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An Incomplete Adjustment

As we leave first quarter 2011, the domestic economic resurgence that we have been experiencing over the past few quarters is showing some signs of strain. Several economists, including Goldman Sachs, JP Morgan, and RBS have recently downgraded Q1 GDP estimates. Moreover, second half 2011 GDP estimates are also being reduced, as economists take into consideration the effect of higher gasoline prices, and potentially tighter fiscal policy. ISM orders and consumer confidence surveys have also weakened, admittedly off of high levels. Finally, core inflation has come in above expectations. To quote Jan Hatzius, the economist for Goldman Sachs, "The upshot is that the growth news is a little worse, the inflation news is a little worse, and the risk that the Fed might tighten before early 2013 has gone up a little….It's all a little messier than we would like."

If the news from the domestic market is a 'little' messier, then the news from the global markets is 'much' messier. The European debt crisis has failed to find full resolution, and the PIIGS (Portugal, Italy, Ireland, Greece, and Spain) countries have had further demonstrations, government changes and continued S&P downgrades and IMF bailouts. Austerity could continue to be the name of the game in Europe for many years to come. Japan's earthquake, a horrific and unfathomable human tragedy, has near-term negative consequences to global economic growth. Strong emerging markets such as China, India, and Brazil continue to raise rates to choke off very high inflation. And most importantly, the geopolitical unrest in MENA (Middle East North Africa) seems unlikely to have a near-term resolution. While we are hopeful that peace and democracy settles in the region, the political situation is in such a state of flux that it is impossible for us to have any level of confidence in any specific outcome. Until the geopolitical situation stabilizes, oil prices are likely to stay high, negatively impacting global growth.

Throughout this messy situation, the US stock market continues to rise. The S&P 500 was up 5% in the quarter, and is now up almost 100% compared with the 2009 low.

The strength in the stock market is supported by many positives. Corporate earnings are strong, and balance sheets are very solid, holding almost $2 trillion of cash waiting for deployment. The M&A environment is strengthening. The employment picture continues to slowly improve. Loan demand has started to show signs of life. Finally stock valuations are relatively reasonable, especially when compared with bond yields. We are hopeful, but not certain, that animal spirits have returned to stay.

Will the US economy be able to sustain itself? Over the long-term we believe the answer is yes. However, we have long said that this recovery is a two step forward, one-step back process. And we think we are near the one-step back stage, and that the market is perhaps overbought at this stage. As Ed Hyman, from ISI put it "We do not see risk of double dip, but are seeing a tone change in the economy." Watching over the situation is Bernanke, who has shown no reservations at stimulating the economy if it gets too weak.

How have we positioned your portfolios? We believe that the barbell strategy that we have been following continues to be relevant. We hold GARP (growth-at-a-reasonable-price) stocks for the two steps forward part, and we hold high dividend yielding defensive stocks to help support the portfolio during the one step back timeframe. In addition, we have been more active at selling/trimming our winners to raise cash to put into new opportunities.

From a sector standpoint, we are overweight financials and energy. Financial stocks should continue to recover from the crisis of 2008 as credit quality improves and dividend payments are reinstated. Energy remains a long term theme; both the need for resources, as well as a greater conservation.

Being fiduciaries of your money we keep a wary eye on the horizon. Government budget practices are clearly high on our worry list. Given our capital preservation focus, we are balancing our stock investments with fixed income, MLPs, REITs, and preferred stock at levels that we believe are appropriate for the risk tolerance of each account. With bond yields rising on an improving future economic outlook, we have started to be a bit more aggressive in reinvesting the proceeds from maturing bonds.

We look forward to speaking with you soon and thank you for entrusting us with the management of your money.

Sincerely,

John A. Zaro III	JM Sam Nevin, Jr.	Laura K. Drynan
Managing Partner	Partner	Managing Director