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PARTNERS GROUP

The Partners Group Presents:

MONTHLY ECONOMIC UPDATE

March 2011

MONTHLY QUOTE

“Forgiveness is not an occasional act; it is a permanent attitude.”

– *Rev. Martin Luther King*

MONTHLY TIP

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MONTHLY RIDDLE

1987, 1993, 1997, 1999 ... these are not only years on the calendar, but also prime numbers. After 1999, what was the next year that was also a prime number?

Last month's riddle:

You walk into a restaurant, and the floor is covered with a kind of wood – but the wood is neither straight nor smooth. What kind of wood is all across the floor?

Last month's answer:

Sawdust.

THE MONTH IN BRIEF

As a call for democracy spread across the Middle East in February, U.S. stocks posted a nice advance, responding more to earnings reports and domestic economic indicators than headlines from abroad. Historically, this February was a pleasant anomaly; the Dow, NASDAQ and S&P 500 all registered monthly gains of 2.8% or better. In real estate, home sales data painted a mixed picture. Consumer confidence in America rose remarkably ... but not as remarkably as the prices of oil, gold and silver.¹

DOMESTIC ECONOMIC HEALTH

Americans grew more upbeat about the economy last month. One possible factor: the payroll tax holiday was offering them more take-home pay. The Conference Board's February survey came in at 70.4, a big leap up from January's 64.8 mark. The poll hadn't seen a number like that in three years. February's final University of Michigan consumer sentiment survey came in at 77.5, a 3.3% gain – and similarly, the best number in 37 months. Personal incomes had grown by a whopping 1.0% in January, according to the Commerce Department; however, personal spending only grew by 0.2%, the smallest monthly increase seen in the last few months. Yet there was a 0.3% rise in retail sales, which were 7.8% better than they had been in January 2010.^{2,3,4,5}

The January unemployment report came out, and it mirrored the December report: the jobless rate dipped another 0.4%, but largely as a result of jobseekers dropping off the unemployment rolls. While the jobless rate was down to 9.0% in January, non-farm payrolls only grew by 36,000 positions. The brutal weather may have affected the numbers.⁶

We learned that inflation increased by 0.4% for the second month in a row in January, with year-over-year inflation at 1.6%. Producer prices rose by 0.8% in January – that was the seventh consecutive monthly increase and the fourth straight monthly increase of 0.6% or more.^{7,8}

Looking at the manufacturing and service sector, the twin Institute for Supply Management indexes continued to reflect expansion. ISM's February service sector index came in at 59.7 (a 0.3% increase over January) while the February manufacturing index went to 61.4 from the previous month's 60.8. The latest data showed durable goods orders rising 2.7% in January ... but minus aircraft orders, they actually retreated 3.6%.^{9,10,11}

GLOBAL ECONOMIC HEALTH

As protests demanding more democratic governments erupted in Egypt, Bahrain, Yemen, Tunisia, Algeria, Libya, Morocco, Iran and other nations in North Africa and the Middle East, fear began to spread about possible interruptions to oil and commodity shipments. These fears sent Brent and NYMEX crude oil prices over \$100 per barrel last month. Would the economic effects of the unrest have the potential to dampen the global recovery? Would Saudi Arabia see the level of unrest seen in Egypt? The stock and commodity markets are still watching and waiting; global markets outside the Middle East held up reasonably well last month.

The difference between haves and have-nots has become glaring in the European Union, and few statistics demonstrate that better than unemployment figures. In February, Germany's adjusted jobless rate fell to 7.3% - the eighteenth decline in the last 19 months. Compare that to the jobless rates in France (9.7%), Ireland (13.4%, having tripled since 2005), Greece (13.9%) and Spain (20.3%). The European Commission thinks Germany's economy will grow 2.4% in 2011; the German government estimates 2.3% growth. Inflation pressures do seem to be building: producer prices in the Eurozone shot up by 1.5% in January, the biggest monthly surge since 1982; producer prices have gone up 6.1% across the last 12 months of data. The European Central Bank did keep its benchmark interest rate at 1.0% last month.^{12,13,14}

Turning to Asia, the news arrived that China's manufacturing sector had slowed to a pace not seen in six months. In contrast, India's manufacturing sector accelerated to a pace unseen in three months; its overall economy had grown by 8.2% in 4Q 2010, and that represented a slowdown. As for the largest economy in Southeast Asia, Indonesia's annualized inflation rate heated up to a 22-month high of 7.1% in February.^{15,16,17}

WORLD MARKETS

Many European indices mimicked the behavior of the Dow, NASDAQ and S&P 500 and posted gains last month. In Asia, the going was a bit tougher. Looking at data from Morningstar calculated in U.S. dollar terms, Germany's DAX rose 0.52%, Japan's Nikkei 225 advanced 4.67%, Australia's All Ordinaries gained 1.41%, and Canada's TSX Composite and China's Shanghai Composite were both up 4.31%. Indices across the Middle East had a rough month, but they weren't alone: Pakistan's Karachi Stock Exchange fell 8.7% in February for its poorest month in 20 years. Also heading south last month: India's Sensex (-2.75%) and Hong Kong's Hang Seng (-0.37%). In YTD terms, the Egyptian EGX 30 was the world's worst performer at -20.9%. Other notable YTD downturns after two months: the Sensex (-13.1%) and the PSE Composite in the Philippines (-10.3%). The hottest indices after two months of 2011 included the Russian RTS (+11.3%), Spain's IBEX (+10.1%), the FTSE MIB in Italy (+11.4%) and the French CAC 40 (+8.0%).^{18,19,20}

The MSCI World Index (-0.80%) and MSCI Emerging Markets Index (-1.01%) had subpar months. In YTD performance, the World was at +4.75% after February while the Emerging Markets was at -3.79%.²¹

COMMODITIES MARKETS

The run toward hard assets was dramatic and swift. Gold pushed toward its all-time high as prices climbed \$79.50 across the month, silver pushed toward a 30-year peak and oil prices briefly topped \$103. The performances of these three commodities in February were as follows: gold, +5.7% to \$1,409.30 an ounce; silver, +20.0% to \$30.80 an ounce; oil, +5.2% to \$96.97 a barrel. Cotton led crops in February, ascending 14.0% to a new record of \$1.91 a pound. The U.S. Dollar Index lost 1.13% for the month and settled at 76.87 on February 28.^{22,23,24,25}

REAL ESTATE

Even with the weather, existing home sales were up 2.7% for January. The increase was not matched in new home sales – they slid by 12.6% in that month. Existing

home prices slipped 1.0% in December, according to the latest available Case-Shiller home price index data. How about January's pending home sales? Well, they were down – down 2.8%, and down for the second straight month.^{26,27,28}

Did mortgage rates rise last month? Yes. Freddie Mac calculated a 0.15% rise in average interest rates on 30-year FRMs (4.95% at the end of February), a 0.13% increase in the average rate for the 15-year FRMs at (4.22%), a tenth-of-a-percentage point rise in the average rate on the 5-year ARM (3.80%), and even the average rates for 1-year ARMs ticked up 0.14% to 3.40%.²⁹

Oh yes, regarding Freddie Mac and Fannie Mae ... the federal government reached a decision about the two GSEs last month. It intends to wind them down over the next several years. So if there is no Freddie Mac or Fannie Mae, what degree of mortgage financing will the government offer? The Obama administration presented three options to Congress in February, with the idea of generating legislation by 2014. One option has the government leaving the mortgage market apart from the VHA, FHA and other existing agencies. Two other options would create “reinsurance” programs. A limited version would backstop private mortgages only in economic or real estate downturns; another would provide protection for mortgage investments already guaranteed by private insurers. All three options open the door for higher mortgage costs later in this decade.³⁰

LOOKING BACK...LOOKING FORWARD

Last month, the DJIA recorded its finest February since 1998. In fact, the Dow gained a terrific 11.09% across December-February.¹

% CHANGE	Y-T-D	1-MO CHG	1-YR CHG	10-YR AVG
DJIA	+5.60	+2.81	+17.52	+1.65
NASDAQ	+4.88	+3.04	+22.37	+2.93
S&P 500	+5.53	+3.20	+18.96	+0.70
REAL YIELD	2/28 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	1.03%	1.46%	2.02%	3.52%

Sources: online.wsj.com, bigcharts.com, treasury.gov, treasurydirect.gov - 2/28/11^{1,31,32,33}
 Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
 These returns do not include dividends.

So far, the U.S. stock market has sauntered by most of the danger signs coming out of other areas of the world. Can stocks keep this up? Are we due for a correction? Could this current bull run actually turn into the next great secular bull market? These were the questions analysts entertained last month. We can turn to history for some short-term encouragement: the DJIA has advanced in both January and February in 26 of the years since 1940, and in 25 of those years the Dow has finished up for the year (1974 being the lone exception). While there is much room for improvement with regard to our economy (the jobless rate, the residential and commercial real estate sectors, GDP), we are having a much easier time of it than some other regions around the world, and our consumers and employers seem reasonably optimistic.³⁴

UPCOMING ECONOMIC RELEASES: Here are some of the headlines in the making for the rest of March. The first trading week of the month ends on a day when we receive the February jobs report and news about January's factory orders (3/4). After that, we have January wholesale inventories (3/9), the initial University of Michigan March consumer sentiment poll plus February retail sales and January business inventories (3/11), an FOMC rate decision (3/15), the February PPI and February building permits and housing starts (3/16), February's CPI and industrial production figures and the Conference Board's LEI index (3/17), February existing home sales (3/21), February new home sales (3/23), February durable goods orders and the final March consumer sentiment survey from the University of Michigan

(3/25), February consumer spending and January pending home sales (3/28), the Conference Board's March index of consumer confidence and the January edition of the Case-Shiller home price index (3/29), and finally a report on February's factory orders (3/31).

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