◆ COMMENTARY ◆

PRIVATE CAPITAL MANAGEMENT, INC.

TEL: 303.370.0055
FAX: 303.370.0066

WWW.PCM-INC.COM

250 STEELE STREET • SUITE 350 • DENVER, COLORADO 80206

First Quarter 2012

"ONE OF THE THINGS WE HAVE TO BE THANKFUL FOR IS THAT WE DON'T GET AS MUCH GOVERNMENT AS WE PAY FOR."
- CHARLES F. KETTERING

During the first three months of this year, the S&P 500 was up an impressive 12%, making it the strongest start to any year since 1998. This followed an 11% gain last quarter, for a cumulative 28% rally since the early October lows, when the situation in Europe looked bleak and US economic data weakened. By contrast, China was up only 2.9% this quarter and Spain actually fell -6.5%.

Is the Party Over?

While we have seen an impressive rally during the last six months, the S&P 500 is still 10% below the October 2007 highs even though operating earnings are at a higher level today. On a trailing basis, the Price to Earnings (P/E) ratio of All US Corporations is at 12.5x (average=13.7x) and the Forward P/E ratio on the S&P 500 is still only 13x (average=16.2x).[1] While valuations are not as attractive as they were six months ago, equity markets are still not overvalued.

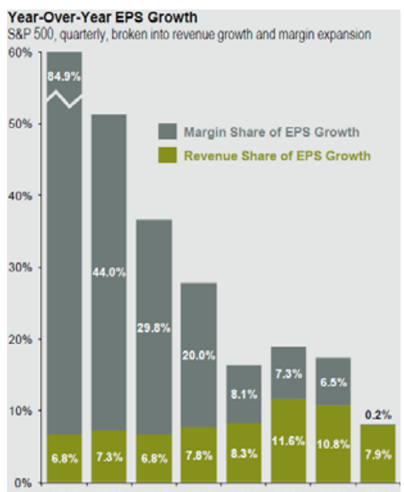
Importantly, recent US economic data has been improving and may be just in time to help offset the slowdown in China and Europe. The US unemployment rate dipped to 8.2% in March, reflecting a less than expected 120,000 increase in payrolls and 164,000 decline in the labor force. Federal Reserve Bank of New York research shows the jobless rate may fall as low as 6% by the first half of 2013.[2] Declines in jobless claims helped push the Leading Indicators Index up a sizable +0.7% in February from +0.4% in January. Household financial obligations as a percentage of disposable income fell to 15.9% in the fourth quarter, a 28-year low. Personal consumption expenditures increased 0.8% in February, the largest increase in 7 months. Consumer credit increased $17.8 billion in January for the biggest three-month gain in over a decade. Consumer Sentiment reached 76.2 in March marking the highest level of the recovery.

The strengthening US economy comes just as Euro-zone GDP contracted for the first time since 2009, falling -0.3% in the fourth quarter. Euro-Zone unemployment rose to 10.8% in February, the highest level in 14 years. According to the Centre for European Reform, a think tank in London, the ratio of investment to GDP in Europe is at a 60-year low as corporate cash holdings in the Euro-zone are at a staggering $2.64 trillion and $1.19 trillion in the UK.[3] Chinese Premier Wen Jiabao cut this year's Chinese GDP growth target to 7.5% from a long standing target of 8% and below actual growth of 9.2% last year.

Following the recent rally, investors should be braced for a correction/consolidation in the equity markets and likely lower returns for the remainder of the year. The Chartist, however, does not anticipate a correction of any substance at current levels but says one could come from much higher levels.[4] In other words, sit tight. We believe the markets will need improving economic data to continue grinding higher.

Reversion to the Mean

Corporate profits are currently the largest proportion of national income in post-war history, and there is an increasing number of US companies reporting negative Q4 Y/Y earnings growth and missing 4Q11 earnings estimates.[5]



Source: Standard & Poor's, Compustat, BEA, FactSet, J.P. Morgan Asset Management

As the graph to the left shows, corporate profit margin expansion has been a significant driver of earnings growth over the past few years, but at a declining rate. A growing number of market strategists are calling for margins to revert to more normalized levels. However, if the economy continues to improve, the Revenue Share of EPS Growth (green) could increase and help offset some of the declining Margin Share of EPS Growth (gray).

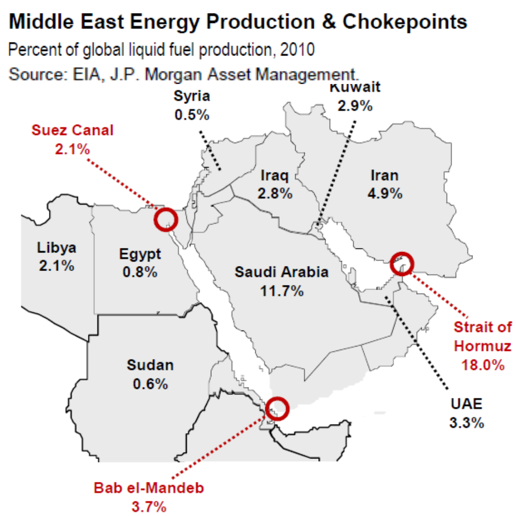
Brinkmanship

Key risks in the latter half of the year are the economic, tax policy and debt-related issues that need to be resolved by year end. Specifically, the Bush Era Tax Cuts are set to expire this year, budget sequestration calls for $600 billion of cuts to defense and domestic discretionary spending over 10 years, while the US Debt Limit could be reached before year end.[6] Given this is an election year, it's unlikely much progress will be made on these key issues until after the elections in November. Economists estimate that if nothing is done, higher tax rates and sharp spending cuts could subtract 3%-4% from US economic growth.[6] At current growth rates, that would push the economy dangerously close to another recession. Additional political brinkmanship is almost a foregone conclusion and, contrary to popular belief in Washington, this is not good for the economy.

First Quarter 2012

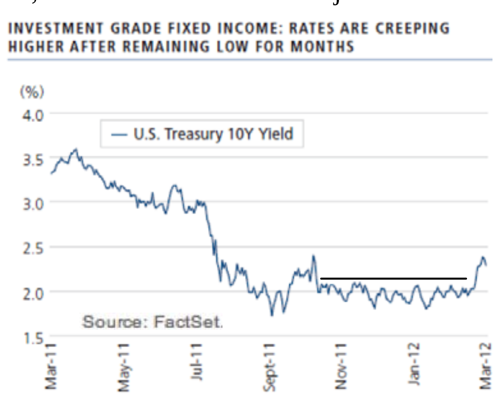
Geopolitical Risk

Recent news headlines addressed the possibility that Israel could make a preemptive strike to prevent Iran from gaining nuclear weapons capabilities. Despite above average crude oil inventories, this threat has caused gasoline prices to rise. As the map shows, nearly 20% of the world's oil supply travels through the Strait of Hormuz near Iran. A closure of the Strait would almost certainly cause a dramatic rise in oil and gasoline prices. A recent report by the Milken Institute estimates that each sustained $10 increase in the price of a barrel of oil will reduce US GDP by 0.3%.[7] This is a meaningful amount for an economy growing at only 3%.



The Winds are Changing

The US Bond market has been in a bull market for the last 20 years, when interest rates peaked in the 1980s. We believe those winds will begin to change. US corporate bond issuance reached a record $427 billion during the quarter, while yields on investment-grade debt in the US declined to a record low 3.4% on March 2nd.[2] Junk bond sales in the US also soared to a record $91.6 billion during the quarter.[2] Spreads on high yield bonds are near the long-term average of 6%, but yields on junk bonds issued during the quarter averaged only 7.98%, the lowest rate since the junk-bond market was created in the 1980s.[8] With the 10 year US Treasury yield at only about 2.2%, and consumer prices increasing 2.9% annually in February, US Treasuries currently offer a negative 'real' return and are a good way to get poor slowly. We're not recommending investors sell bonds completely; however, we believe that an actively managed diversified approach will be important going forward.



The Elevator Speech

As you may know, part of our investment philosophy is that the track record of a mutual fund goes up and down the elevator each day with its investment team. Essentially, we make investments with specific people, not mutual fund companies. Several weeks ago we learned that one of our favorite managers, David Iben at the Nuveen Tradewinds Group (whose funds are closed to new investors), decided to leave the firm. As Chief Investment Officer for the Tradewinds Group, we believe Iben was critical to the investment process. As a result, we sold our sizable positions in his two mutual funds. We believe actively monitoring investment managers is critical and is just part of the service we provide to our clients.

Thank you for inspiring us each day.

As we look back on the past few years, we cannot help but think how fortunate we are to be working with such wonderful clients. We are grateful for the opportunity to work with so many people who share so much of their lives with us, and continue to inspire us each day. Thank you for placing your trust with PCM.

Private Capital Management, Inc. would also like to thank everyone who referred clients to us during the quarter. Referrals are vitally important to our firm and allow us to continue to grow while remaining focused on research.

~The PCM Team

By the numbers…

Index	Close	1st Quarter	Year to Date
S&P 500	1408	+12%	+12%
MSCI EAFE	1553	+10%	+10%
MSCI Emerging Markets	1041	+13.7%	+13.7%
Barclay's US Aggregate Bond	121	-1.3%	-1.3%
DJ|UBS Commodity	141	+0.9%	+0.9%

Data provided by Thomson Reuters as of 3/31/2012

[1] "Market Insights: Guide to the Markets 2Q | 2012" J.P. Morgan Asset Management 3/31/2012
[2] "Bond Sales Top $1 Trillion on Record-Low Yield" Sridhar Natarajan www.businessweek.com 3/29/2012
[3] "Firms' Cash Hoarding Stunts Europe" Stephen Fidler 3/22/12 www.wsj.com
[4] "The Chartist Newsletter" Dan Sullivan & Steve Mais www.thechartist.com 4/5/2012
[5] "The First Sign of Weakness in Corporate America" Richard Bernstein 3/19/2012
[6] "Weekly Investment Commentary – Have We Reached the End of the Rally?" Bob Doll 4/2/2012
[7] "Outlook for the Economy" Robert Johnson, CFA www.morningstar.com 3/27/2012
[8] "Junk Bonds Feed a Hungry Market" Matt Wirz www.wsj.com 3/30/2012