

INVESTMENT OUTLOOK

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counsel*

- ◆ Strong first quarter for stock market.
- ◆ Monetary policy and inflation in focus.
- ◆ U.S. housing market not ready for recovery.

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Stocks treated investors to one of the best first quarters in over a decade. After climbing steadily throughout January and most of

February, the market did trip over the spike in oil prices from the Arab upheaval and the stunning tragedy in Japan. The market gave up roughly 6% before regrouping and raced ahead in the last half of March. The major U.S. market indexes gained 5% or better for the quarter with smaller capitalization issues leading the pack. While many foreign markets also fared well, the broader indexes for both developed and emerging markets lagged the U.S.

As always, financial markets need something to worry about, but the prevailing sense lately is that the financial crisis is well behind us and the economy is slowly but surely on the mend. The market had little reaction to the uprisings in the Middle East and North Africa until it seemed that the chaos might spread to Saudi Arabia, the world's largest producer of crude oil. The Japan disaster was interpreted by the market in terms of the impact on global supply chains. The verdict of the market was that both situations were manageable and did not present systemic risk

First Quarter 2011 Review and Outlook by Whitney Brown

to the global economy. There has even been a good bit of positive spin put on the Japan crisis in terms of the economic boost from rebuilding and the potential for that country to break out of its malaise of the past two decades. The European debt crisis has roiled markets several times over the past year, but each flare-up seems to generate a little less heartburn than the one before. This time around Portugal is in the barrel, but the market has been less inclined to project the problem onto Spain or Italy.



Looking out to mid-year and beyond, markets will need to grapple with a number of issues. One of the more prominent is the Federal Reserve's winding down of its quantitative easing program known as QE2. With recent data indicating a marked improvement in labor markets and continuing economic growth, it's unlikely that program will be extended beyond its scheduled end in June. Some analysts think the economic recovery is not strong enough to sustain itself without this extraordinary monetary support, but odds are high that the markets have already factored in the end of this program. In addition, there is little doubt that the Fed will continue to hold short term rates at very low levels for most of this year if not well into next.

Lately, inflation has come back to the fore as a hotly debated topic. Surging prices for energy and food have certainly heightened near-term concerns about inflation becoming a problem. However, the rising prices for energy and agricultural commodities can be largely attributed to weather or geopolitical events that are not long-term in nature. High commodity prices tend to be self-correcting since higher prices encourage more supply but curb demand. As long as unemployment in the U.S. and Europe remains high, we are not likely to see inflation get out of hand any time soon. Inflation has become a more pressing concern in faster growing countries like China and Brazil, but recent indications are that inflationary pressures have eased and that policymakers are making the right moves to regulate growth and deter asset bubbles. Indicators of longer-term inflation expectations have remained stable and are very much in line with readings over the past decade or

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<u>Market Measures</u>	<u>1st Qtr</u>	
S & P 500 (price)	5.4%	
Dow Jones Industrial Average	6.4%	
NASDAQ Composite	4.8%	
Russell 2000	7.6%	
MSCI EAFE	2.7%	
Barclays Capital Inter Gov't/Credit Bond Index	0.34%	
	<u>3/31/11</u>	<u>3/31/10</u>
10-Year Treasury Bond Yield	3.48%	3.84%
Three-month Treasury Bill Yield	0.10%	0.16%

First Quarter 2011 Review and Outlook (continued)

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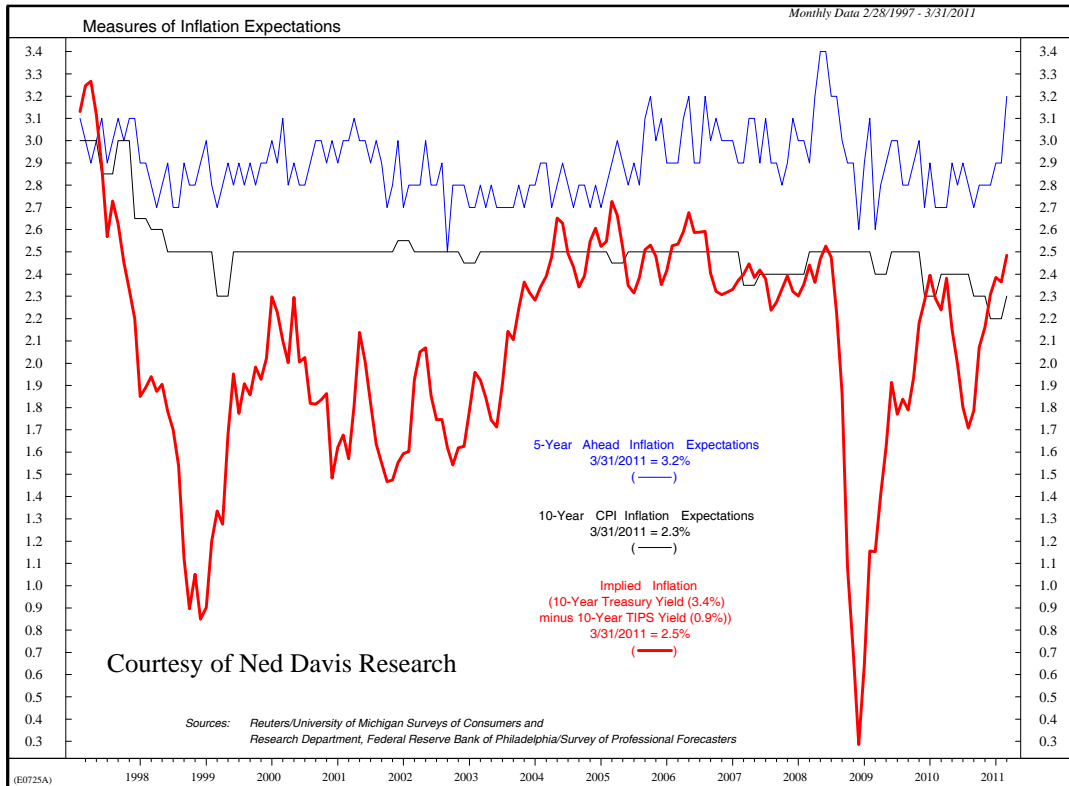
so. The chart below illustrates the fluctuation over the past 14 years of inflation expectations for 5 and 10 years ahead.

While not a new issue, the U.S. housing market continues to weigh on the economy. Critical indicators of housing activity such as sales, building permits, and

mortgage applications remain stuck near historic lows. While the rate of mortgage delinquencies has shown improvement, there is an enormous supply of foreclosed properties to be sold. That can only continue to drive home prices lower until the market clears. Again, this is a well-known and much discussed problem that has likely been

taken into account by financial markets. It is also one of the main reasons the Fed will continue to keep interest rates low so as not to dampen what limited housing activity there is.

We would not want to paint the picture too rosy. It is not. Nor is the market too complacent. However, there may be a growing sense that after surviving the worst financial crisis since the Great Depression, the developed world is starting to own up to its problems, chiefly too much debt. Even in the U.S. there is serious dialogue about making hard choices to cut the deficit. There may be no easy answers, but a willingness to address the problem is more than half the battle. The reality for investors is that, for now, stocks offer the most appealing trade off between risk and reward.



Municipal Bond Update by Watt Dixon

Uneasiness has crept into the usually calm municipal bond market. The media has had a field day targeting a few of the individual weaker municipal bonds that have been issued. Illinois and California bonds have received the worst press. This muni bond scare was exacerbated by a "60 Minutes" interview with market analyst Meredith Whitney last December. Whitney also grabbed headlines after correctly predicting the bank stock meltdown in 2007. In her "60 Minutes" interview, she predicted that we could see "hundreds of billions of dollars worth of defaults in the municipal bond market". Whitney's comments did initiate some panic selling of muni bonds, especially on the longer end of the yield curve. Thus far, her catastrophic prediction has not materialized at all. In fact, a Congressional panel is considering whether Ms. Whitney's comments added to the volatility thus allowing some investors to profit unfairly.

The AAA Bloomberg 30-year municipal bond rate peaked for the quarter on January 14th at 5.12%. As of this writing, the yield has fallen to roughly 4.75%. As rates have dropped, bond prices have risen, showing an increase in demand for municipal bonds. Not exactly what you would expect if the bottom was falling out of the muni bond market.

The supply of municipal bonds has dried up a bit during the first quarter of 2011. The taxable Build America Bonds that were issued in 2010 were very popular with investors. This big rush into these "BAB" bonds in 2010 affected the supply of municipal bonds available in the first quarter of 2011. Demand for muni bonds has also risen this year.

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Libyan and Japanese Impact on World Petroleum Markets by Stebbins Hubbard



The recent events in Libya and Japan have led to a disruption in normal economic and productive activities affecting world petroleum markets. Libya produces 2 percent of world petroleum and is North Africa's second largest producer of crude oil.

Japan is a large consumer of crude oil and refined products. Libya is a supply story, whereas Japan is a demand story.

The questions in Libya are how long the fighting will last and whether the petroleum production infrastructure will suffer any lasting damage. So far, buyers of Libyan petroleum - for the most part, European refiners - have been able to muddle through and do without. Historically, the disrupted volumes are initially replaced mainly with the drawdown of inventories and then with increased production from other countries that have the capacity to increase output quickly. But, it is becoming increasingly clear that this is more than a passing crisis, and the market will need to make adjustments for the longer term.

Japan is the world's third largest petroleum consuming economy behind the United States and China, with 2010 estimated petroleum consumption averaging 4.4 million barrels/day. While the earthquakes and tsunami have spared its industrial heartland, the nation's entire economy has been affected - as have many other economies that depend on Japan for imports and exports. In the near-term, the disaster will cause a temporary reduction in Japanese petroleum demand, partly offsetting the Libyan supply shortfall. While market attention has been focused on

the nuclear power generation infrastructure, the scope of the damage is broader and includes thermal power generation, refineries, factories, ports, roads, and other transport logistics that directly affect the use and movement of petroleum. Longer term, however, market expectations are that the Japanese disaster will cause petroleum demand to rebound in order to support reconstruction efforts when they get underway and make up for some part of the loss in nuclear power generation.

These two events have sent crude oil prices on a roller coaster. On February 14, just before major demonstrations began in Libya, the spot price of Brent stood at \$103 per barrel. In the wake of the Libyan uprising, by March 2, Brent increased to almost \$116 per barrel, before retreating over \$6 per barrel on the back of the Japanese earthquake and tsunami, only to rise above \$120 more recently as the Libyan confrontation intensified. The chart below shows the spike in oil prices.

Recent events in the Middle East and the North Africa region have unsettled an already tightening petroleum market, leaving market participants to evaluate and cope with the possible short- and long-term effects of both current and potential supply disruptions. The extent and duration of Libya's supply disruption will depend on several factors. Much will depend on the political outcome and the acceptance of the government in power by both the Libyan people and the international community following the end of hostilities. Sanctions would need to be lifted to allow for international participation in Libya's petroleum sector. Following commercial and contractual negotiations, any

infrastructure that has been damaged will have to be repaired and the knowledge base will have to return to the country before production can begin to ramp up. In light of these considerations, it is not surprising that the world crude market still reflects large uncertainties.



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Reminder: Charitable Donations Can Satisfy IRA RMDs Again in 2011



by Ted Feinour

In the fourth quarter 2010 edition of our *Investment Outlook* we commented on provisions in the 2010 tax bill relative to 2011 required mandatory distributions for IRAs. This provision permits people age 70½ and older to transfer IRA distributions directly to charitable organizations and use such distributions to satisfy required mandatory distributions. The amount donated in 2011 from an IRA to a charity is excluded from one's taxable income in 2011, although claiming a tax deduction for the donation is not permitted.

After preparing their 2010 income tax returns, several of our clients commented on how much tax was due on their 2010 required IRA distributions. Unfortunately, a great many people had already taken their 2010 distributions before Congress belatedly reinstated the charitable donations provision late in 2010.

Since the charitable contributions are allowed again this year, we are recommending clients consider making their charitable gifts as part of their required minimum distributions. We would be happy to discuss this with you if you are contemplating making direct donations.

Municipal Bond Update (Continued)

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charitable groups and others that traditionally buy taxable bonds, began buying tax free munis when the supply of the Build America Bonds ran out. Meredith Whitney's comments added to the volatility in an already shaky municipal bond market, pushing yields up dramatically but mainly in the longer maturity issues. Short rates rose, but not much.

If the economic recovery continues to improve, we could experience an inflationary environment where we see rising interest rates. We have chosen to concentrate our bond portfolios in short to medium maturity bonds. These shorter bonds are less sensitive to interest rates moves. In addition, as the bonds mature sooner, funds will be available to reinvest at presumably higher rates, as opposed to being locked in for many years at the current low rates we have now.

Nationwide, defaults in municipal bonds have been limited to the non-rated issues (land deals, nursing homes, etc.). Muni default rates are running 50% less through the first quarter of 2011 than in 2010. With muni bonds, as with other bonds, the quality varies greatly from issue to issue. We are lucky to live in state with such high quality bonds. The State of Virginia bonds carry the highest rating of "AAA" by both S&P and Moody's.