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Investment Counsel since 1961

Second Quarter Commentary 2011

For the second quarter, the S&P 500 Total Return index was flat. Investor sentiment was markedly different from the first quarter. For the first four months of 2011, investors invested \$18 billion into US stock funds. However, in the subsequent two months, investors withdrew \$26 billion from stock funds. After a strong April, the European debt crisis, the impact of the Japanese tsunami, higher than expected Chinese inflation data, and a slowing US economy all negatively impacted equities. Several factors should relieve this economic pause.

The recent short-term resolution of the Greek debt issue, stronger US manufacturing readings, and evidence that Japan is emerging from their crisis, pushed commodity prices and bond yields higher. Crude oil has recovered from its lows, but it is still down over 15% from its high. This has lowered gasoline prices and should increase consumer discretionary spending. Bank lending standards are still historically tight, but recently, lending has been easing. There is no question that US economic growth of around 2% for the first half of 2011 is disappointing and will be well below what analysts expected at the beginning of the year.

Oil prices are once again increasing despite international efforts to lower prices. The futures prices are up 6% from the lows hit after the announcement to release 60 million barrels of oil from the Strategic Petroleum Reserve (SPR). Investors are focused on increased worldwide demands. Increasing demand from China, India, Saudi Arabia, Brazil and other emerging markets has created a global market that is more inelastic than in past years. China alone imports almost a million barrels a day more than the same time last year. By circumventing OPEC with the release from the SPR, we may well find that they will lower production. Saudi Arabia has already indicated its displeasure by lowering the premium of their light grade by a mere ten cents, not a reassuring signal for those expecting lower prices.

Oil is increasingly difficult and more expensive to find and extract. We seek domestic oil exploration and production companies that are able to grow their production and are therefore less dependent on a high oil price for growth. In particular, we are encouraged by the developments of Continental Resources, Whiting Petroleum, and Brigham Exploration in the Bakken Shale. As the oil recovery and extraction technologies improve, the estimates for recoverable oil continues to increase. New drilling and "fracking" technologies allow production companies to increase the expected ultimate recovery per well, which increases the net asset value for the company. Within certain broad parameters, the price of oil will not impact capital expenditures by the oil companies. We have added Carbo Ceramics, an oil service company, to your portfolio.

In the short-term, technology stocks have been a very mixed bag. While IBM made a new all-time high, the stocks of Google and Microsoft both struggled and are down for the year. Since technology allows companies to replace labor, margin improvement through increased technology spending is their priority.

Forester Research projects that spending on the "cloud" will grow from \$40 billion to \$240 billion in the global IT market over the next ten years. Cloud computing provides a platform on which corporations can increase margins by lowering fixed costs. While adoption rates are increasing, penetration is still low. In Google's case, their new chrome book, the first colored computing laptop, operates on web-based software. It can store all your files in Google's "cloud" so you can retrieve your most critical documents from any computer. You are not out of luck if your laptop is lost or stolen.

The technologies driving cloud computing and the penetration of smartphones is still nascent. The consumer is migrating from cell phones to smartphones. We expect that the next step will be from traditional PC's to tablet computers. Total tablet sales are expected to rise to 70 million globally up from 20 million in 2010. For the first time, total tablet and smartphone sales will exceed total combined PC sales as consumers and corporations de-tether from wired infrastructure. Tablets are designed to rapidly connect to a network to access data, but not to store the data on the machine. This is the essence of cloud computing. Tablets are creating the foundation for an even more robust mobile ecosystem and are another step towards cloud computing. Microsoft and Google are both beneficiaries of the migration to the "cloud."

A recovery from a recession caused by a financial crisis typically is accompanied by slower growth and takes longer than a recovery from a more common cyclical recession. We seek those companies that can grow independently of macro economic conditions. Growth stocks are driven by earnings' gains. We expect second quarter earnings to be robust.

Thank you for your continued support.

Sincerely,

Bill Miller