

First Quarter 2011 Commentary and Outlook

The strong first quarter rally in equity markets was interrupted by rising commodity prices, continuing sovereign debt risks, uncertainties about a nuclear meltdown in Japan, and rising oil prices on the backs of revolutions in North Africa and the Middle East. Understandably, investors stepped back to evaluate the potential impact of these events on corporate profits.

An uncertain economic backdrop

These issues are unlikely to be resolved quickly. Although the Federal Reserve and its second round of quantitative easing (QE2) have provided ample liquidity, which may support near-term demand for “risk assets”, the economic backdrop for the equity markets appears considerably less certain than it did just a few months ago.

There is no shortage of events that could undermine the fragile global economic recovery. The Fed’s ability to control the path of interest rates, effectively manage its balance sheet, and avert 1970s-like inflation is in question. The congressional battle over raising the nation’s debt ceiling likewise holds potential to affect global financial markets. Much is also at stake with China’s efforts to tame inflation, with Europe’s sovereign debt crises, with the global response of monetary authorities to commodity induced inflation and domestically with the ongoing deterioration in U.S. housing prices. All cast shadows over financial markets, as does the possibility of QE2 ending ahead of a self-sustaining economic recovery.

The newest and most significant threat to stability is the potential for swings in the price of oil that can interrupt the smooth functioning of the international economic system. Revolutions in the Middle East and North Africa, the heart of the world’s oil supply, are occurring at a time when global excess capacity is quite low. This could well develop into an extended period of highly volatile oil prices, including price spikes that diminish the outlook for corporate profits.

Oil supply-and-demand dynamics

At current production levels, spare capacity of crude oil is razor thin putting the global economy at risk of price spikes that can threaten growth. The fact that non-OPEC oil production is projected to demonstrate limited growth for several years means that OPEC must meet the bulk of incremental demand, estimated at around 1.5 million barrels a day for each of the next several years. OPEC’s excess capacity, largely based in Saudi Arabia, is modest, at an estimated three to five million barrels a day, and not expected to increase meaningfully in the next several years. This is ahead of any reduction of Libyan production which is already down more than one million barrels a day. It also doesn’t factor in any increased demand from Japan to rebuild and replace some of its lost nuclear power with oil-based power generation.

In sum, a tight supply-demand balance for oil over several years suggests a high risk of oil price shocks, which can depress economic activity. It is worth noting that short-term oil price spikes preceded five of the past six recessions.

The Middle East Crisis Has Just Begun

Geopolitical considerations in the Gulf region have always been complex, and those underlying complexities suggest that the region's recently heightened tension and violence are unlikely to dissipate soon. Populist social-spending policies are becoming increasingly important tools for governments to maintain order and avert unrest. The resulting budget pressures will underscore the need of Gulf countries to receive a higher price for their oil. Add to that, the possibility that state-owned oil companies may have less capital available to pay for new production and development and this situation suggests that oil prices may remain elevated compared to the marginal cost of production, which is estimated to be in the area of \$80 per barrel, and rising around 10% annually.

In this setting, with spare capacity tight and geopolitical tensions high, the price of oil is likely to be unusually volatile, with price spikes followed by steep but short-lived declines as demand is cut. Over the next several years, consumers will lead the reduction in demand, through energy efficiency, greater use of substitute energy sources and behavior modification. Over the longer term, industry will increasingly account for the greater share of demand destruction. Asia accounts for most of the roughly 22 million barrels of fuel oil consumed daily for industrial purposes. Since fuel oil is likely to continue to sell, on an energy-equivalent basis, at a premium to such alternatives as coal and natural gas, it is reasonable to expect that industry will switch over time to these more economical sources of energy. While there will likely be periods of price spikes in the future, they will probably not be of long duration. Over time, the price of oil should largely track the marginal cost of production.

The result of these pressures is likely to be slower economic growth, perhaps with a period of stagflation, and increased economic volatility. All of this may eventually translate into higher risk premiums for financial assets.

Investing in Solutions

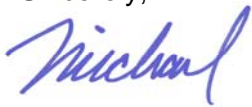
Energy buyers will want to diversify their energy mix to gain greater security of supply on economically attractive terms. This points to steepening global demand for natural gas and liquefied natural gas (LNG) in the years ahead. Global demand for LNG is projected to rise at least 10% a year over the next five years. Natural gas sells at an energy equivalent discount to fuel oil and, as an added inducement, is also more environmentally friendly than oil or coal. Infrastructure will be in place to accommodate this growing demand for LNG.

Companies that are positioned to capitalize on the expected increase in natural gas and LNG consumption represent attractive investment opportunities. One such investment opportunity is a midstream LNG infrastructure company. We believe the company is well positioned to emerge as a world leader in LNG infrastructure. We expect this company's extremely able management team will materially expand the company's earning asset base and will initiate significant new business projects that, in the years ahead, will lead to substantial increases in free cash flow and market value per share.

Events in the Middle East and North Africa, and the earthquake and tsunami in Japan, have focused investor attention on emerging global opportunities for natural gas and LNG. With the shift to natural gas in its early stages, and given the long lead times of infrastructure projects, we believe that this business is in the initial leg of a multi-year period of value creation and outperformance.

In view of the dynamics that are driving the global market for natural gas and LNG, this sector represents fertile ground for investments with the potential for superior long term returns, and is an area of focus for our investment team.

Sincerely,



Michael A. Steinberg
Managing Partner