VIGILANT Capital Management, LLC

January 12, 2011

View from the Pier

While the Great Recession of 2008 is twenty-four months behind us, it still remains fresh in the minds of investors, consumers and policy-makers alike. And rightfully so, for, although the economic environment feels better today, the repercussions of the events of that period and the policy decisions executed as a means of extraction from it, are likely to remain present, sometimes obvious and sometimes not, for years to come. The damage, both psychological and monetary, has kept many from fully committing to the recovery, particularly in the developed markets that suffer from the structural challenges that will likely undermine economic strength over the intermediate-to-long term.

That said, as we close out 2010 and begin the new decade, optimism is back on the rise and expectations have moved significantly higher. Indeed, the economic recovery around the world has been impressive, although uneven, from the depths of the trough. The 2010 global real GDP (Gross Domestic Product) will prove strong, continuing the momentum generated by the robust recovery of 2009. Better still, the fourth quarter of 2010 witnessed a re-acceleration in the global growth trajectory and it appears that this momentum is being carried into the early part of 2011. This is important, as many have already forgotten the difficulties that began in the late-spring and the genuine concerns that the U.S. economy was going to endure the rare double dip.

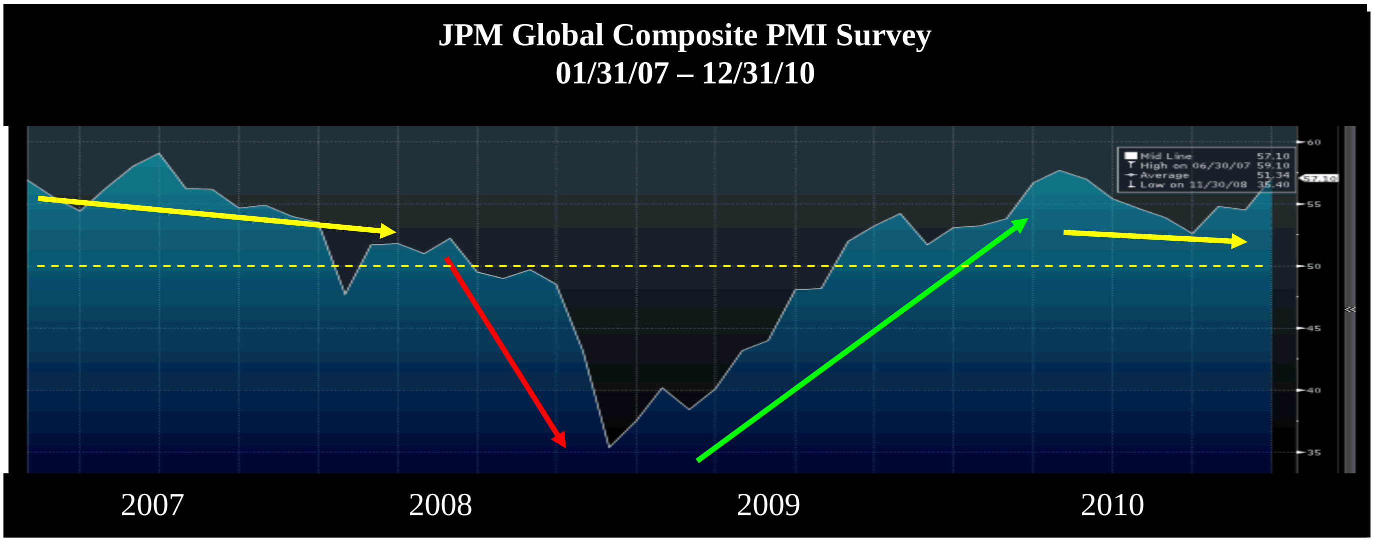
The financial markets reacted on cue throughout the year. The ebb-and-flow of the economic recovery was reflected in each of the financial asset classes and they exhibited high levels of volatility from quarter-to-quarter. Equity investors finished the year feeling particularly bullish, forgetting that, entering September, stocks were well in the red. Fixed income investors were less comfortable with the year's finish, having experienced abrupt and painful moves across a wide swath of bond sectors as yields moved higher with greater violence than most expect from the asset class. Commodity exposure proved very lucrative once again, with gold prices getting most of the attention, but the shiny metal's rise was, in fact, dwarfed by a host of other materials experiencing strong demand around the globe.

We are pleased with 2010, having delivered real capital expansion to investment portfolios, and we remain somewhat optimistic that economic growth is carrying some momentum into 2011 which may, in turn, provide reward for investors early on. But caution cannot be abandoned against the rising expectations that are permeating market commentary and the ever-present risks that lurk within a complex global system. Developed regions remain over-leveraged and under-employed, a dangerous cocktail that has policy makers on edge and exceptionally accommodative. Conversely, emerging regions are overheating and attracting levels of capital that are difficult to manage and which place challenging pressures on currency exchange and local monetary policy. A world that just two years ago collaborated on policy to revive the global economy now finds itself conflicted, as more countries choose to act independently, creating an environment in which policy risk is likely to move to the fore. Further, when we watch the Wall Street houses trip over each other to "one up" their estimates, we naturally get a little bit nervous. When consensus is particularly optimistic, we become concerned about the emergence of unintended consequences and, with the level of involvement on the part of the global central banks over the past two years, such consequences are a near certainty somewhere along the line.

Finally, portfolio management, too, is in transition. Over the past two years, the most important decision was, simply, to be invested. But as economic-growth trajectories mature and stimulus programs fade, we expect security-specific decisions to become more important and managers will need to work harder to uncover the most attractive risk/reward opportunities. We believe those opportunities are best found in securities that are participating in the global market place, be they equities that are delivering superior earnings, bonds that offer the most attractive risk-adjusted yields, or hard assets that are being consumed at faster rates than they can be reasonably supplied.

Economics

The global economy decelerated into a soft patch during mid-2010 and we suggested at the time that muted and bumpy growth trajectories should be expected by investors. Excess leverage, extraordinary policy actions, and adjustments to the natural transition of economic strength are powerful and emotional influences on supply and demand - the building blocks of economic activity. What has emerged over the past few months has been a pleasant surprise, particularly as it relates to the developed regions of the United States, Western Europe and even Japan, all three of which have exhibited a re-acceleration of economic growth, despite their structural challenges. One of our favorite and most dependable set of leading indicators is the Purchasing Managers surveys that are conducted each month across the manufacturing and services industries of many countries. The aggregate of the country surveys is the JPMorgan Global Composite PMI Survey, which depicts the mid-year rebound nicely on the far right side of its graph. The entire chart, as shown below, covers the last four years and illustrates a classic business cycle decline and rebound into a trough and out to its peak. The surveys are indicative of *relative* activity; they capture inflection points and changes in momentum rather than measuring *absolute* levels of economic output. They do, however, contain an important historical relationship to absolute levels of economic activity as highlighted by the yellow dotted line that has historically represented the demarcation between absolute economic expansion (above the line) and economic contraction (below the line) as measured by quarterly Gross Domestic Product (GDP) reports that are released after-the-fact. It is the real-time nature of the PMI surveys and the rich data contained therein that make these reports so valuable and, critically, the equity markets have a very high historical correlation with the PMI surveys, moving nearly in lock step. We have utilized a color-coded set of arrows to help illustrate what we believe may be considered a "green light, yellow light, red light" strategy for equity investors.


JPM Global Composite PMI Survey
01/31/07 – 12/31/10

* Bloomberg

At a December 2010 level of 57.1, well above the demarcation mark of 50, the global economy is expanding smartly, particularly when considering that *relative* responses tend to become dilutive over time. The strength is greatest within many of the emerging market regions; the BRIC nations (Brazil, Russia, India and China) are leading the way because of their sheer size and contribution to global economic output, but many other countries continue to support our thesis that the transition of economic power is truly global in nature and not country specific. Chile, Peru, Turkey, Indonesia and many others are fully engaged in the global marketplace and experiencing high levels of economic output. For many of these regions, the growth is so strong that inflation and capital-flow concerns have become top priorities, requiring active monetary intervention to try and slow the pace. Our bullish long-term view regarding the investment opportunities that fast-growing emerging markets may present is unwavering, but their course will not be a straight line and the risks of monetary intervention have a long history of mixed results. Enthusiasm and expectations can also get over exuberant for regions exhibiting such strength, and these, too, are reasons to be cautious and disciplined about one's investment approach to long-term opportunities.

By contrast, policies within the developed regions remain exceptionally supportive, as illustrated in the U.S. by the existence of negative real interest rates (rates that are lower than the rate of inflation) and the second round of quantitative easing (affectionately called QE 2, and reflective of the Federal Reserve's purchasing securities in the open market). Japan, the world's third-largest economy, seems nearly a lost cause as their long struggle with failed policies, weak consumer spending and chronic deflation continue unabated, countered only by the strength in exports that are demanded by its neighbors. The austerity measures throughout much of Europe would seem to represent a fairly significant headwind over the intermediate-to-longer term, but the weaker currency and accommodative money supply measures have stimulated economic output in the near term, particularly for export-driven economies like Germany. That leaves the U.S., with its flagging real estate market and elusive employment picture. And yet, while the jobs and housing markets struggle, the economy has hung in there and, as we mentioned earlier, exhibited good relative strength in the final quarter of 2010 that should carry into the early part of 2011. Retail sales were generally better than expected and have given a boost to production and inventory replenishment. Whether the reemergence of the U.S. consumer is sustainable, or, simply a case of recession fatigue, is likely to be determined by what happens to jobs and housing, two critical linchpins to consumer health. Washington, for its part, has removed some of the uncertainty for business, and the extension of the tax cuts clears a headwind, at least for the time being. And let us not forget the Federal Reserve and its quest to revive the American economy, apparently at any cost, as it has followed through on its commitment to asset purchases to the tune of another $600 billion by June 2011. The question is whether monetary and fiscal stimuli along with the boost in consumer spending will be enough to induce a long-term expansion within the private sector.

In the end, a sustainable economic recovery for the U.S. will require three things: (1) Jobs - steady paychecks are the ultimate lubricant for economic activity, and therefore, for the U.S. economy it is about jobs (acknowledging that private-sector employment has contracted steadily for nearly 15 years); (2) Confidence - consumers need to feel confident in their balance sheets, so personal debt must be reduced and residential real estate must stabilize; (3) Government Finances - the fiscal position of the federal, state and local governments must all get healthier, and difficult-but-necessary decisions need to be made and accepted.

As noted above, we expect the momentum that built during the fourth quarter of 2010 to carry into the early portion of 2011. Both developing and emerging economies are experiencing positive growth that should continue for a while. However, full-year 2011 global growth expectations have moved significantly higher in recent weeks, moving the pendulum from double-dip fears to optimism that, to us, seems excessive. We are not pessimistic regarding economic growth but we cannot ignore the headwinds which we expect may blow forcefully later in the year. In particular, we believe developed markets will continue to struggle with the de-leveraging process. The reality is that sovereign governments have excessive debt levels and local governments are plagued with revenue/spending imbalances. These factors will be powerful counters to private sector growth. Further, emerging markets are being forced to actively pursue policies to slow growth and cool inflation. Intervention has a checkered history and increases the risk that growth slows too far, or inflation proves overly difficult to control.

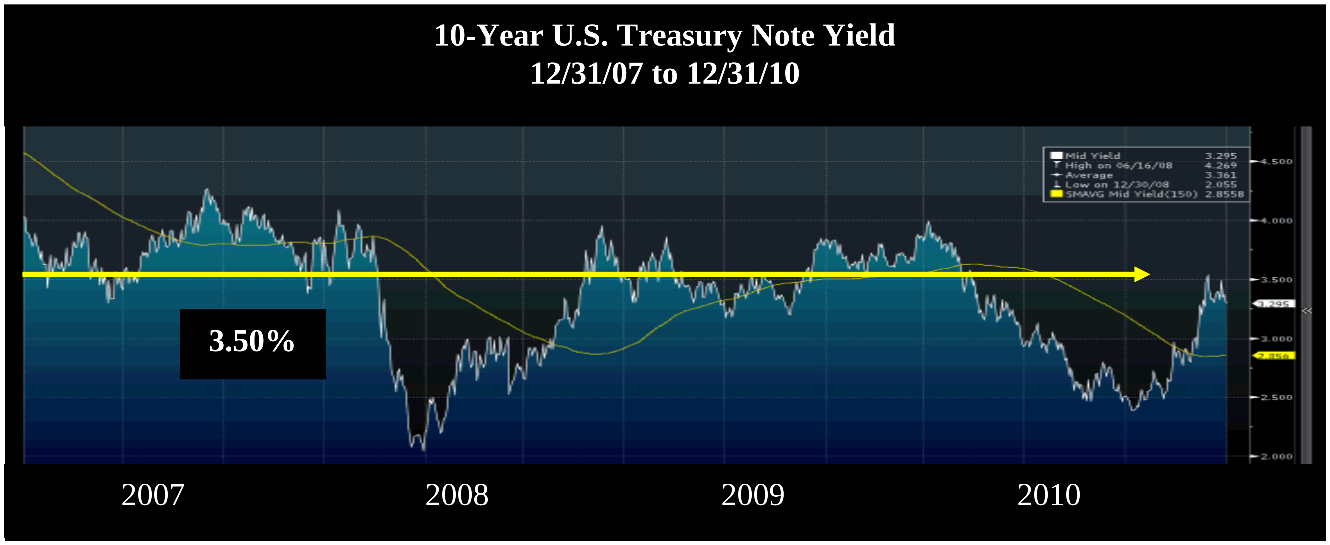
Fixed Income

The fixed income markets are tied to the hip of economic conditions given the role that central banks around the globe play in establishing interest rates on the short-end of the yield curve through monetary policy action. Further out on the curve, investors determine the yields on bonds, predicting the impact of monetary policy in the context of inflation. We don't believe that traditional inflation, prices rising because of the scarcity of goods and services, is a likely problem for the mature economies of the U.S., Europe, and Japan. Excess capacity remains across a wide swath of the global economy, whether measured by manufacturing capacity or excess labor. The abundance of the two most significant cost inputs will keep a lid on traditional pricing pressures within these geographies. By contrast, the more adolescent economies that are growing and experiencing rising standards of living will demand greater volumes of natural resources and basic necessities (better food, shelter and energy resources), and are more likely to experience rising price pressures. We are witnessing this across a host of regions, many of which are struggling to control food and other commodity prices. As noted above, policy intervention aimed at alleviating these pressures increases the likelihood of unintended consequences, something investors must navigate. As we have discussed before in previous Views, there can exist a dichotomy of softer domestic demand for discretionary items and strong global demand for necessary items which can ultimately lead to a scenario in which the things we *need* will cost more and more, while the things we *want* are apt to cost less and less.

Fixed income investors tend to establish strategy based on their perception of inflation or deflation. The idea that inflation and deflation may actually co-exist is not an environment to which investors have given credence but we would argue that such a scenario could play out and prove particularly challenging in the years ahead. It would not surprise us to witness a higher level of volatility within the fixed income markets as the pendulum swings more violently than most are accustomed to. Further, as more investors scour the world for yield, the impact on capital flows and currency rates will add to the volatility and political tensions. Our purchases of foreign bonds over the past few years have taken advantage of this environment, but we will need to remain vigilant to prudently capture the rewards that may materialize relative to the expected risks.

Interest rate volatility, born from the debate of inflation v. deflation, was on full display in the U.S. during the fourth quarter of 2010 as economic indicators perked up from the summer doldrums. It was a stark reminder to bond holders that the asset class contains a risk profile that must be managed. Investors who held longer-maturity bonds or mutual funds experienced rapid price declines, while those with shorter, more actively-managed durations were considerably more stable. The following graph is of the 10-Year U.S. Treasury Note over the past three years. While from start-to-finish yields have not changed much, the volatility illustrated by the two valleys either represented peril or opportunity depending on the position you had leading into those periods.

10-Year U.S. Treasury Note Yield
12/31/07 to 12/31/10



* Bloomberg

Policy risk should be carefully considered by bond investors. As noted above, buyers of developed-market debt face accommodative policy risk, while securities in emerging markets are more likely to experience the implications of restrictive policies. Further, there are myriad fixed-income sectors with varying risk profiles, including asset-backed securities, corporate issues and high-yield bonds, all of which deserve adequate consideration. We believe that a delicate balance should be sought in order to maximize cash flows, protect *real* capital, and support other portfolio activities that fit the overall investment strategy that has been designed to best achieve objectives.

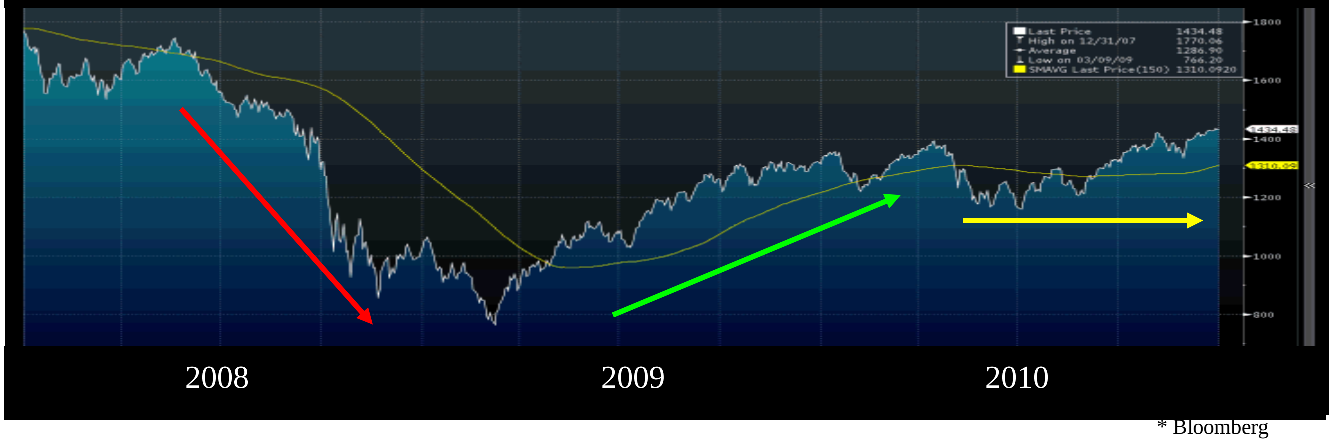
Finally, we are attentive to an additional matter within the U.S. fixed income markets: the fiscal dilemmas of state and local governments, which are confronting budget crises of an unprecedented magnitude. Creative, and at times drastic, measures will need to be taken by states and municipalities across the country. The uncertainties associated with decision outcomes automatically increase the risk profile of this bond sector and we expect continued pressure on state and local budgets to create isolated concerns regarding select municipal debt ratings, with a larger risk that municipal debt markets become less liquid. The challenges facing many municipalities must be monitored carefully.

Equities

Stocks are one of the best discounting mechanisms of future economic activity and 2010 was no exception. Global stock markets appreciated to a high in April – just as the PMI surveys peaked. They quickly retreated through the late-spring and summer months, accurately reflecting the economic soft patch that ensued. Given where stocks finished the year, it is easy to forget that the major averages were in decidedly negative territory when investors returned from the Labor Day holiday. Finishing out the year, stocks moved higher in lock step with improving PMI surveys and a re-emerging economic growth trajectory. It is important to keep in mind that fully half of the 2010 stock gains came in just the final month of the year. Such rapid appreciation has contributed to rising expectations, a combo that can transition quickly into a profit-taking pull back in the markets on just the slightest disappointment.

The following graph illustrates the price movement of global stocks through the economic trough in 2008 and along the recovery of the last two years. The global equity markets enter the new decade residing at highs not seen since the entry point of the significant global declines during the fourth quarter of 2008. The color-coded arrows match those illustrated in the Global PMI graph from above, and are supportive of our belief in the near-real-time correlation between that set of economic data points and the discounting mechanism that is the equity market.

S&P 1200 Global Equity Index – Price Change
12/31/07 to 12/31/10



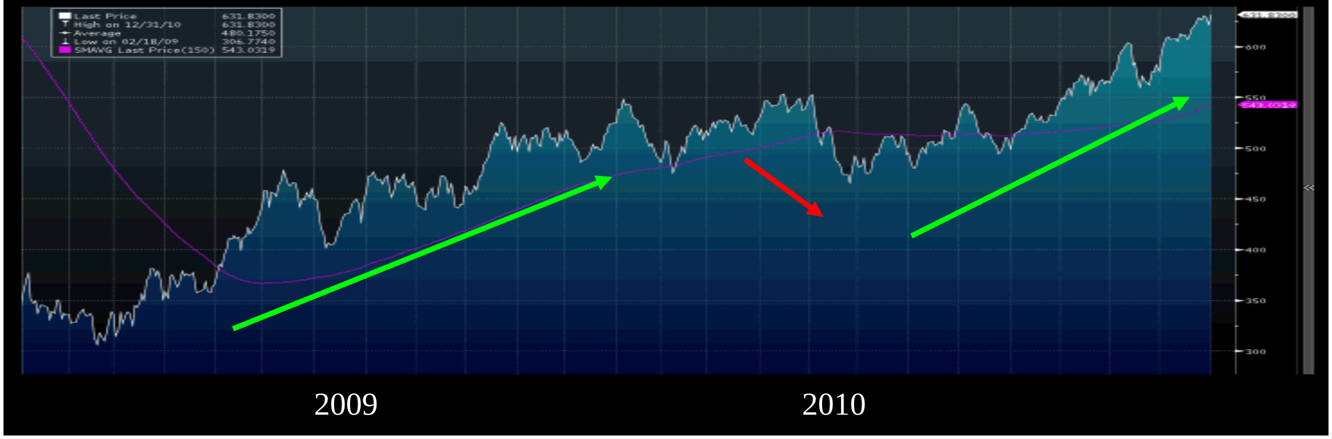
* Bloomberg

The yellow arrow on the right side of the chart is indicative of our cautious optimism. We are encouraged by the general momentum that the global economy has carried into 2011, despite the various headwinds that we expect may emerge later in the year. With the economic backdrop as it is, we consider stock valuations within the context of investor expectations. The consensus earnings growth for 2011 has steadily increased with the rising economic output expectations and now stands at roughly 18% year-over-year growth. We don't believe that the economic headwinds cited above provide the environment for companies to experience revenue growth and/or margin expansion to meet these lofty expectations. Our top-down, macro view generates an estimate of closer to 14% earnings growth and translates into the index of global stocks trading at nearly 14 times our forward earnings estimate, a valuation level that leaves about equal upside to downside for the broad market. However, our bottom-up industry and security analysis is uncovering compelling stories and attractive valuations, suggesting that a high degree of discrimination is likely to be required to achieve better risk-adjusted returns in 2011.

Hard Assets

Economic growth is generally associated with increasing demand for commodities, but this is particularly true when high levels of growth are coming from emerging markets that are eager to transition into the modern world and their denizens seek higher standards of living. This insatiable appetite for commodities has been on display for the last decade and is likely to continue for years as large populations demand stronger infrastructure, better food and shelter, and access to discretionary goods and services. This is an important theme within our global investment strategy, and its contribution to 2010 portfolios was again positive. The following graph represents the S&P Global Commodities Index price change over the past two years, and depicts an environment where the supply of the broad basket of commodities is struggling to meet demand.

S&P Global Commodity Index – Price Change
12/31/08 to 12/31/10



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As we enter 2011 we believe that commodity prices fairly represent the general supply / demand imbalances associated with our thesis regarding economic momentum. The devastating floods in Australia are one example of how already tight markets for commodity goods can become even tighter, but the primary driver for our long-term thesis on the group overall remains the huge resource demands of the emerging economies. While China's infrastructure spending dominated the headlines over the past decade, we would not be surprised to see India begin to match spending on transportation, energy and utility infrastructure if they intend to keep pace in the highly-competitive global community.

Gold has always been a highly debated topic, a situation that has been exacerbated by its meteoric rise in recent years. Historically, we have owned it as a hedge against inflation. Of late, and in large part in response to the actions of the U.S. Fed and the European Central Bank, many investors have flocked to gold, a representation of the fear that has emerged in the world around sovereign risk, as it relates to excess debt and the fear of default, and/or the true value of fiat currency. This is legitimate and is an element of our thesis on gold, but we would add an additional factor: the value placed on gold as jewelry, particularly in regions of the world where wealth and discretionary income are on the rise. That said, speculators are circling gold and current prices appear elevated; however, the "store of value" effect will continue to be present in the decade ahead and we will look to purchase gold again at lower prices.

Allocations to the publicly-traded real estate sectors (REITs), both domestic and international, remain challenged in our opinion. Despite the sector's strong price performance since early-2009, the group still faces stiff headwinds of high vacancy rates, excess debt relative to value, and a wave of refinancing that is set to occur over the next three years. We continue to believe in the asset class over the long-term, but prefer to find a better entry point when fundamentals turn more attractive.

Conclusion

The global economy showed excellent strength as we exited 2010 and momentum should carry into the beginning of 2011. The strength is broad-based across geographies, developed and emerging markets alike, causing expectations for 2011 economic output to rise substantially in recent weeks. We share the optimism in the near-term, but we find it hard to ignore the pending difficulties, particularly in the context of high expectations. Developed markets must balance the need to stimulate employment growth while instituting a fiscal discipline in order to manage the excessive debt load. Conversely, emerging economies are taking active steps to cool growth and cap inflationary pressures, an undertaking that carries considerable risk, if history is any lesson (and it usually is). If policy makers around the globe are somehow able to navigate these headwinds successfully, equity markets remain attractive with reasonable valuations. Longer term, we continue to see compelling opportunities for firms which are positioned, or are successfully re-positioning, to benefit from the likelihood of faster growth in the developing economies. Fixed income markets aren't as expensive as they were six months ago, but in the context of long-term yields, bonds certainly contain considerable downside risk if not managed appropriately. And commodities have had quite a run into the beginning of this new year, so much so, that a breather may be the most likely outcome over the near-to-intermediate term, despite our long-term bullish view of the group. Lastly, global commercial real estate markets remain a most difficult call. Between 2005 and 2008, a huge number of properties were purchased at extremely elevated prices and with excessive leverage, much of which will require refinancing over the next three years. We suspect there may be a better time to buy into this sector.

We are grateful for the opportunity to bring you the View from the Pier and, as always, we welcome your questions and comments.

Scott Sorensen Managing Director	**Daniel Mulkern** Managing Director	**Christopher Lyford** Managing Director
Jeffrey Carlisle Managing Director	**Laurie Chandler** Managing Director	**Lawrence Blaisdell** Managing Director

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