TRITON

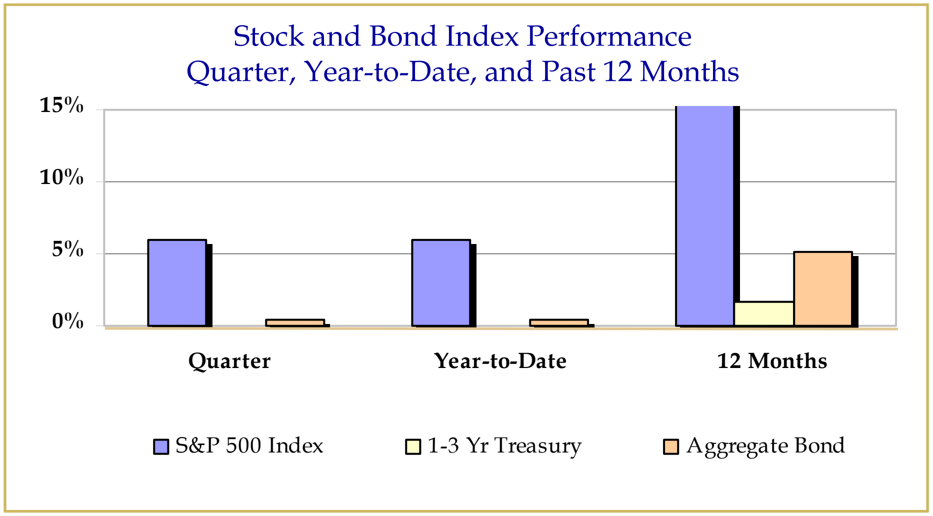
INVESTMENT ADVISORS, LLC

Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair.
~ Sam Ewing

Equities climb the wall of worry, while bonds react uncharacteristically to bad news.

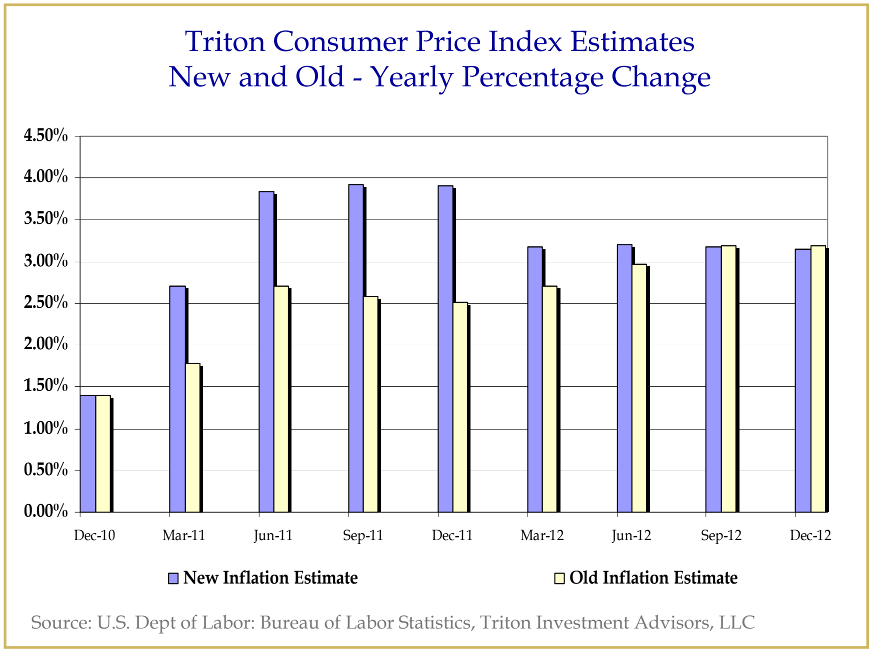
Earthquakes, tsunamis, political uprisings, falling home prices, creeping inflation, and trouble at Berkshire Hathaway – you'd expect stocks to weaken and bonds to rally, but that was not the case. The S&P 500 Index returned nearly 6% in the first quarter, while returns in the general bond market were basically flat. Strong corporate earnings and positive revisions emboldened equity buyers, while the pending curtailment of Mr. Bernanke's asset purchase program caused bond buyers to balk. One particularly large bond investor walked away from the table completely. Whether it was his selling, or a general reaction to the stream of positive economic news, Treasuries were nonetheless held in check as world events unfolded.

The U.S. Treasury market's failure to rally in response to global disturbances reminds me of "the curious incident" of the dog that didn't bark. The inference in the Sherlock Holmes story is that the midnight visitor was someone the dog knew well. Would Mr. Holmes infer that bond investors know well that which equity investors do not recognize? Does Mr. Gross?



The Golden Quarter

Stock market investors have been encouraged by the improving profitability of corporate America. Earnings estimates for 2011 are up nearly 13% since the beginning of the year, and 24% since we last discussed the matter (June 2010). Dividends have also been rising, with S&P 500 payouts 6.9% higher than year ago levels. These bullish factors drove the S&P 500 index to "its best opening quarter since 1998" according to Standard & Poors. In addition, P/E valuations remain "relatively low for the forward 2011 S&P 500, giving investors encouraging fundamentals to hold stocks."



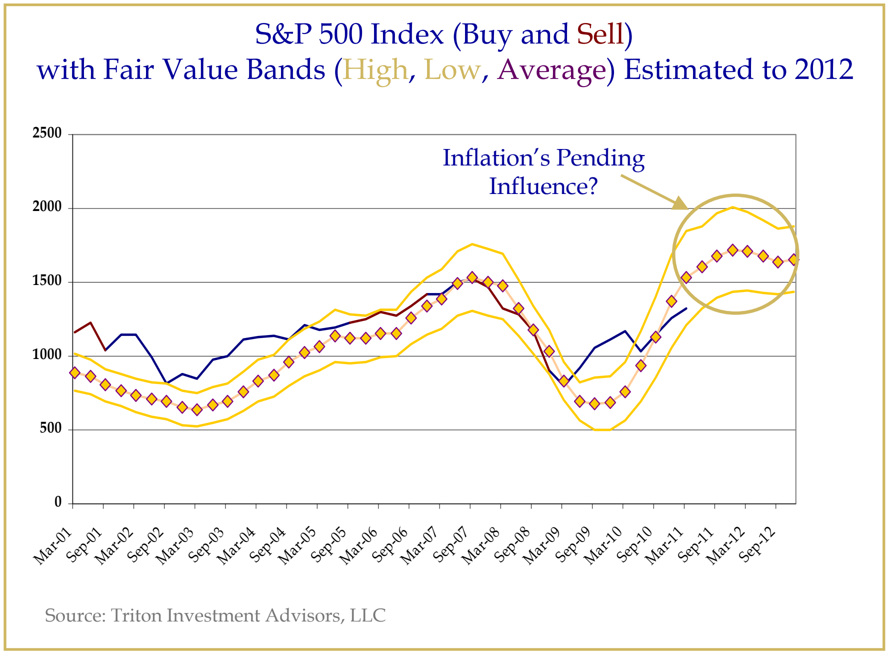
We generally agree with S&P's assessment of the equity market, but we are starting to see hints that corporate earnings comparisons may get more difficult. Input costs are trending higher in response to elevated gasoline and commodity prices, as captured by the CPI Index. As such, we have had to raise our estimates for inflation (see chart above). Temporary pressures won't have a large effect on profitability or valuations. However, if inflationary expectations become entrenched, new stock market highs will be more difficult to attain.

Mapping the Road to Profitability

Inflation's recent upward trajectory has largely been a function of higher raw material prices and a weak dollar. Commodity based inflation doesn't typically translate into sustained inflation unless it is coupled with higher labor costs, and there appears to be sufficient slack in the economy (unemployment) to prevent a meaningful rise in wages. In the short run, however, higher material costs can effect equity valuations if margins are squeezed. The recent underperformance of consumer related companies – unable to pass along higher costs to their cash-strapped customers – illustrates this point.

Inflation also effects the multiple of earnings (P/E) that investors are willing to pay for stocks. High inflationary periods are associated with low P/E ratios, while periods of low inflation generally produce high earnings multiples. We are currently in a low valuation period (as noted by S&P) that also happens to be a accompanied by low inflation. This combination has been a great for stocks, but will it last?

Recent inflationary readings have lowered our fair valuation targets (see chart below). Our response has been to lower our equity allocation targets. However, the investment roadmap depends on many events yet to happen. Any combination of better earnings, lower inflation, or lower stock prices would cause us to reverse this position.



Investing in an Uncertain and Volatile Environment

The stock market is off to a good start in 2011 thanks to positive economic news and good productivity. There have been year-over-year gains in employment, industrial production, and new orders. Tightening credit spreads now imply that the likelihood of low quality corporate bond defaults is about the same as it's been for the past thirty years. Clouding the horizon is the rise in commodity prices. The Producer Price Index is 8.6% higher than it was in March 2010.

Addressing the needs of fixed income investors has been difficult in this market. We've been hedging our bets through a combination of short Treasuries (insurance against an unforeseen calamity), exposure to the aggregate bond market (a laddered mix of corporate and government debt), and high yield (for income). This approach has worked fairly well to date. The impact of the Japanese disaster has yet to be felt, and may provide a window of relative economic softness that bond holders will appreciate. Eventually, however, the withdrawal of Federal Reserve buying will overwhelm all other issues. This could result in an expensive haircut for bond holders.

The first hints of inflation are sneaking into our stock models, but we can't be sure of the permanence yet. Stock investors will also have to adjust to the market once the Fed removes the training wheels from the economy. We should stress that the immediate impact of the Fed's withdrawal is far from certain. Our response to higher inflation was to lower stock allocations by three percentage points. Significant changes in Fed policy could result in much greater changes in allocation. We continue to see opportunity, but as always, we monitor the landscape for change.

Glossary of Terms Mentioned

Credit Spread – The difference in yield between low rated and highly rated bonds. A narrowing spread often indicates an improving economic climate, while a widening spread may indicate expectations of a weaker economic environment.