



Market Commentary

Monitor January 2012

2011 was a year of significant volatility and uncertainty in the stock and bond markets, yet at year end, it was little changed. As always, the market contended with opposing economic, political, international and even cultural factors. Economic factors included the slow moving US economy and employment; political factors focused on the debate between the Republicans versus Democrats vision for the future; international factors included the financial crisis in Europe and the Asian economic slow-down; and finally, the cultural view of what we expect from the markets, our government and ultimately ourselves. A look back at 2011 will not provide much guidance for the future, except in the short term, more uncertainty and volatility. Therefore, what may prove more helpful is explaining the perspective we here at Slavic have taken in re-allocating our managed portfolios as overall investment guidance.

First, we expect more economic growth from home than the rest of the world. Despite our difficulties, we remain the world's economic leader. The protracted recession of 2007-2008 and the ensuing sluggish economy have been far better than crisis-laden and recession-prone Europe and the bubble-bursting real estate and stock markets of Asia. US banks are among the best capitalized in the world, and slowly employment is improving as businesses and employees adjust to the transition economy. Therefore, we have reduced international allocations to the portfolios and favored US index funds. Second, interest rates have been at record low levels since 2008. The Federal Reserve has announced that it will keep rates low for at least another year. However, we believe rates could begin to rise back to normal levels if the economy picks up steam. This would be bad news for bonds because as interest rises, bond prices fall. Consequently, we have diversified our fixed income allocation with a position in utilities. Utilities pay a strong dividend yet may not experience all of the downside risk of bonds in a rising interest rate environment.

Third, we are adjusting our allocation in commodities away from precious metals and basic materials to a more energy-focused fund. Much of the economic and political uncertainty that pushed gold to record levels is already factored into its current price; therefore, it could languish at or around today's price for much of the coming year. What will continue to increase is the demand for energy. A strengthening US economy, and more importantly emerging markets, will voraciously consume energy. I saw this first hand on a recent trip to India where traffic-clogged streets and polluted air was clear evidence of Asia's emergence into the industrialized world. It is projected by the International Energy Agency that energy demand could double in the next 10 years, so this seems to be a permanent trend.

Lastly, we have increased our money market or cash positions because the economic, political and international environments still have significant risk. The market has been amazingly resilient through this past year despite the potential of bank and sovereign defaults, US debt, regional wars, Middle Eastern revolutions and terrorist attacks. But so far, all of these issues have been worries but not actual events. If all of these factors remain stable, the market could have a good year, but if any one of them erupts into a reality, then the market could fall precipitously. A greater cash position may lower return in the best scenario, but in the event of a major problem, it will buffer the loss and at the time of the event provide fresh cash to deploy once the damage has been done. Defer a lot, but be careful.