



| | Mar. 31 Close | 2011 YTD |
|------------------------------|---------------|----------|
| Standard & Poor's 500 Index: | 1257.64 | ↑5.4% |
| 10-Year Treasury Note Yield: | 3.45% | |

Investment Outlook: Markets Resilient Ahead of Looming Challenges

April 1, 2011

Dear Investors,

Most people, if they had known in advance what events were to transpire in North Africa and Japan during the first quarter of 2011, would probably have expected global equity markets to be weak. Yet despite the turmoil in the Arab world (and consequent sharp increase in oil prices during the quarter) and the horrific earthquake/tsunami/nuclear disaster in Japan, global markets posted solid performance in the first three months of 2011.

The S&P 500 Index advanced 5.4% in the first quarter, but not without enduring a bout of volatility in March as the Japan disaster unfolded. Bonds weakened somewhat, as the prospects for a continuing economic recovery brightened and investors shifted money from bonds to riskier assets such as stocks and commodities. Bond prices fell as the yield on the ten-year U.S. Treasury note increased by 15 basis points from 3.30% on January 1st to 3.45% at quarter's end. Decent economic data, along with the approaching conclusion of the Fed's quantitative easing program, also likely contributed to the weakness in bonds.

The U.S. economy continues to recover. For the first time in many months we received heartening news on employment, as employers added 440,000 jobs in the quarter and the unemployment rate decreased to 8.8%, its lowest level since March 2009. Corporate profits also remained strong and the markets responded favorably to solid year-ahead outlooks from many companies. Despite the strong corporate sector and improving consumer sentiment, however, there are two main worries for the economic recovery in the near term: a less accommodative stance from the Federal Reserve and rising material prices.

The Federal Reserve, under the leadership of Chairman Bernanke, has provided a torrent of liquidity to support the economy since the financial crisis of 2008. Now, with unmistakable signs of a healing economy, it is highly likely that Mr. Bernanke and his colleagues at the Fed will soon begin to prepare investors for the time when the Fed is no longer going to coddle the economy. The Fed's current \$600 billion bond-buying program (QE2) is scheduled to end in June, and the improving economic data makes QE3 unlikely at this point. Thus, both the equity and bond markets will have to get used to the idea that a major factor in today's low interest rates, namely a big bond buyer out there called the Fed, will ultimately be going away. Only after Fed support is gone will we find out just how strong our economy really is.

The second looming challenge to the economy is the sharp rise in commodity prices. Plain and simple, the prices of nearly all basic materials have skyrocketed. The putatively tame core inflation rate that market watchers often tout excludes food and energy, but it is just these two components that have seen the largest

increases and are the most impactful to consumers. Why are they going up so fast? Let's take the energy matter first.

Oil prices surged during the quarter, going from \$91 to \$106 per barrel, a rise of 16%. The reasons were, on the surface, pretty clear: widespread social unrest in the Arab world shut down Libyan oil exports and put into traders' minds the possibility that the stability of Saudi Arabia, the location of the majority of the world's spare oil production capacity, might be threatened as well. Upon closer inspection, however, Libya, which accounts for only 1.5% of global oil production, is not an irreplaceable player in the oil markets. And fears of a Saudi revolution are almost certainly overdone, as there is very little chance of any meaningful political change there. These temporary factors are merely excuses to bid up the price of oil. The substantive factor that will drive oil prices much higher into the future is simple: we are burning 90 million barrels of oil per day, a faster rate than ever, and each additional barrel of oil is more difficult to find and more dangerous and expensive to extract. Oil is over \$100 per barrel now and is widely considered to be expensive. It seems inevitable that in the not too distant future \$100 oil and \$4 gas will be the bottom end of a new, higher range that takes hold as states scramble to secure ever more scarce energy resources.

Not to be outdone by energy prices, food prices are surging courtesy of a confluence of factors not likely to reverse themselves anytime soon. The first factor is the weakness in the U.S. dollar, which declined 3.8% in the last three months versus a basket of major currencies as the Federal Reserve's quantitative easing program pumped hundreds of billions of freshly-created dollars into the economy. Agricultural commodities are quoted in U.S. dollars on world markets, so weakness in the dollar usually results in higher prices.

Second, grain prices are being pushed upward due to changing diets, particularly in developing Asia. As their incomes increase, people spend more on food. Specifically, they begin to consume more protein. And meat—whether beef, pork or chicken—requires huge quantities of grain to produce. For example, it takes seven pounds of grain to make a single pound of beef, four pounds of grain to produce one pound of pork and two pounds of grain to produce one pound of chicken. A rising standard of living in Asia and the rest of the developing world will continue to exert upward pressure on global grain prices.

A third factor contributing to elevated food prices is the increasing percentage of the precious global harvest that is being used to make biofuels. Many countries, concerned by the uncertain long-term supply outlook for oil, have established targets for using biofuels. The U.S. Congress, for example, has said that we as a country must use at least 36 billion gallons of biofuel annually by 2022. In 2000 only 1% of the global harvest was used to make fuel; but in 2010 it was up to 6%. Biofuels are set to continue to compete with the food supply and will support grain prices.

Strong corporate profits and gradual but demonstrable economic progress have underpinned the impressive recent performance of the equity markets. But high food and energy prices, as well as a less accommodative Federal Reserve, are normal and unsurprising hurdles an economy starting to gain traction must inevitably face.

I welcome your comments and feedback.

Best Regards,

Peter

Peter C. Thoms, CFA
Orion Capital Management LLC
1330 Orange Ave. Suite 302
Coronado, CA 92118
Tel: 619-435-1701 Fax: 619-435-1706
www.orioncapitalmgmt.com