

## **First Quarter 2011 Market Commentary and Outlook**

The S&P 500 entered the first quarter of 2011 with significant momentum from the impressive fourth quarter earnings reporting period. This momentum was fueled by indications that the economic recovery, now twenty months old, is still intact. The Federal Reserve's additional aggressive liquidity injections, which started mid-year 2010, contributed to a bullish "don't fight the Fed" investor /corporate psychology. As a result, by mid first quarter, equity markets had rallied over thirty percent from their "double dip" induced July 2010 bottom. However, the specter of global macro events, this time dramatic political turmoil in the Middle East (crude ended the quarter up \$22.40 per barrel at \$106.66 from its mid February low), along with the natural and nuclear disasters in Japan, combined to challenge investor confidence. Fortunately, the S&P 500's subsequent 6% decline from mid-February to mid-March was essentially eliminated by quarter end as investors perceived the slow down scare as temporary.

### **More "Goldilocks"– We Think "Nominally" But Live in a "Real" World**

The language in the Federal Reserve's March 15<sup>th</sup> Policy Statement (see excerpts below) was more upbeat than the January statement as the Fed noted a firmer footing to the recovery and an overall improvement in the labor markets. Although the Fed noted a significant rise in commodity prices, the statement noted that they expect these increases to be transitory, and repeated that their longer term inflation expectations remain stable.

*"Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Currently, the unemployment rate remains elevated, and measures of underlying inflation continue to be somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate. The recent increases in the prices of energy and other commodities are currently putting upward pressure on inflation. **The Committee expects these effects to be transitory, but it will pay close attention to the evolution of inflation and inflation expectations.** The Committee continues to anticipate a gradual return to higher levels of resource utilization in a context of price stability."*

While we agree with the Fed's view on the recovery gaining traction, we disagree with the Fed's assertion that there is not an inflation problem. While there are near term factors including dramatic weather and global supply disruptions, we are more concerned about secular shifts in inflation expectations and an acceleration of a trend toward significant purchasing power deterioration for U.S. households. Even the world's largest retailer, Wal-mart, with its global purchasing clout, is worried about higher prices. Here are recent comments from Wal-mart CEO Bill Simon from a 3/31/11 meeting with USA TODAY's editorial board, *"Still, inflation is going to be serious, We're seeing cost increases starting to come through at a pretty rapid rate."*

The remaining portion of the letter is dedicated to our thoughts and strategies around inflation and how we will attempt to protect our clients from the financially corrosive and, at times, stealth effects of declining purchasing power. The key take away for all clients will be to understand the significance that we attribute to this serious financial risk.

### **Inflation Everywhere – Non-U.S. Central Banks Have Been Vigilant**

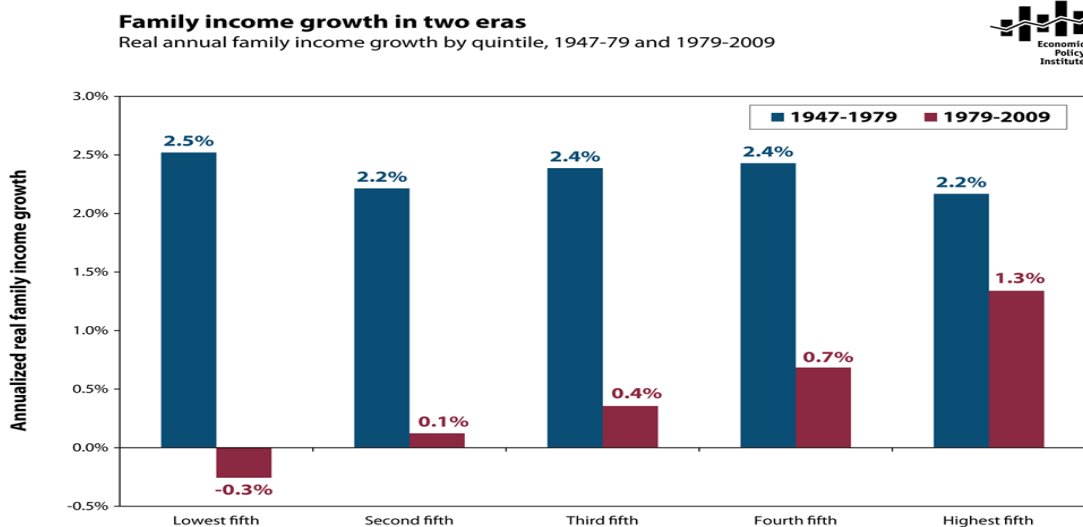
As shown in the RDQ Economics Global Inflation Monitor chart (highlighted in yellow on the following page), few, if any countries are experiencing flat or lower inflation trends year over year. Many central banks have been raising interest rates and bank reserve ratios (some aggressively) to head-off what they see as a growing problem. In an unfortunate but somewhat appropriate analogy, the Japanese utility TEPCO waited too long to provide alternative cooling

options for their fatally damaged Fukushima Dai-ichi reactors. This resulted in a dangerous temperature-induced radiation release spiral. By the time TEPCO acknowledged that they had lost control of the reactors, the window of opportunity to utilize traditional cooling measures was gone. We worry that recent decisions by the U.S. Federal Reserve may result in a similar scenario. In no way do we believe that a global economic overheating scenario is unfolding at the pace of the Fukushima Dai-ichi meltdown, however, we do believe that the U.S. Federal Reserve is running the risk of missing its opportunity to fight the smoldering heat of inflation with traditional methods.

RDQ ECONOMICS GLOBAL INFLATION MONITOR							March 24, 2011	
	Period	Trend (current vs. year-ago)	Current Inflation Rate	Prior Period's Inflation Rate	Inflation Rate 3-Months Ago	Inflation Rate One-Year Ago	Central Bank Target	Above or Below Target
<b>Advanced Economies</b>								
Australia	Q4_2010	higher	2.7	2.8	2.8	2.1	2% to 3%	-
Canada	February-11	higher	2.2	2.3	2.0	1.6	2%	Above
Euro Area	February-11	higher	2.4	2.3	1.9	0.9	2%	Above
Japan	January-11	higher	0.0	0.0	0.2	-1.3	1%	Below
New Zealand	Q4_2010	higher	4.0	1.5	1.5	2.0	1% to 3%	Above
Switzerland	February-11	lower	0.5	0.3	0.2	0.9	2%	Below
United Kingdom	February-11	higher	4.4	4.0	3.3	3.0	2%	Above
United States	February-11	flat	2.1	1.6	1.1	2.1	1.7% to 2%	Above
United States (core PCE)	January-11	lower	0.8	0.8	0.9	1.8	1.7% to 2%	Below
<b>Asian Emerging Markets</b>								
China	February-11	higher	4.9	4.9	5.1	2.7	4%	Above
India	January-11	lower	9.3	9.5	9.7	16.2		
South Korea	February-11	higher	4.5	4.1	3.3	2.7	3%	Above
Vietnam	March-11	higher	13.9	12.3	11.8	9.5		
<b>LatAm Emerging Markets</b>								
Argentina	February-11	higher	10.0	10.6	11.0	9.1		-
Brazil	February-11	higher	6.0	6.0	5.6	4.8	4½%	Above
Venezuela	February-11	higher	29.8	28.9	26.9	27.0		
<b>Eastern Europe</b>								
Poland	February-11	higher	3.6	3.6	2.7	2.9	2½%	Above
Russia	February-11	higher	9.5	9.6	8.1	7.2		
Turkey	February-11	lower	4.2	4.9	7.3	10.1	6½%	Below
Ukraine	February-11	lower	7.2	8.2	9.2	11.5		

### U.S. Households Losing Purchasing Power – Is This Accelerating?

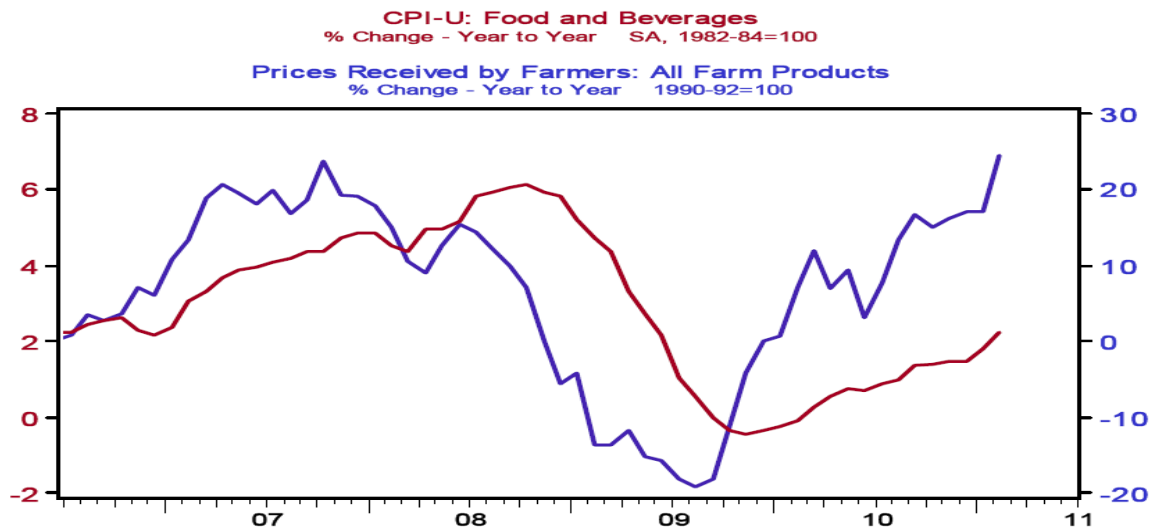
All quintiles (20% increments) of income in the U.S have been losing relative “real” spending power over the past thirty years (compared to the prior thirty years) as seen in the Economics Policy Institute chart below. All quintiles have experienced deterioration, with the lowest quintile actually experiencing a decline in their real income over the 1979-2009 period.



Source: EPI analysis of U.S. Census Bureau data.

We have outlined in past letters the reasons for this loss in real income growth and the resulting negative implications for the U.S. standard of living. We will not take the time to rehash that content here other than to say, we believe this long slide was initially unleashed in the early 1970's with the Nixon administration's decision to remove the gold backing of the dollar. This was a rather innocuous decision at the time. In hindsight, this decision essentially created a "blank check" mindset and removed any limits on dollar printing and hence debt monetization. We now fear that the recent dramatic liquidity actions of Quantitative Easing 1 (QE1) and Quantitative Easing 2 (QE2) may represent additional milestones in the continued deterioration in real incomes and hence the standard of living for U.S. households. Fiat currencies, much like stocks, typically decline in value as more shares are issued. A further decline in the dollar's purchasing power could lead to serious inflation, especially in a world in which demand for resources is being driven by forces outside of a depressed, over-leveraged U.S. economy.

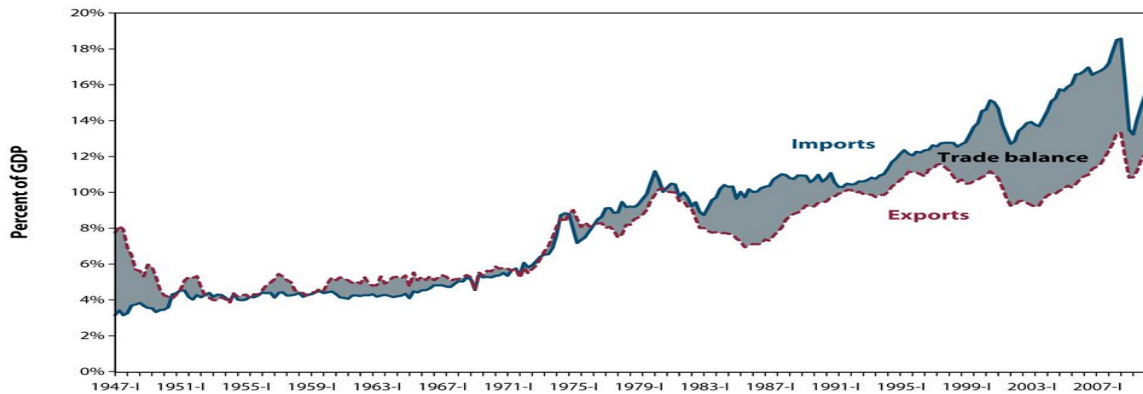
### **Warning Signals – Food And Energy Prices Rocket based upon Global Demand**



Source: RDQ Economics

Historically inflation has been a more regional issue, driven by short term supply and demand imbalances, and occasionally by monetary missteps. Our concern is that this time it may be different. As noted above, while we do believe that there are short term weather and distribution issues at play, we feel that there are longer term secular trends driven by global economic integration that are now impacting prices and are likely to significantly impact prices going forward. While the Federal Reserve continues to justify their liquidity actions based upon lack of resource utilization in the U.S. economy (specifically high unemployment), we worry that they are missing an important point. As one can see from the Economic Policy Institute chart at the top of the next page, the U.S. has run an expanding trade imbalance over the past thirty years (highlighted in grey). This extended imbalance has resulted in a dramatic outsourcing of jobs and incomes to some of our global suppliers (i.e. China, India and Brazil). The resulting standard of living improvements for them, and hence demand for food stuffs and energy products, has essentially been funded by this imbalance. The timing of this trade deficit and the decline in the relative real growth rates of income in the U.S. as highlighted above is no coincidence. Essentially, we have not only transferred sources of income to our competition, we have provided them with the funding to take global resources away from us. Going forward, we will compete with these pools of labor for talent, income, and sadly, the fruits of labor (i.e. basic needs and resources).

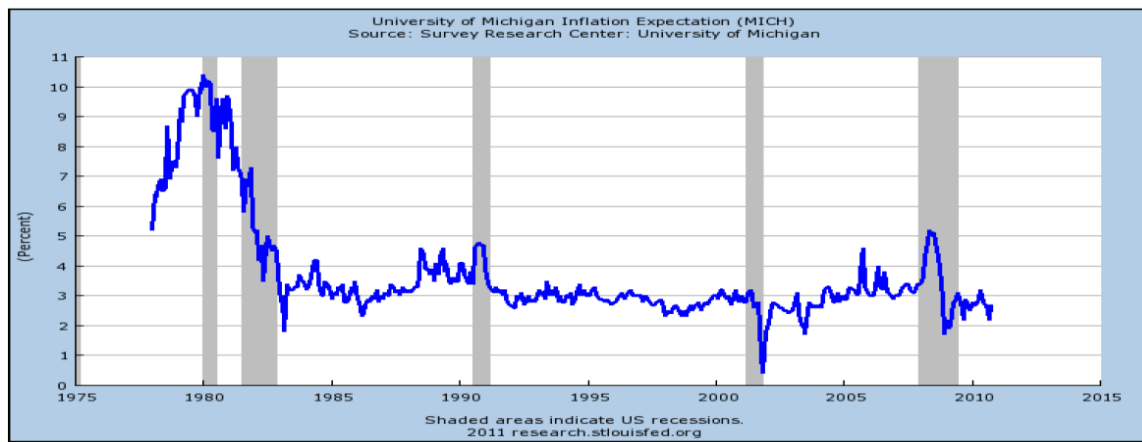
### Growing integration into the global economy Imports and exports as a percent of GDP, 1947-present



Source: Bureau of Economic Analysis data.

### Still Low By Historic Standards - Long Term Inflation Expectations Are Set to Rise

As we can see in the University of Michigan Inflation Expectations chart below, U.S. inflation expectations remain low by historic standards. Unfortunately, the reality of higher prices has already started to hit home. While personal income rose 0.3% in February, real disposable income actually declined 0.1%. Motivated by an improving labor market and a temporary income boost from the reduction in social security taxes, the consumer has been spending. Nominal Personal Consumption Expenditures (PCE) increased 4.8% in the first quarter. The bad news is that spending gains are being consumed in higher prices for food and energy as the PCE Price Index was up 4% over the same period. According to RDQ Economics, over the past three months, 67% of the Price Index increase has come directly from food and energy prices. While the Fed sees these as temporary trends, we are concerned that they are the proverbial canary in the coal mine and warrant significant consideration in our client asset allocations.



### Protecting Our Clients – BFP Tactics Across A Diverse Client Base

Beaumont Financial Partners customizes accounts based on individual risk, time frames and objectives. This complicates this discussion, but we feel that it is critical that you understand what we are doing across a variety of client accounts to protect your purchasing power. The following list is not all inclusive, but highlights many of the strategies that we are implementing across the asset classes.

**Fixed Income** – Our bond strategy continues to focus on purchasing high quality, short duration and, when possible, inflation protected bonds or bond funds. The rationale behind the short duration is to avoid locking assets in at these abnormally low rates. While bonds were actually

up 6.5% in 2010 based upon the Barclay's Aggregate Bond Index (BCAB), we believe this was mostly due to unnatural acts by the Federal Reserve. With expectations that QE2 will be coming to a close this June, the bond market has delivered a flat price performance in the first quarter. We see the current artificially low rate environment as a stealth tax being placed on savers to bail out the banking industry. We do not want to prolong that tax for our clients by locking in these rates for any period of time. Political and financial pressures are building to allow rates to find their natural level. We see the most recent permission granted to banks to restart their dividend payments as the best indicator that the Federal Reserve believes we are nearing the point where the bandage of low interest rates can be removed. Assuming rates normalize, we may return to a more traditional longer duration bond ladder to maximize income. Unfortunately, in the near term, real rates on short duration bonds are historically low and have been, in some cases, negative. We have decided to accept the near term opportunity cost in an attempt to protect principal. The following is a review and definition of some other inflation fighting bond funds that we hold.

**Treasury Inflation Protected Notes (TIP)** – This ETF seeks to replicate the Barclays Capital U.S. Treasury Inflation Notes Index. In order to achieve its objective, the fund will use a passive indexing approach. Treasury inflation protected securities guard the value of your investment by increasing the principal value of your bond by the rate of CPI inflation, seeking to ensure that periods of high inflation will not erode the relative value of your coupon. The term "relative" is used here because the interest rate of a bond will be less meaningful if inflation is very high and vice versa.

**International Government Inflation Protected Notes (WIP)** – This ETF seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of an index that tracks the inflation protected sector of the global bond market outside the United States.

### **Non-Dollar Denominated Bond Funds**

Foreign central banks have been more aggressive in their fight against inflation and, as a result, have lifted rates. These attractive rate disparities create a double benefit: 1) the value of the underlying currency increases as more capital flows to these markets in search of high yields; and 2) there is the natural benefit from greater income. The following are two bond funds which take advantage of the falling U.S. dollar and higher interest rates abroad.

**Franklin Templeton Hard Currency Fund (ICPHX)** – Invests primarily in high quality, short-term money market instruments (and forward currency contracts) denominated in currencies of foreign countries and markets that have historically experienced low inflation rates.

**Aberdeen Asia-Pacific Income Fund (FAX)** - A closed-end bond fund that provides exposure to Australian and Pacific Basin government and state bonds, with a 47% weighting in corporate bonds and 35% in government and agency debt as of February 28, 2011. Credit quality averages A or better and the current annualized yield is 6.26% per Bloomberg. Distributions are typically paid monthly and shares are trading at a 7% discount to net asset value as of April 11, 2011.

### **Equity Holdings**

As discussed in previous market commentaries, we have focused many of our stock specific holdings in large, blue chip multi-national corporations. These firms generate better than 50% of their revenues from overseas markets and are well positioned to benefit from continued growth there. We believe much of the decline in purchasing power for U.S. households will be driven by the loss of relative purchasing power of the dollar. These shares provide a hedge against this trend due to their non-dollar profits. Due to faster growth in emerging markets and the evolution

of middle class wealth, many of these companies have already passed through price increases. Their pricing power can protect operating margins and provide another inflation hedge.

In addition, we look for core equities that have a history of paying a stable dividend and have demonstrated the ability to grow their dividend over time. One can think of the growth rate of the dividend as an annual raise, especially for those living off of the income generated from their liquid assets. We identify and target companies which generate Free Cash Flow (FCF). FCF is the raw material for paying and growing a company's dividends. Abbott Laboratories, with an ~4% dividend yield, is a great example of this kind of stock. Abbott not only maintained their dividend, but grew it at a double digit rate right through the worst of the 2008-2009 financial meltdown while many other companies were cutting or eliminating their dividends.

### **Real Assets**

A simple definition of real assets is "something that cannot be created with a printing press". Gold is one of the best known real assets and dates back to the first known Middle Eastern civilizations where gold provided a means of exchange and a store of wealth. While gold is a substantial holding within our real asset allocation, silver, energy, soft commodities are also represented in these holdings. Globally, currencies are losing their "full faith and credit" characteristic as central banks, most notably the Federal Reserve, utilize printing presses to create more and more paper currency and debt. This combined with the growing demand generated by an improving standard of living for the emerging market middle class, has and should continue to put upside pressure on commodity prices. Therefore, holding a basket of these real assets, which we believe should retain their value during inflationary periods, is another significant hedge in your portfolio.

**Central Fund of Canada Limited (CEF)** – This is a specialized investment holding company which invests primarily in long-term holdings of allocated, segregated, and unencumbered gold and silver bullion and does not speculate on gold and silver prices. At October 31, 2010, the Class A shares of Central Fund were backed 98.0% by gold and silver bullion.

**Elements International Soft Commodity ETN (RJA) & Market Vectors Agribusiness (MOO)** – RJA seeks to replicate, net of expenses, the performance of the Rogers International Commodity Index - Agriculture Total Return Index. This index represents the value of a basket of 20 agricultural commodity futures contracts. MOO is an ETF that seeks to replicate a global agribusiness stock index comprised of individual equities within the agriculture and food sector.

### **SUMMARY**

As we have outlined above, encouraging signs including an improving labor market and solid consumer and corporate spending have kept the market and our outlook cautiously optimistic as we once again climbed the macro "wall of worry" in the first quarter. Last year it was the fear of a double dip and a Euro crisis, combined with the volcanic ash that closed the airspace over Europe for 6 days. This time the slowdown scare came from the dramatic unrest in the Middle East and the natural and man-made disasters in Japan. The market continues to maintain its "don't fight the Fed" posture heading into the first quarter earnings reporting period. We expect to hear corporations spell out supply disruptions and cost challenges, handling these as temporary issues and disposing of the earnings impact through one-time charges. We believe management's message, in most cases, will likely be for a continued global economic recovery. The tone of their outlook will be the key issue that the market will be focused on during the earnings reporting calls. While we have also maintained the "don't fight the Fed" mantra, we have added a corollary "as long as the Fed can fight", due to our increased concerns about the direction and signal of global inflationary trends. We are watching two key indicators to determine how much wiggle room the Fed has left after QE2. The first is the dollar and the second is U.S. interest rates. If the dollar starts to decline more rapidly or if rates start to

climb at an accelerated pace, this may indicate that the Federal Reserve is significantly behind the curve and has lost credibility as an inflation fighter. We believe, as outlined above, that the question is not if, but when will inflation fully present itself? How quickly and at what pace inflation comes will determine what actions the Federal Reserve will be forced to take and the repercussions these actions have on the investment environment.

As always we look forward to guiding you through these challenging times and thank you for your trust and confidence. If you have not done so recently, please review your portfolios with your relationship manager. In the meantime, if you have any questions or comments please feel free to contact us at 781-237-7170 or email me at [mstack@bfpartners.com](mailto:mstack@bfpartners.com).

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