QUARTERLY COMMENTARY
First Quarter 2011

Since our year-end commentary, interest rates have risen, Japan has suffered terribly from earthquakes, a tsunami and radiation exposure, and violent unrest has spread throughout the Middle East and Northern Africa. On a positive note, corporate earnings continued strong, and the flood of money from QE2 has led to additional growth in most areas of our economy. As measured by the S&P 500, stocks advanced by 5.9% in the first quarter. Treasury bonds were flat to down moderately. Corporate bonds were slightly positive except for junk bonds, which continued their powerful advance with a 3.9% jump. Safe short-term investments provided essentially no return. The Fed succeeded again in "forcing" (their word) investors to assume risk to earn a return. In general, the more risk one assumed, the more return one earned.

At year end, I wrote a very detailed commentary addressing the many pros and cons facing the domestic and global economies. I have just reread that document, and it remains entirely current. While I will not repeat that analysis here, I encourage you to review it on the Mission website. It presents the many variables that could prove critical in determining the course of the economy and the securities markets in the months ahead.

Headlines assail us daily with reasons why the domestic and global economies could suffer. European countries are in increasing danger of default. A growing number of Mid-East countries are involved in armed conflicts. The giant economic power of Japan has been severely compromised by ecological disasters and their aftermath. Domestically, employment remains near its weakest levels since the Great Depression of the 1930s. Housing prices continue to fall, and a huge inventory of homes for sale argues against any near-term price improvement. Unprecedented and monumental debt levels have become a flashpoint of disagreement between differing political ideologies about the role and scope of government in the years ahead.

Notwithstanding the litany of problems, the liquidity-induced global economic recovery has propelled most world stock markets to three-year highs. Government willingness to rescue almost all failing countries and essential institutions has promoted widespread confidence that governments will not permit the kind of systemic failure that threatened the world financial system just over two years ago. The eagerness of most world central banks to fuel the still unfolding recovery with a copious supply of new money has built a firm foundation for investor confidence.

In recent weeks, however, some cracks in that wall of confidence have materialized. The bodies politic in such countries as Ireland, Iceland and Germany have been less than unanimously willing to bail out all who have been harmed by prior financial misadventures. On April 15 the yield on two-year Greek debt skyrocketed to 18.5%, demonstrating a very high degree of skepticism that such government debt will escape default in one form or another.

Tom Feeney provides frequent economic and investment commentary on our blog at www.missiontrust.com/blog.

Similar debt has experienced intermittent rallies and declines through the past year as levels of confidence in the probable success of government bailouts ebbs and flows. This latest manifestation of concern, however, demonstrates that even the most reassuring words of government officials do not prevent confidence from dissipating.

We believe that risks remain greater than potential rewards for both stocks and bonds. What materializes in markets in the months ahead will depend on whether or not investors remain confident in favorable outcomes. Governments and central bankers will certainly continue to offer reassurances of the ultimate success of their efforts. Their job, however, may become increasingly difficult if current trends persist.

Global growth rates are slowing, and inflation in emerging countries is forcing more restrictive monetary policies. Domestically, QE2 is coming to its scheduled end, and political opposition is growing to any continuation of bailout policies. Analyst after analyst is dropping current quarter GDP estimates from the 4% level to about 1.5%. The economy is running the risk of falling again to stall speed despite the greatest infusion of rescue money in human history. This is testimony to the depth of the hole we have dug for ourselves over the past three decades with our borrow and spend approach to economic life. There is no easy way out. There is significant risk, however, that all we have accomplished with our massive rescue efforts is bail out the most egregious perpetrators of financial malfeasance, defer the pain for ourselves and send the bill to our grandchildren.

As recent European events demonstrate, confidence can be a fragile and fleeting commodity. Investors quickly convert from bulls to bears. In recent weeks, equity buyers have become scarce, but market averages have not declined by much, because sellers are virtually non-existent. Any number of events could create an urgency to sell that would propel prices lower. Our concern is not about a normal correction of the powerful advance of the past two years. We fear, rather, that the underlying problems of excessive indebtedness have been exacerbated, not solved, leaving our entire financial system in grave danger. Most of the bad loans remain on somebody's books. If the growth of the world economy slows, servicing that debt will become increasingly onerous, especially if interest rates rise.

While there is no certainty that the worst will unfold, that potential is very real. It would be folly for investors to believe that the government rescue has eliminated the risks that pushed stock prices to 50% losses twice in the past decade. In such an environment we will continue to look for value in equities or fixed income securities on significant price declines and add as much safe yield to the portfolio as possible from assets not committed to longer term securities.

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