



MARKET WATCH

First Quarter 2011

THE
SANIBEL  CAPTIVA
TRUST COMPANY

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CURRENT OUTLOOK

As 2011 begins we are struck by the greater clarity of many investment issues compared to just three months ago. At the same time, other issues have become somewhat more problematic. Therein lays the challenge of navigating through the difficult times that always follow a financial crisis.

Three months ago, uncertainty reigned in both political and fiscal policy realms. National Congressional election polls suggested the possibility of a change in the direction of government policies. The extension of the Bush-era tax cuts beyond their mandatory calendar 2010 year-end expiration was totally up in the air. Monetary policy was being intensely debated. In an attempt to keep interest rates low, the Federal Reserve wrestled with whether to try a new round of stimulus through the outright purchase of massive amounts of U.S. Treasury debt.

We now know with certainty that the political landscape did undergo a major re-shaping with Republicans taking control of the House of Representatives. The tax policy at the Federal level is now set for at least the next two years with the extension through calendar 2012 of the Bush-era tax cuts. And quantitative easing (QE2) by the Federal Reserve will most likely be in place for the coming six months assuring unusually low short-term interest rates for the time-being. In addition, a surprise compromise between the President and the Republicans unleashed a second-round of fiscal stimulus strongly encouraged by Federal Reserve Board Chairman Ben Bernanke. Over the last 30 days estimates for 2011 U.S. economic growth have increased from roughly 2%-3% to near 4% in some cases. Corporate profit growth estimates have also been increased to reflect this improved economic outlook. Is it any wonder that equity markets have risen some 20% from their lows in August?

There remain, however, at least three unresolved issues. Any one of these issues alone would be sufficient to cause a hiccup in the rosy scenario outlined above. The first issue is the impact on global growth of the continuing EuroZone sovereign debt crisis. It is reviewed in an interesting fashion in another Market Watch piece this quarter. It makes good reading.

The second unresolved issue is the continued low level of activity in the U.S. construction and real-estate industries. Whether we are talking about residential construction operating at levels 75% below the 2006 peak or the hard-to-quantify issues in the commercial construction area, this part of the U.S. economy, including real-estate in general, typically amounts to upwards of 20% of Gross Domestic Product (GDP). Until this segment of the U.S. economy shows performance more in line with pre-financial crisis levels, overall economic growth levels will be muted.

The third issue that lacks the clarity we would like is the ultimate resolution of the U.S. federal, state and local budgetary morass. States and localities have no choice but to cut services and reduce employment. The federal government has no choice but to face higher levels of interest costs and a possibly debilitating currency crisis once the “sugar high” of fiscal stimulus comes to an end in 2013. As we pointed out in our Current Outlook of October 2009 — “*Monetary restraint and some fiscal discipline may be just what the ‘bond vigilantes’ will require once economic growth is restored. Whether these actions are done in the context of crisis or reasoned dialogue may determine how capital markets perform over the coming 12-24 months*”.

ON-LINE NEWSLETTER NOW AVAILABLE

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HEAVY METAL

Since the early part of the last decade, owning things that “would hurt if it fell on your foot” has been good advice. A list of such items would include industrial metals, coal, barrels of oil, bales of cotton and other bulk commodities. The Commodity Price Index rose 163% from 2000 thru 2010, with energy up 204%, industrial metals 201%, and commodity food prices up 105%.

In order to better understand this “secular” rather than “cyclical” bull market it is essential to recognize the principal factors which have been strongly in evidence.

Supply and Demand

Throughout the 2000s demand for commodities was driven initially by demand for housing and other construction in the U.S. and the Euro-zone. A sudden interruption in global commodity demand did occur as a result of the financial crisis of 2008. Strong demand then continued due to the rapid capital and infrastructural advances in the emerging economies, particularly China, India, and Brazil. As global standards of living begin to significantly improve in many areas of the world, so has the demand for higher protein diets. The job of increasing food production to meet this higher demand takes years with such strong secular forces.

Currency Valuation Levels

A second secular cause of rising commodity prices relates to currency values. Since most global commodities are principally priced in U.S. Dollars, currency trends also exert significant influence on prices. Importantly, a 30-40% decline in the U.S. Dollar Index since 2001 has helped provide a prevailing lift to commodity prices.

Speculative Interest

As the secular bull market for commodities continues, so has the interest in trading such commodities for speculative profit. The proliferation of new specialized investment vehicles linked to broad commodity baskets and even individual single commodities has attracted new investors, hedgers, and speculators alike.

For most investors, any significant new investment in commodities would likely not be very appropriate at current levels. Downside pressure on commodity prices could be felt if the emerging market economies begin to slow significantly. China, rumored to have hoarded huge amounts of several leading commodities, is beginning to experience increasing urban vacancy rates due to sporadic overbuilding.

From the standpoint of corporate profitability, most well-managed U.S. companies and multinationals have effectively hedged or factored in higher raw material and energy costs with product prices at existing levels. The strongest companies have weathered the financial crisis, maintain strong balance sheets, and are now in the process of expanding profit margins despite rising costs. Baring another energy and commodity price spike or hyper-inflation, most companies are likely to benefit from eventual stability or even moderation in commodity costs as supply and demand imbalances begin to equalize again at some point.

Looking forward to the decade ahead, the secular bull market in commodities will begin showing its age and the benefit will be felt more by the ever increasingly efficient business and industrial consumers of energy and commodities rather than the producers, traders, and speculators in commodities.

A BLEEDING CONTINENT

Imagine the following scenario unfolding: The state of South Carolina is insolvent and every bank within its borders has been nationalized. New Jersey can't pay its vendors and asks for billions in emergency loans. Banks in Florida, New York, and Illinois are teetering because they have lent these states money and have to take write-downs. Meanwhile, budget deficits in several states grow to crippling proportions, and their legislatures opt to cut pensions and public sector wages. Unemployment soars above 15% and general strikes result. Texas, Indiana, and Georgia – three states running balanced budgets – begrudgingly pledge financial support, force austerity measures on the other states, and join with the federal government to create an omnibus bailout fund.

Implausible sounding as it is, this describes the sequence of events that has brought Europe's desire to maintain monetary union to its financial inflection point. As we go to print Ireland, Spain, and Portugal face more debt downgrades. Bond investors and hedge funds are pressuring debtor nations to take massive debt write-downs and balance their budgets. The European Union – at the prodding of fiscally healthy nations like Germany – committed to an extraordinary treaty amendment that would create a \$1 trillion emergency fund for all the troubled nations to tap.

Indeed, what started as a run on banks in Iceland in 2008 (Europe's version of the collapsed Bear Stearns hedge fund that triggered our mortgage crisis) was never stopped in its tracks, but spread like a slow virus. Unlike the U.S., Europe has lacked a "Treasury" that could print money at will to stimulate all the troubled economies. Further, no nation in crisis except England had its own currency that it could manipulate to manage its problems. And until recently, there was no political will to mend the trade, credit, and productivity imbalances that left several countries highly vulnerable to the credit crunch. In December, the reckoning period began. European finance ministers now must deal with loan defaults, budget deficits, debt downgrades, and housing busts. They are also simultaneously forced to solve the more-intractable problems created by bloated public welfare and pension programs, aging populations, and inflexible labor markets.

Whether or not EU nations can adhere to bailout solutions, the upshot for American investors is that European markets most clearly are following a "New Normal" trajectory of slower growth, protracted credit problems, chronically higher unemployment, and government budget contraction. At the macro level, this will have an impact on global growth, since Europe comprises 1/5 of world output. At the micro level, Europe is the second-largest export market for American companies.

We will stress quality in buying European assets – when we buy at all – investing only in companies (and countries) with healthy, improving balance sheets. This is the strategy we pursued with American companies before, and during, the credit crunch. We have intentionally limited our exposure (both here and in Europe) to the New Normal "trouble spots" – housing, banking, and consumer discretionary spending – and continue to favor valued-added service companies and manufacturers with healthy export potential.

	GDP (bil.)	budget deficits/ GDP
Germany	\$3,306	-3.3%
Italy	\$2,036	-5.2%
Portugal	\$224	-9.4%
Spain	\$1,375	-11.2%
UK	\$2,258	-12.0%
Greece	\$305	-13.5%
Ireland	\$204	-14.3%
U.S.	\$14,750	-11.5%

source: IMF

PORTFOLIO REVIEW & STRATEGY

The fourth quarter of 2010 was very rewarding to equity investors, as major stock markets finished the year strongly. Riding the wave of firmer-than-expected economic data and business-friendly political deal making, the total return of the Standard and Poor's 500 Index rose more than 10% in the three months ending December 31st. For the full year, the S&P 500 gained more than 15%, including dividends.

The fourth quarter was led by the energy and materials sectors, as investors pushed these companies' stocks up more than 18% in the hopes of a continued global economic recovery. Stronger year-over-year retail sales enabled the consumer discretionary sector to continue its amazing outperformance, with these stocks finishing the year up nearly 26%! Looking forward, we would need to see the earnings of these companies catch up with the stock prices before we would be comfortable committing new investment dollars.

Rising bond yields in December resulted in the telecom and utility sectors underperforming in the fourth quarter, as investors found their dividend yields somewhat less attractive on a relative basis. However, with President Obama signing the \$858 billion tax/stimulus bill, the extension of the favorable dividend tax treatment presents income-oriented investors with a great opportunity at these prices.

After a strong performance in the previous two quarters, bond investors experienced negative total returns, with the Barclay's U.S. Treasury Index falling 2.0% in the quarter. The yield on the 10-year U.S. Treasury, after bottoming at 2.3%, rose to finish the quarter at 3.3%. Despite all the volatility in the bond market, the 10-year Treasury yield finished only slightly lower than where it started 2010, at 3.8%. The bond market seems to be telling investors that economic growth, aided by continued government stimulus, will eventually lead to inflation, which has been off the table since the financial crisis began in late 2008. It is for this reason that we are currently avoiding new investment in bonds, and in many cases moving income-oriented clients with a longer time horizon into high-dividend yielding equities.

The US Dollar index increased 1.5% in 2010, as renewed fears of the Euro-zone debt crisis came front and center once again in the minds of investors. Despite the strength of the U.S. Dollar, commodities – led by the 14% quarterly increase in the price of crude oil – finished the year up 17%. We are paying close attention to the way corporations manage these increases in input costs, as profit margins can be negatively affected if not properly hedged.

Despite the equity markets having posted double-digit positive returns in both 2009 and 2010, we are still able to find high-quality companies and sectors that are under-appreciated by "the market". In particular, the largest multinational companies, with ample cash on their balance sheets and steady earnings growth, have been ignored in favor of "risk assets" like commodities and specialty retailers. We expect to see a rotation into the high dividend companies in the next year or two.

When building a portfolio, we continue to emphasize a global investment approach. However, it is very difficult, if not impossible, to accurately predict which parts of the world will outperform or underperform in any given market cycle. We will continue to look for investments with exposure to multiple markets that can benefit not only from global growth but also help neutralize the fluctuations in the currency markets.

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Our wealth management philosophy follows a strict discipline to preserve clients' wealth and to achieve their long-term objectives and provide for annual cash flow needs. Portfolios are separately managed by our in-house experienced portfolio managers.

We welcome your phone call.

Sincerely,

S. Albert D. Hanser
Co-Chairman and CEO

Donald (Chip) Lesch
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