Marble Harbor Investment Counsel, LLC
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Fourth Quarter, 2010 Letter

January 2011

Happy New Year!

Your investments and the market had a good year, and especially a good fourth quarter. Though volatile, the S&P 500 rose 14.8%.

Throughout 2010, sentiment migrated from concern that we would experience a "double dip" recession and slide into deflation that would be hard to shake into current fears over inflation and currency depreciation. This shift occurred for several reasons: First, the US and global economies both showed weak, though sustained growth throughout the calendar year. Second, we saw a pick-up in demand for raw materials from China as their economy expanded due to increased exports as well as a huge stimulus package from their government. Finally, the US Federal Reserve implemented a second round of Quantitative Easing ("QE2"). This has led to lower interest rates and flooded the system with dollars, fueling some investing, but also speculative buying of risky, liquid assets – conditions we observed in the period leading up to the financial crisis. Finally, while the US has many issues to work through, compared to many other countries, we may be the proverbial Pygmy, casting a long shadow in a land of midgets. Taken together, we have enjoyed a liquidity-fueled boost to the stock market.

To build their countries – buildings, roads, power plants, airports – China and India need to buy and make a lot of stuff. And like the sustained period of demand that the US went through in the post-WWII era, these, and other developing countries are using great quantities of steel, copper, aluminum, and silver. Their growing middle-class citizens are eating higher-calorie diets and wearing more expensive clothing. They are traveling all over the world and buying the trappings of luxury. These behaviors are clearly seen in global markets. Tourism and luxury good purchases are up and commodity prices have appreciated rapidly in the second half of this year.

This brings up an important point: While the U.S. is still the largest consumer of most things, that consumption isn't growing very fast. Consequently, unlike any time since perhaps World War I, the United States is not directly "calling the tune" when it comes to the cycles of inflation and deflation for many goods and services. For example, many of the manufactured goods we buy in the US are made in China. It is *Chinese* wage inflation that affects the price of toys and computers, and not the AFL/CIO. Similarly, as China turns into a massive importer of food-stuffs, their demand determines the price of corn and sugar, and so the price of Frosted Flakes is at some level determined by the appetites of Shenzen and Shangdong, and not San Francisco.

Of the challenges we face, deficits in the public sector are particularly concerning. Collectively, states and municipalities have made promises of pensions and retirement benefits that far outstrip their ability to pay. These promises were made in very different times. People had shorter life

spans, medical cost inflation was lower and the economy was better. Further, the politicians making these promises found it expedient to agree to workers' demands rather than risk a crippling strike that would jeopardize re-election. As New York's Mayor Bloomberg is finding out, piles of garbage in the streets are a sure way of losing the vote! Municipalities and states have accumulated enormous unfunded liabilities that are weighing on their ability to provide services.

When we buy bonds, we are lenders. And at the current level of interest rates, these deficits give us pause, especially where the lender of last resort (the Federal Government) is running a huge deficit. We are troubled by this set of circumstances, and so we continue to be conservative in how we approach bond portfolios – keeping maturities relatively short and amongst higher quality issuers. This strategy has been vindicated recently, as municipal and taxable bonds have lost between 2.5-5% of their value in the last couple of months. This is the equivalent of 1 or 2 ***years*** of interest on these bonds. In a low rate environment, the tiny bits of extra yield available by taking a little more risk can be wiped out in the blink of an eye. That doesn't seem worth the risk to us. At higher yields – both in absolute terms and relative to those available from higher-quality stocks – we will once again be interested in assuming the risk of being a longer-term lender to municipalities. In the meantime, it is hard to get excited about most bonds.

On the other hand, as we discussed last quarter and in our recent *Harbor Light* we are finding good relative values in the equity markets. We expect that over the long-term, these companies will provide us with attractive returns. Highlighting this observation, several successful and prominent bond managers have either begun to, or have applied to be able to, buy stocks in their bond funds. This is remarkable. In the short-term, however, markets may mimic the ups and downs of our delicate, slow and volatile global recovery. Nonetheless, the healthy cash flows and dividends from your portfolio companies should allow them to progress at a faster pace than the economy.

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