

Economic and Market Commentary

While investors thought the only headline news affecting the markets and their portfolios involved the European sovereign debt crisis, the first quarter of 2011 proved to be quite eventful. Along with the ongoing PIIGS's (Portugal, Ireland, Italy, Greece, and Spain) saga, investors were surprised by the political unrest that spread across the Middle East. This development had a dramatic effect on oil prices, causing a spike in the price of light sweet crude from \$84.32 in mid-February to \$106.72 by March 31st. The political situation in this region continues to unfold and may intensify as we move forward through the year. On March 11, 2011, the world witnessed tragedy in Japan with the 8.9 magnitude earthquake followed by a tsunami that caused widespread destruction. The stock market's immediate reaction to the natural disaster was a sell-off and a 3.63% decline in equity valuations. The resilience of the markets was soon realized with a quick recovery and eventual positive return for the month.

The first quarter of 2011 was one of the strongest in recent history with the Dow Jones Industrial Average rising 6.41%. The S&P 500 and NASDAQ also ended the quarter on a positive note, with gains of 5.42% and 4.83% respectively. As a result of the Middle East turmoil, Energy was the best performing sector with a gain of 16.29%. The Industrial sector was the next best performer closing out the quarter with a return of +8.20%. The worst performing sectors for the quarter included Consumer Staples and Utilities, which still managed positive returns of 1.74% and 1.62% respectively. These gains, on top of previous gains from 2010, drove markets closer to recouping their losses from the bottom in March of 2009. Cumulative gains from the bottom for US markets are up 90%, International Developed Markets are up 84% and International Emerging Markets had the best run as of yet at 132% from March 2009.

Most of the global market indices also closed out the first quarter in positive territory, with the exception of the Nikkei 225 which declined as a result of the market disruption caused by the natural disaster. US equity indices were the clear winners in the first quarter as most international markets are still facing concerns over their own recoveries as the MSCI World Index (ex US) had a gain of 3.4% as converted to US dollars. The impact of the weaker dollar can be seen clearly in these numbers as the local returns were only 1.3%. There was an interesting reversal of performance in the first quarter as developed markets outperformed emerging markets which had returns of around 1.0% and slightly less in local currencies, another result of a weaker dollar during the first quarter.

Bonds, as measured by the Barclays Aggregate, were nearly flat with a quarterly return of just less than .05%. Investors continued to seek out returns by chasing high yield bonds, a sector that had the highest gains of all bond markets at 3.9%. Considering the consensus of a potentially rising interest rate environment and continued fears of problems in the Municipal market, it's not surprising that Treasuries, Investment Grade Bonds, and Municipal Bonds all had flat to slightly negative returns for the quarter. Yields on US Treasury Bonds continued on their upward path as the Fed approaches the end of their quantitative easing, known as QE2. For the first quarter of 2011, yields which move in opposition to a bond's price on the long end of the yield curve, increased slightly to 4.5% for the 30 US Treasury Bonds where the 5 year treasury yields rose around ¼ of a percentage to 2.2%. These quarter-end results are merely a snapshot in time and don't really describe the daily volatility in the bond markets both here and abroad.

The Federal Reserve Board remains on hold with its target Fed Funds rate at 0 - .25%. At the March 15th meeting, the Federal Open Market Committee again cited a "risk to growth" resulting from "non-existent investment in non-residential real estate and a depressed housing sector." Although most Future Implied Probability Models indicate that the Fed will maintain these low levels until early 2012, some analysts are calling for a modest rate hike toward the end of 2011. As long as the Fed's definition of inflation (CPI and PPI) remains in check, short-term interest rates should remain unchanged for the near term.

Gold closed the first quarter with a modest 1.12% gain. Despite the muted 1Q performance, the price of gold fluctuated wildly falling over 7% by the end of January. The pull back, which was a direct result of the political turmoil overseas, was short-lived however as the commodity quickly rebounded. Gold is considered by many investors to be a safe haven and a good hedge against future inflation. However, it is non-producing in that it pays no dividends, and owning physical form has associated liquidity issues. A modest portfolio weighting in a broad-based commodity index is a prudent strategy for long-term investors seeking enhanced diversification.

U.S. economic data continues to gradually improve. Manufacturing has demonstrated incremental month-over-month gains and the gradual improvement in the ISM Manufacturing Index is directly linked to the weaker dollar. High unemployment and lackluster housing data continue to be a drag on economic growth, but signs of improvement are evident with the recent decline in the Unemployment Rate to 8.8% as a little more than 475,000 jobs were added in the first quarter. It has taken 18 months to achieve this level from the lofty high of 10.1% in October 2009. While the entire world continues to struggle to recover from the recent recession, the gross domestic product (GDP) grew at an annualized rate of 3.1% for the fourth quarter of 2010. For many economists and investors alike, this shows evidence of a continued trend that at least the US is on a slow but steady track to recover. Core Inflation levels remain subdued with (YOY) CPI and PPI coming in-line with analysts' expectations of 2.7% and 5.8% respectively. The Consumer Sentiment Index has been in flux over the past two years but is also on a moderately upward trend.

With all that investors have to worry about, fears of inflationary pressures have moved closer to the forefront, already affecting food prices which are up 37% as measured by the United Nations Food Price index. Considering an almost coordinated increase in commodities, it's likely this can be attributed to both an increase in demand and increased speculative interest from investors. While inflation is often just a byproduct of economic growth, the obvious fears could be disruptive, delaying or even stalling economic growth and recovery. While the Fed does not seem concerned over near term inflation, the yields in the long end of the market suggest concerns from investors. At this point, all investors can do is monitor inflationary pressures and evaluate how it will in turn affect markets and individual companies.

With so many significant events taking place across the globe, it's hard for investors to decide what's important and what is "just noise" when it comes to their investments. Wall Street is notorious for having some of their best returns while climbing a wall of worry. As confusing and frustrating as it may be, noise, conflict, and conflicting opinions are probably here to stay. The key for investors of all sizes is to stick to a strategy that will weather all storms over long time periods, avoid the distractions, and stick with what really affects markets for more than a few days or weeks.

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