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First Quarter 2011 Commentary

Zooming In And Out...

Despite the continuing saga in the Middle East and North Africa and the ongoing tragedy in Japan, markets managed to eke out modest returns in the first quarter. These results are largely attributable to the continued strength of our own economic recovery here in the US. I must confess to a certain level of quiet satisfaction, having spent far too much time arguing with naysayers on why the world was not going to end in 2008, 2009, and 2010. Since the market bottomed in March of 2009 it's up roughly twofold, reflating the wealth of those who exercised discipline during the downturn. US Gross Domestic Product (which measures our country's economic health) appears to be accelerating past the 4% growth barrier and corporate profitability, earnings, cash flows, and cash holdings are all at or near record levels. Indeed, corporate America has about \$2 trillion in cash sitting on its books. In short, things keep getting better gradually.

To be sure, we continue to face broad challenges to sustained economic growth. North Africa and the Middle East continue to pose political challenges and the instability will likely continue for some time. The largest threat we face here is purely economic – in the form of potentially higher oil prices. Still, most economists seem to feel that our current recovery and expansion will be able to absorb moderate increases. Disruptions in Saudi Arabia, Iran, and other large players in the Middle East could certainly change this outlook, but don't appear to be imminent.

Japan continues to wrestle with its problems due to the earthquake and tsunami. While it is still the third largest economy in the world, Japan's contribution to the global economy has been muted for many years. Bank of America economist Ethan Harris estimates that the Japanese disaster will shave 0.1% off of global economic growth estimates of 4.2% for this year. While we all continue to feel for the anguish and suffering of the citizens of Japan, the global economic effects are likely to be short lived.

On a more domestic level, we're all rightfully concerned about our monstrous deficit, but we've seen an interesting and encouraging political shift over the past few months. Specifically, it now seems to be acceptable for politicians of all parties to discuss reductions in entitlement programs as a way to address the problem. Make no mistake - the deficit problem will not dissipate without changes to entitlement programs like Social Security, Medicare, and Medicaid. Everyone will likely feel the effects in one way or another, but the result will be a healthier future for us all. I'm cautiously optimistic we'll begin to see some definitive steps to reduce the deficit as soon as this year. Stay tuned on this topic, as it represents the biggest long term challenge we face.

A more worrisome short term problem is the condition of state and local budget shortfalls, which are predicted to worsen into 2012. Despite what many may feel are personal attacks on unions, collective bargaining, and public sector pensions, this is simply evidence of how deep these problems run, and how the solutions will require contributions from all citizens. We cannot simply tax or spend our way out of the hole. Still, all the news isn't bad here. The most severe problems are limited to seven or eight states – all of which have taken decisive steps to address the problems.

Housing prices continued to decline slightly due to excessive supply from foreclosures and not enough demand (or lending) to soak up the inventory. But, the foreclosure picture is somewhat distorted. Only 5 states – California, Michigan, Arizona, Florida, and Illinois – accounted for 51.4% of all foreclosures in 2010.* This would seem to suggest the real estate problem is no longer a national one, but is more isolated in specific areas. This too will improve over time, but it will be a while before meaningful improvements are seen here.

Finally, \$1,400 gold and \$4.00 gasoline seem to be signaling the decline of the dollar and a huge upsurge in inflation. (Still, the entire world is still willing to lend the US Treasury all the money it wants for ten years at a paltry 3.4%, and to be paid the principal and interest in US dollars. This would seem to indicate that inflation may not be going to the moon anytime soon.) Certainly, inflation will return at some point. My biggest concern here is that consumers still have far too much debt for anyone's good. In 2007, household debt was 130% of disposable income – clearly modeled after our free spending politicians. Ahem. Today, it stands around 118%. The long term average is closer to 70%.** Inflation will certainly crimp the consumer's recovery, but another year or two of personal debt reductions with low inflation would certainly help. In short, we're clearly not there yet.

The ultimate outcome of all these challenges is unknown, which brings me to the point of this commentary: *So what else is new?*

Pick any year in your life – ten years ago, twenty, fifty. Then, go Google that year and look at the news of the day. You'll find no time in history that the world (and the US specifically) wasn't facing fearsome and difficult challenges. And yet somehow, those crises du jour vanished and were replaced by new ones.

There is a funny moment in the classic comedy, *Tootsie*, when Dustin Hoffman appears on TV for the first time dressed as a woman. At one point, the cameraman zooms in for a close-up, and everyone in the control room kind of screams. The director says to the cameraman, "How far can you pull back?" The cameraman responds, "How do you feel about Cleveland?" My point here is simple: Zooming in on the current challenges can cause you to take your eye off your long term objectives. As I've said before, today's crises simply replaced yesterday's crises, and tomorrow will bring new ones. (Please don't argue with me on this. I've got far too much evidence in my corner.)

So zoom out for a moment. Your weapons for protecting, preserving, and growing your wealth haven't changed. Broad diversification, a portfolio in line with your tolerance for risk, and periodic rebalancing have successfully weathered the coming and going of these crises over time. And it will be no different this time. The economic engine of our economy has been and will continue to be the growth of corporate earnings and the expansion of small and medium sized businesses through hiring and employment. If you want to zoom in on anything, keep your eye on these two items as the best indicators of future direction and the pace of our economic recovery.

See you next quarter.

Jeff Helms, CFA

*RealtyTrac, *First Trust Advisors*, March, 2011

** *Bloomberg, Blackrock*, 1/2011