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The Teflon market

Client Newsletter
Quarter Ending March 31, 2011

Market has strong quarter in spite of serious international problems.

Stocks enjoyed the best first quarter of the year since 1998, and begin April on an upbeat note. For the first quarter of 2011 the Dow closed up 6.9%, the S&P 500 up 5.95%, and the NASDAQ up 5.15%, a very strong showing in the face of continued uprisings in the Middle East, rising oil and commodity prices, and the Japanese earthquake and Tsunami. Dubbed by some, "the Teflon market", the market just kept rising in the face of bad news. Volume was steady if not spectacular, a sign that the market had not entered a frothy stage. Indeed retail investors are yet to get excited by the market which has now reached its highest levels in three years.

Traders are unwilling to bet against the market. Short sellers had the lowest level of loans against stocks sold short in five years. The ratio of long bets on the market to short bets is a near a six year high. Hedge funds are less willing to take the short side against a rising tide.

Bond funds continued to experience outflows, while some bond funds slipped into negative territory for the year to date. Readers of this column and our clients know that we have been encouraging the reduction of exposure to bonds for some time. We see no reason to change that position, particularly as Fed futures are betting on a rate rise by the end of the year.

What has brought about this melting up? Surely the massive intervention in the markets by the Federal Reserve not only stemmed the downward trend, but aided in the recovery. Intervention in the markets by the Fed to buy bonds, and keep down interest rates, called Quantitative easing, supplemented the low interest policy of the Fed along with record government spending buoyed the economy. The record low interest rates have aided the economy even as banks face fresh scrutiny for their lending practices. Low interest rates also allowed the dollar to weaken which pumped up the manufacturing sector all over the U.S. and the globe. Strengthening in manufacturing activity in the U.S. was especially welcome in the Rust Belt, and the White House.

In the month of March, employment rose by 216,000 jobs, still below par, but a welcome relief to the numbers we have seen for years. The official unemployment rate fell to 8.8% from 9.8% in November, but of course these numbers do not count those who are underemployed or just quit looking for work. Indeed we are still 7.25 million jobs off our peak.

The rise in oil, and other commodity prices put additional pressure on consumers and manufacturers. Still projected earnings for Q1, which will be released over the next weeks, are forecast to grow about 13% for the S&P with Materials, energy, and industrials leading the way. Utilities and telecoms are forecast to be the laggards. Even consumer discretionary earnings are tipped to grow nearly 10%.

Housing is very local even as the overall market remains weak. Higher gasoline prices are encouraging people to look closer to their jobs rather than longer commutes. Schools still matter even as school financing suffers. Probably the best correlation to your home price is the quality of your local school district. The finances of your local schools and parks may be more intertwined with your own finances than you think.

There is still a long tail of problems to be resolved from the Middle East and the Japanese crisis. The most obvious fallout of the Middle East will be higher oil prices with the effects on the overall economy and the consumer specifically. From the Japanese crisis, we could expect to see a repatriation of Yen and liquidation of Japanese investments around the world. However, we have not seen this yet, but we did see the Yen appreciate dramatically in anticipation of these events. A concerted effort by the Japanese and other central banks against the Yen brought Yen value down.

Questions have arisen about the ability of the Japanese to continue servicing their national debt. However, the Japanese have no choice but to make good on their bonds as most Japanese bonds are owned by the Japanese government and that venerable of all Japanese investors, Mrs. Watanabe. In other words they owe it to themselves. In earlier columns we have opined that Governments which owe its debt to itself and its citizens do not default. Longer term the Japanese government will have no choice but to continue to buy Japanese Bonds, in a sort of perpetual Quantitative Easing because Japanese citizens are old and getting older. The government is losing buyers to death; they are not being replaced as the Japanese population shrinks and the survivors are less inclined to buy government bonds. Young Japanese are deferring marriage and children. Rumor has it that more diapers are sold in Japan to old people than for babies.

For years Japan has run the largest deficit in the world compared to its GDP, but under the current administration, we have become number one in the world. In fact we now own the number one position in the world for percent of debt to GDP among advanced, emerging, and low income countries. Not something to be proud of.

Our portfolios are poised for growth, which is consistent with our mandate. We have been reducing fixed income holdings where possible, as we expect the Fed to begin raising interest rates. We like the international markets especially as the dollar weakens. We have exposure to emerging markets which are growing nicely. We have holdings which will help us as inflation become stronger.

If you would like to discuss your own portfolio in more detail, please do not hesitate to call us.

Best personal regards,

William D. Rutherford, President
Rutherford Investment Management LLC.

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