MVCM Quarterly Newsletter

First Quarter Ended March 31, 2011

A Quarter of Fury and Fortune

In our Annual Market Outlook at the beginning of 2011 we expressed the view that the most likely thing we could count on for the year ahead was volatility. The first quarter certainly did not disappoint on that front. Ongoing questions about the nascent economic recovery combined with the actualization of some very impactful geopolitical X-factors for a high-octane cocktail of volatility in risk asset markets. As the quarter drew to an end, the economic growth story managed to fend off the recent one-two punch of instability in the Middle East and the humanitarian disaster in Japan. The S&P 500 recovered all the ground lost earlier in March, and finished the first quarter up 5.92%, a strong showing to be sure. Emerging markets equities, which had started the year on negative footing and turned sharply lower with the woes of early March, staged an even more impressive comeback, coming back into positive territory for the year to date by March 31.

Consider what the markets have been through. At the beginning of the year the persistent problems in the Eurozone's debt markets were still the hot topic of conversation. Indeed, these problems have not gone away – Portugal in particular remains mired in a credit crisis with successive downgrades to its debt ratings. The case for growth, still strong with 3-4% GDP expansion expected in the US for 2011, revealed its inherent fragility.

Then a man in Tunisia set fire to himself and catalyzed a whole region of the world to rise up, and demand to live more dignified, prosperous lives. That region, of course, happens to sit on much of the world's supply of oil. Finally, the long-expected "Big One" rocked the northeast coast of Japan on March 11, unleashing the fury of a deadly tsunami and setting off a nuclear disaster at the Fukushima Dai-Ichi Power Plant.

That risk asset markets managed to absorb these body blows is encouraging, and adds some degree of confidence to predictions for an up year in 2011. But that confidence is necessarily tempered.

How Much More?

The use of phrases like "body blows" and "one-two punch" in the previous paragraphs is not accidental. The imagery of a boxer in the ring, enduring one blow after another after another and somehow still standing, seems apt. The question is: how much more stamina do the markets have for whatever else is due to come our way in 2011? Our two biggest concerns in terms of what could deliver a really nasty hit are commodities and interest rates. Of these, commodities are perhaps the bigger concern for 2011 while interest rates are more likely to be a more chronic ongoing problem.

The tension in the Middle East (which we believe is likely to be a complex affair playing out over years, if not decades) is not the only source of commodities anxiety. Agricultural products from sugar to soybeans, coffee to corn, have been soaring for months now and in many cases are at all time highs. The food riots we saw take place mid-2008 in Mexican villages and Philippine marketplaces may become a regular feature given the extreme impact of higher staple food prices on a large swath of emerging markets populations. Here in our own country, the gas station and the grocery store account for a large chunk of the non-discretionary budgets of households – and as these budgets go up the income available for discretionary wants and whims goes down. If anything could really put a wet blanket on the economic growth story it would be exactly this.

The bond market was basically flat for the first quarter, with losses in the Treasury sectors being offset by a decent run for corporate bonds, particularly high yield. Credit risk is not a major concern in the US corporate sector (though it does hang threateningly over the municipal market). But interest rate risk is the real sword of Damocles. Our view is that the rough waters bonds slipped into last fall are going to continue to be a major challenge in the months and years ahead, requiring nimble navigating and an even more active use of alternative means to secure low-volatility exposure in our portfolios.

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