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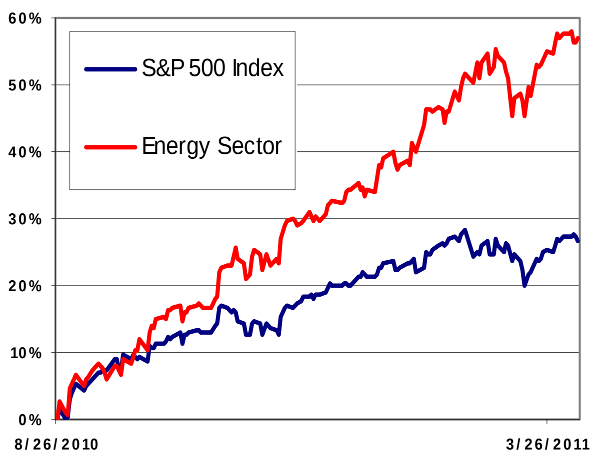
Investment Matters

For the quarter ended March 31, 2011

Energy Stocks Catch Fire

As Yogi Berra said, "It's like déjà vu all over again". Just three years ago the price of oil was $110 per barrel, the Energy Stock Index (XLE) was $80 per share and gasoline was approaching $4.00 per gallon. Today, the numbers are virtually the same and all three are expected to go higher. The cost of energy and the prices of energy stocks are booming as they did in 2008.



SINCE AUGUST, ENERGY STOCKS ARE UP 57%, ALMOST DOUBLE THE 27% INCREASE IN OVERALL STOCK PRICES.

But as recently as last August energy stocks were in the doldrums, at least relative to the general stock market. While the S&P 500 had moved up 55% from its bottom in March, 2009, the Energy Index had risen only 35%. All of that changed the day Federal Reserve Chairman Bernanke gave his Jackson Hole (Wyoming) speech hinting at a second round of quantitative easing. Quantitative Easing is best understood as printing money or creating money from nothing, which only the Fed can do.

Since the Jackson Hole speech, energy stocks are up 55%, more than double the 25% increase in overall stock prices. Energy stocks are going up even faster than the price of oil, which is up 44% for the same time period. And Mr. Bernanke was true to his word; the second round of quantitative easing (QE2) began in November and continues today.

> "Either QE2 will ...cause an increase in the demand for energy, or it will cheapen money causing an automatic increase in energy prices. "

There are at least two ways to look at this: either QE2 will stimulate the economy and cause a dramatic increase in the demand for energy or, it will cheapen the value of money thereby causing an automatic increase in energy prices irrespective of demand. So far, it seems to be both. The economy is a little stronger and the value of the dollar has lost about 8% on the world market. The outcome of this experiment will have profound effects not only on the price of energy stocks but on the future course of the economy and overall inflation.

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What Inflation Problem?

Do we have an inflation problem?

The Federal Reserve, in the person of Ben Bernanke says, no. He cites the meager 1.1% increase in the Core Consumer Price Index (CPI) over the last year as evidence that inflation is low. It's true that this is about half the rate of core inflation over the last ten years.

But the Core CPI measure excludes food and energy prices, exactly the items which people point to when they assert that inflation is a developing problem. The Fed argues that food and energy prices are volatile and that a temporary spike will not lead to an intransient inflation spiral. The Fed notes that wage growth is anemic, labor markets are weak and factories are operating below capacity.

Headline inflation, which includes food and energy, is up 2.2% over the past twelve months, lower than the 2.4% average of the last ten years. The issue comes into better focus when we look more closely. In the past three months the CPI has risen at a 5.5% annual rate. With oil at $110 per barrel, and with Middle-East political unrest growing, this alarming trend seems likely to continue. Many people point out that part of

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Inflation: continued

the increase in oil prices is due to the decline of the dollar and that the Fed, by printing more and more dollars, is exacerbating the problem.

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China is still a relatively poor country. Chinese economic output in 2010 amounted to $4,283 per person. U.S. economic output per person was more than 10 times that amount, $47,132.

Economist Art Laffer estimates that after-tax corporate profits as a percentage of total U.S. economic output will reach 9% in 2011, a fifty year high.

Priming the Economic Pump

Every national politician worth his salt has an economic prescription to fix what ails the U.S. economy and to get it going again. These usually fall into one of two categories, one involving less government and the other involving more. Despite these diametrically opposed options, politicians never bother to explain their rationale for choosing one or the other.

The fact is that there are two basic theories which explain how the economy works. One, which is based on work done by a number of Austrian economists, focuses on investment; the other which is based on the work of John Maynard Keynes, focuses on consumption.

The important difference comes down to a chicken and egg question: which comes first, investment or consumption? If you want to get the economy moving faster should you focus your efforts on stimulating business to invest in more production or on stimulating consumers to increase their spending?

Intuition tends to favor the Keynesian approach. After all, why would a rational businessman invest to produce things which consumers are reluctant to buy? If consumers start buying more, businessmen will respond by building more plants and hiring more workers to meet the increased demand.

The problem with the Keynesian approach is that using government dollars to stimulate consumer spending has not proven very effective. First, all the government dollars have to come from somewhere, either current taxes or current borrowing. Current taxes take money out of someone's pocket and so reduce their spending. Current borrowing means higher future taxes which people perceive as a permanent drain on their income. Also, government stimulus programs are always temporary. It has clearly been shown that people view temporary windfalls much differently than permanent income increases; they tend to save a big portion of a windfall but are willing to spend most of a permanent increase. No government can afford a permanent program to raise the income of all consumers.

Historically, the Austrian solution has had more success. A wide range of government policy changes from reduced tax rates in 1964, to reduced regulation in the early 1980's, to making ready for war in the late 1940's, provided increased incentives for business to invest. In each case, as business expanded and hired more workers, consumers responded by spending more money. This resulted in better economic growth for all.

So, when you hear a politician endorse a policy improvement designed to stimulate the economy, ask yourself which theory he or she is using. Better yet, ask yourself if this idea will either permanently stimulate consumers to increase their buying or permanently encourage businessmen to invest their money in new production. If the answer is neither, the policy is probably politically rather than economically motivated.

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The Bottom Line: 3/31/2011

Market Indicator	**Current Value**	**One Year Change**
Large company stocks *(S&P 500 Index)*	1326	15.1%
Small company stocks *(S&P Small Cap Index)*	447	24.0%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	3.5%	From 3.8%
Inflation *(Consumer Price Index)*	222.3	2.2%
Energy *(West Texas Intermediate Crude Oil)*	$106.77/bbl.	27.5%
The economy *(Inflation adjusted GDP)*	$14.8 trillion	2.8%

QUOTABLE

"By a continuing process of inflation government can confiscate... an important part of the wealth of their citizens"

John Maynard Keynes

Robshaw & Julian Associates, Inc.
6255 Sheridan Drive, Suite 400
Williamsville, New York 14221
Tele: (716) 633-6555
E-mail: info@robshawjulian.com
Website: www.robshawjulian.com