Seven Investment Themes For 2011

In 2011 we think a number of very positive themes will play out for the LSGI portfolio. We see the following developments in 2011, all of which create interesting investment opportunities:

1. **Energy Prices Will Rise** – Global economic growth will continue to drive energy demand upward for crude oil, coal, and natural gas. We think the demand growth will push prices higher. Our commodity specific analysis is as follows:

   **Coal** – Modest growth in U.S. domestic coal consumption coupled with continued growth in U.S. coal exports will result in a dramatic drop in coal stockpiles. Year-end generator stockpiles will fall to their lowest since 2006.

   U.S. coal consumption will likely exceed production in 2011 as U.S. electric demand in 2011 will increase almost four percent. While most coal is sold under longer term contracts, basic spot prices could increase 10-20%.

   Globally, increases in steel output and demand for thermal coal from China and India will continue to post impressive gains. According to some coal producers Chinese coal imports in 2011 could almost double over last year as their economy continues to expand at an impressive rate.

   Longer term the trend in global pricing is upwards, so much so that Peabody Coal claims that we are in the early stages of a global coal ‘super-cycle’. We think thermal coal prices in the U.S. will continue to advance in 2011, making natural gas fired electrical generation more competitive. Charts courtesy the Energy Information Administration and the Financial Times.
**Crude Oil** – Global demand for crude oil rocketed upward in 2010 at the second highest pace in two decades. We expect demand probably averaged around 86.7 million barrels per day when all the data is reported – a record – exceeding the 86.6 million barrel per day record average seen in 2007. The robust demand explains the price chart at right (courtesy Financial Times). We expect more of the same in 2011.

With continued demand growth and record production levels in 2011 we expect crude oil prices to periodically move into triple digit figures. On average we see crude oil prices fluctuating between $90 and $110 per barrel.

Drilling in the Gulf of Mexico, home to roughly 18% of U.S. crude oil production, has abruptly slowed even with the lifting of the moratorium. Decline curves for offshore wells are steep. Production from existing fields in exporting countries such as Mexico continue to decline in most cases and new discoveries are struggling to replace these losses.

Global spare production capacity – a key to stable prices – continues to fall. Due to the lack of transparency in the global market the extent of this decline is difficult for the experts to quantify. But the lack of capital expenditures, and the project delays and cancellations due to the recent global recession, point to lower growth in capacity than expected. Chart below courtesy The Economist.

Demand for crude oil from developing countries such as China will continue to astound. China’s auto sales should eclipse the U.S. in 2011 for the third consecutive year. China should sell roughly 18.5 million units, well above the 12.8 million units light vehicle forecast for the U.S. Auto ownership rates in the U.S. are 70 cars per 100 people. In China the rate is 3 cars per 100 – so the sales growth in China could continue for a decade or more.

In 2010 it is estimated that China’s oil consumption increased by roughly ten to eleven percent over year earlier levels and accounted for the largest incremental increase in global crude oil demand. International Energy Agency officials called this rate of growth ‘astonishing’ and have noted the era of ‘cheap oil’ is over. Keep in mind that U.S. oil consumption has also resumed growing with the economic recovery. We expect more of the same in 2011.

In this environment merger and acquisition and deal-making activity in the energy sector increased significantly in 2010. This activity tended to elevate stock prices of all firms in the energy group, and we think smaller to mid-sized firms who are aggressively increasing production and reserves in secure political areas should be the major beneficiaries – or the target - of such activity.

All of which is very favorable for the energy sector, especially domestic crude oil producers.
Natural Gas – Bloomberg reported that natural gas and cocoa were the two worst performing commodities of the twenty-two that they tracked in 2010. We don’t think this will repeat. We expect U.S. natural gas prices to average 20% to 25% higher in 2011 than in the year earlier period.

Most analysts expect continued weakness in the commodity so our forecast is somewhat outside the consensus. But we see some very positive developments that in our opinion point to the fact that natural gas prices bottomed in 2010 and will begin a slow long term trend upward.

First, Gulf of Mexico drilling and permitting activities have declined from last year’s levels. While the moratorium has been lifted we don not expect activity to recover to pre-accident levels any time soon.

The 'typical' decline curve for a Gulf of Mexico natural gas well it is extremely steep. Offshore natural gas production has been declining for some time now, and we expect those declines to accelerate in 2011. The Gulf of Mexico supplies roughly 12% of U.S. natural gas production.

Second, reviewing company announcements with regard to their drilling and development plans over the last year almost every company is emphasizing the development of their ‘oily’ prospects. With crude oil at $90 and natural gas selling at an energy equivalent level of $25 a barrel this makes a lot of economic sense. Capital will be allocated where the returns are greatest – and returns on oil field development have generally been sweetened by the high commodity price.

As a result of this re-focusing the North Dakota/Montana Bakken field development is running wild, along with the northern portion of the Texas Eagle Ford shale that contains high amounts of liquids and crude reserves, among a number of others. With the allocation of capital to oil prospects, fewer wells will be drilled for natural gas.

At year end Baker Hughes reports the oil rig count is near record levels, while the natural gas rig count fell to the lowest level in 10 months. Charts of rig counts for oil and gas courtesy Baker Hughes.

Third, many oil and gas leases were taken several years ago by companies who paid thousands in bonuses to the mineral owners. These leases must be developed or they expire after a given period of inactivity. Many of the most attractive leases in shale fields that companies wanted to preserve with production have been drilled. So the economic incentive to drill has diminished, and the legal reason to drill (to hold the leases by production) has also diminished.

Fourth, the costs of directional drilling and hydraulically fracing the formations are escalating very rapidly. The more costly the well the less economic sense it makes to drill a natural gas prospect, especially after the leases have been held by production.
Keep in mind many of the natural gas shale wells have multiple target zones that can be developed later if the lease is held by production. Many companies indicate that with leases held by production they are focusing elsewhere, and will return as economics (higher natural gas prices) dictate.

Fifth, and this point should not be under-emphasized, is the amount of coal to natural gas switching that is occurring in the electrical generation sector. Coal prices are rising – and China may double coal imports this year after being a next exporter several years ago – putting continuing upward pressure on that commodity. Exports of coal from the U.S. are increasing at a fast clip due to growing global demand, and for some grades of coal the price rises have been relatively steep (natural gas historical pricing chart through October 2010 below courtesy Guinness Atkins Energy Report).

With natural gas prices depressed and coal prices rising, from an economic standpoint natural gas becomes very competitive with coal on a cost basis for electrical generation. We have seen more natural gas powered plants are displacing coal generation for the incremental load due to economics.

In the Midwest, the Department of Energy demand data shows that 57% of the region’s electricity was generated from coal last year, down from 68% in 2008 and 70% in 2007. Meanwhile, gas-generated power rose to 23% last year from 16% in 2008. Those are huge changes in fuel selection. Gas traders say that as the winter progresses coal to gas switching should accelerate.

Sixthly, the winter season is shaping up to be a normal one—at least it has not been abnormally warm to date. The winter heating load has been typical, and the natural gas drawdowns from storage are what one would consider normal. But we still have the bulk of winter in front of us, so this remains somewhat of a wildcard. A warm or cold January and February could substantially impact demand for better or for worse. Long term forecasters we follow predict a ‘normal’ winter for the U.S. Midwest.

Seventh, the U.S. economy is slowly recovering from the Great Recession. Natural gas usage for industrial purposes is starting to inch up. With rising grain prices and near-record farm income we expect fertilizer will be in high demand next spring—and natural gas is a major feedstock. Due to the low price of natural gas in the U.S. the cost of the fertilizer feedstock and manufacturing is much less than in Europe. We expect expanding economic activity will increase demand.

Last, long term forecasters say that the 2011 hurricane season (next summer) will be an active one. We place little reliance on these forecasts, but weather trends do indicate that it will be a period where the odds favor more active storms in the Gulf. Any shut-downs or damage offshore would impact the markets short term, possibly longer.

We don’t see a huge move or spikes in natural gas prices in 2011, but average prices could well be 20% to 25% higher next year than in 2010—a move in the right direction. The fact the market has discounted natural gas stocks so heavily, and the consensus is for natural gas prices to stay flat for years, means any move upward should be amplified in the stock prices of these firms—especially if merger and acquisition activity in the natural gas and energy sector continues to accelerate (we think it will in 2011).
2. The Russell 2000 Small Cap Index Reaches Record Levels: Small Company Stocks Dominate -
Expansive monetary and fiscal policies in place at the end of a recession have historically seen smaller company stocks outperform. The last year was no exception (see chart at right – the S&P 600 is a small cap index, the S&P 500 is a large cap index).

Relatively cheap valuations among small cap stocks, earnings expansion, and the active and intensifying merger and acquisition activities will help fuel the outperformance of this sector in 2011.

Most individual investors remain risk adverse and have not warmed up to smaller companies which tend to be more volatile. Many institutional investors ignore the small cap sector since the assets they have under management are too large to effectively invest in the sector.

As risk aversion declines, the global economy recovers, the market advances in a more stable and less volatile manner, and money moves out of bond funds expect to see more interest in small companies – which will be great for performance. We expect the Russell 2000 small cap index to perform very well, exceeding 2007 highs and reaching record levels in 2011. Chart courtesy Wall Street Journal.

3. Stock Selection & Active Portfolio Management Substantially Outperform the Market Indexes –
Over the last several years more and more investors have invested in exchange traded funds that passively track the major market indexes. The correlation between the stock price of individual companies and the major market indexes rose to near record levels with the financial crisis and with the massive inflow of funds that passively track market trends.

This high degree of correlation has created significant mis-valuations in our opinion, inefficiencies that can be exploited by active portfolio managers. Historically the high degree of stock and index correlations decline at the end of a recession. Active managers tend to significantly outperform at that stage of the economic cycle.

Correlations between stock prices and the S&P 500 Index have recently plunged from earlier this year, and we expect these correlations to fall further in 2011.

At the end of 2011 we think the financial journalists will be writing on how poorly investors in passive exchange traded funds that track the market performed versus those who actively managed their portfolio. Chart courtesy The Wall Street Journal.
4. **Food Prices Move Substantially Higher & Food Riots Erupt in Developing Countries** – High crop prices and tight global grain supplies will fuel a bullish outlook for the agricultural economy next year, signaling a windfall for makers of farm equipment, fertilizer and animal feed. We think grain prices will be substantially higher in 2011 as rising demand outpaces production, driving food inflation higher.

Uncontrolled food inflation in developing countries as a result of crop disappointments are likely to lead to a repeat of the crises of 2008 in our opinion, when food riots broke out in a number of developing countries.

Drought in Russia earlier this year slashed production from one of the world’s top wheat exporters and the effects will linger into 2011. In the U.S., corn supplies are expected to decline to a 15-year low following a disappointing harvest. Recent rains in Australia have adversely impacted the agricultural outlook, and weather issues in South America are also raising concerns.

Due to the growing global demand for grains a record harvest will be needed to replenish inventories. Even a normal harvest will not improve the use-to-inventory levels. Corn prices, which in early 2010 were selling for $3.50 a bushel, may spike to $7 to $8 a bushel in 2011.

Ethanol manufacturing used 37% of the U.S. corn crop last year. In 2011 that percentage is expected to rise with ethanol output. Natural gas is a major cost of ethanol and remains relatively cheap, while crude oil prices remain elevated, making ethanol more attractive as a fuel additive.

Note that over the last decade global grain consumption has increased around 2% per year in the chart below. We think production gains in 2011 will likely fall short of the increase in grain consumption as it has in eight of the last twelve years. The world grain stocks-to-use ratio most likely will fall to record low levels next year, which will continue to drive prices upward.
While rising prices for food and energy are a global problem, the U.S. farm sector will be a major beneficiary of these trends. Charts above courtesy Hightower Report and Potash Corporation.

Creighton University’s MainStreet Report for December indicates that both the farmland price index and the agricultural equipment index soared for the month—and both are in long term upward trends.

Land prices gained for an 11th straight month with the index moving to 76.9, its highest level since March 2008, up significantly from 68.1 in November. The farm equipment sales index likewise rocketed higher with a December reading of 77.8, a record high, from November’s 68.1. These trends are great news for LSGI Fund agricultural related holdings.

5. **Real Estate Prices Remain Depressed** – The most recent Federal Reserve study of household wealth indicated that in the third quarter of 2010 household wealth increased by 2.2% - but the value of household real estate holdings declined in value by 3.7%. All of the gains in household wealth were from gains in the stock market. We expect these trends to continue in 2011.

The weak values for homes and other real estate holdings are keeping a lid on the improvement in Americans' net worth according to the Fed's report. With the large number of households with negative equity, the lack of available financing, and the slow job market, real estate valuations may be a drag on the economy for quarters (or years) to come—another reason the Fed might welcome advancing equities prices as a mean to jump-start the economy and to mitigate deflation dangers.

Many economists expect home prices to decline a further 5% to 10% by the middle of next year depending on where they are located. We concur with this assessment. Zillow reported the percentage of home owners with negative equity reached 23.2% in third quarter, up from 21.8% at the end of 2009. Overall, 8 million homes are in default or foreclosure. Not the type of environment where you would expect prices to increase.

Depressed real estate values will keep pressure on the Fed to keep monetary policy expansive, and lower property tax receipts will cause continued revenue problems at the local and state governmental levels.

6. **Investors Return to the US Stock Market** - With the 2008 financial crisis and recession investors have taken a massive amount of money out of U.S. stock funds over the last four years, redeeming their investment for safer alternatives. Much of this money went into bond or money market funds. Prior to 2007 there had been net withdrawals from domestic stock funds only in 1988 and 2002 (chart below courtesy New York Times).

We think the investor, after four years of withdrawals, will slowly re-enter the stock market. We expect net cash flows into U.S. stock funds will be modestly positive in 2011. This would be a very positive development, one that will be especially beneficial for the most inefficient and relatively illiquid parts of the stock market. Cash inflows into equities can do wonders supporting relatively inefficient markets.
The New York Times notes:

“The stock market collapse in 2008 and early 2009 appears to have inflicted far more psychological damage — damage that may have been intensified by the collapse of home values and the deep recession that hit the country, and by the fact that many stocks had not recovered the highs they had reached in 2000. For perhaps the first time since the late 1970s, many Americans seem to have become pessimistic about the future of their country. . . .

In some ways, the current mood is reminiscent of the one that prevailed then. In 1979, Business Week had a cover article on the “Death of Equities,” which it attributed in large part to rising inflation. By 1982, inflation had begun to fall, but the country was in a deep recession. That is when the great bull market of the 1980s began. Few investors seem confident that such a renewal of optimism is likely this time. “

While redemptions of U.S. stock funds continued the multi-year run in 2010, especially after the ‘flash crash’ in the spring, some investors are slowly returning to the stock market as it recovers. A USA Today article last month noted:

_It appears investors are beginning to get comfortable with risk again. Not only are they pulling money out of bond mutual funds at the fastest pace in two years, but they're slowly starting to embrace stocks again._ The shift in sentiment comes as positive economic news and robust corporate earnings lift stocks, which have risen 20% since the start of September. . . .

For the last few months, there’s been a disconnect between the market’s gains and investor behavior. _Investors have been withdrawing more money from U.S. stock mutual funds than they've been adding_. _There hasn't been a positive weekly net flow of cash since late April, according to the Investment Company Institute. That has finally changed. The fund industry organization reported Wednesday that investors added a net $335 million into U.S. stock funds during the week ended Dec. 21_. Although that’s a small amount — stock funds hold more than $5 trillion in assets — the switch to positive flow comes after the pace of U.S. stock fund withdrawals has recently slowed.

While we expect inflows into U.S. stock funds we expect bond funds to suffer. USA Today noted that more than $20 billion was pulled out of bond funds since mid-November, with the weekly outflow in mid-December marking the biggest in more than two years. As interest rates rise bond valuations suffer.

The massive net fund inflow into bond funds over the last two years came to a halt last month. The Wall Street Journal noted “After a stellar two-year run, the bond market is stumbling and a number of investors are betting that stocks will post better returns in the coming months.” Chart at right courtesy Wall Street Journal.

We don’t expect to see a massive inflow of cash into stock funds in 2011, but after four years of substantial withdrawals and with an improving economy we think the outflow of funds will stop. This development could be very important, and bullish, for the market in the year ahead.
U.S. Unemployment Remains Elevated & Food Stamp Use Rises To Record Levels – Job growth turned positive in 2010 but was well below the levels needed to reduce unemployment to pre-recession levels. At year end the unemployment rate stood at __%. With the slow growth U.S. economy we expect the U.S. unemployment rate to remain above 9% for 2011.

In past recessions many of the unemployed found work relatively quickly, but in the latest recession individuals are taking longer to find new job opportunities. The number of unemployed out of work for six months or longer hit new record highs in 2010.

Unemployment benefits in many states have been extended to 99 weeks. The heaviest job losses during the financial crisis were around two years ago – so this cutoff is now coming into focus for those unable to find new jobs.

In 2009 unemployment benefits kept 3.4 million out of poverty, and probably a like number in 2010. The charts, courtesy of the Financial Times, New York Times, and the Economist, tell a chilling story. With a large number of the unemployed unable to find work we expect a large number will run up against the 99 week limit to benefits. Many of these will fall into poverty. Food stamp use, which set a record in 2010, will set new records in 2011.

This is not good news for those looking for work, or for politicians. Social and political tensions in the U.S. will rise in 2011, especially in some of the more economically depressed areas.

These social tensions will keep pressure on the Fed and the Administration to leave accommodative fiscal and monetary policies in place – both of which should benefit the stock market, and ultimately the economy.
INVESTMENT OUTLOOK

In 2010 smaller company stocks outperformed those of larger firms by a substantial amount. For the year ending December 31st the Russell 2000 Small Cap Index gained 26.9% while the large cap Standard & Poor’s 500 Index only gained 15.1% - a substantial small company outperformance.

As for market projections, Goldman Sachs issued their 2011 economic outlook several weeks ago. They project that US stocks, as measured by the S&P 500 index, will rise 23% in 2011 based upon accelerating GDP growth and low short- and long-term interest rates through 2012.

Don Hays of Hays Analytics forecasts a projected gain of 21-27% for the S&P 500. His ‘valuation composite’ has the S&P 500 index as 34% undervalued, so he notes ‘that is not an outrageous expectation. In fact, if anything, our target should prove to be too low’.

We think we have entered a “sweet spot” for investing in smaller company stocks. History tells us the best place to be invested coming out of a recession is (1) in smaller company stocks when (2) individual stock correlations with the indexes fall sharply. We think substantial investment opportunities exist for small cap investors in the coming year.