhibit provides insight into how the stock market performed most of the time and provides encouragement that the future, at least as recorded by stock market declines during the 2000s, is not a permanent characteristic of the stock market of the future.



Our point is that the swings in stock market levels are influenced by factors that may not reflect long-term trends. The double barreled declines of the first decade in the Twenty-first century compare only to the 1930's when a stock market crash, two massive tax increases and a global trade war challenged the validity of investing in stocks for long term growth. Since the low point in the stock market in March of 2009, the S&P 500 has rallied over 140% reinforcing the dynamism of capitalism and free markets. Lesser declines of 20% can also be very upsetting to investors who expected to see portfolios grow in size rather that suffer from short-term variables that were not easy to forecast. Unfortunately, market gains of unusual proportions pulled in more investors who expected further outsized gains even though markets have not been that predictable.

Fast forward to today. We have recovered from two catastrophes and our world dominance is expanding due to our entrepreneurs. No one stands up and affirms the resurgence of this "Americanism"--it just shows up in different ways that lead us to our conclusions. Fracking technology and the resurgence of oil and gas production is one dominant factor but other, smaller events build on the fracking story. For example, the U.S. was voted number one by a global survey of businesses as the best place in the world to invest. Domestic auto manufacturers are moving up in the J.D. Power ratings of vehicle quality. Recently GMC, a subsidiary of General Motors, moved up into the number two spot for initial quality ratings. U.S. auto manufacturers are now exporting cars for sale! In the face of discovering huge new oil and gas deposits, increased auto mileage is lowering year over year consumption. Low cost natural gas is displacing gasoline as a fuel source for vehicles of all sizes. Over the balance of this decade the U.S. will emerge as the “comeback kid” in both the areas of economics and capitalism once thought to be the roots of our downfall.

CONCULSION

As professional investors we are committed to evaluating investment alternatives for our clients. Since we began working together in 1994, we have experienced some interesting market environments. The two world class market declines have chastened us to the point of being more conservative than we were in the late 1990s when technology was the source of creating great wealth. Negotiating our way through two massive bear markets allowed us to learn how to protect clients' assets during these market declines. Yet, in the face of this experience we remained optimistic that the future was still bright for investing in America. We expect to see potholes and road bumps in our future but we see a bright light at the end of the tunnel as we put faith in the American entrepreneur as our strongest asset in a competitive world where we will continue to be a dominant contributor.

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