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QtrNotes

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Market Summary:

In the wake of a volatile financial and geopolitical environment, equity markets made up for any lost ground and closed the first quarter of 2011 in the black. The Dow ended the quarter up 6.4%, while the S&P 500 gained 5.4%. The small-cap index rose 7.6%.

Firestone Welcomes Louise Owen:

Louise joined us in early 2011, after spending nine years at Conlon Dart, an advisory firm in Seattle, Washington. Under the title Operations Manager, Louise has quickly become an integral part of the Firestone team.

New Website Launched:

On the heels of our rebranding efforts announced in our 1Q 2011 QtrNotes, Firestone is proud to announce the launch of our new website. Same address, **www.firestonecapital.com** and a whole new look and catalogue of resources. A special thanks to David Laidlaw's team at Laidlaw Creative for helping us every step of the way.

Markets Show Resilience Through Chaos, Crisis, and Wars

Morningstar analyst Robert Johnson recently wrote: "I'm glad my crystal ball was broken. Three months ago, if my crystal ball had foreseen almost $4 per gallon gasoline, major rioting, government changes across the Middle East, and one of the largest earthquakes in history, I would have concluded that consumer spending was in for a major tumble and that the stock market would fall at least 10%-20%."

We couldn't agree more. The market shrugged off the bad news with first quarter ending on a positive note. The S&P gained 5.4%. International markets lagged with a 2.7% return. The world economy continues to grow and leading economic indicators look positive. We seem to be heading in the right direction, though the ride may be rocky.

Over the next three months the Federal Reserve, through a program called "Quantitative Easing" (QE) will purchase almost $200 billion worth of long-dated treasury bonds, completing its goal of buying $600 billion. QE effectively injects that sum into the economy. Although the Fed has publicly declared the end of monetary easing, if economic growth begins to stagnate, the Fed may feel the need to do more and extend the program.

Weak economic activity, high unemployment, and falling inflation were the impetus behind QE1, which took place from late 2008 to early 2010, and QE2, the current round. Today, the US has recouped all lost output in Gross Domestic Product (GDP). Corporate earnings are expected to hit record highs this year. In addition, since February of 2010, the US has regained more than 1.1 million jobs, bringing the official unemployment rate down to 8.8% from a peak of 10.1%.

Inflation appears to be trending higher overall, but remains below the Fed's 2% target. Although food costs are noticeably higher and energy prices have jumped nearly 20%, the overall inflation rate remains low. This may seem illogical to shoppers, but housing prices, which have fallen, represent more than 40% of the Consumer Price Index (CPI) calculation. In addition, lack of demand has driven down the price of goods such as clothing and electronics. Capacity utilization, the measure of latent inflationary pressure, is still historically low. Inflation is not a near-term threat.

Index	*3/31/2011*	*% YTD*
Dow Industrials	**12,319.73**	**6.4%**
S&P 500 Index	**1325.83**	**5.4%**
Nasdaq Composite	**2781.07**	**4.8%**
Russell 2000	**843.55**	**7.6%**
MSCI EAFE	**1702.55**	**2.7%**
10 Year Treasury	**3.4%**	

The Fed appears to be gaining confidence that the economy can support further growth in jobs and some growth in inflation. Bill Gross, manager of the world's largest bond fund, has already weighed in on his forecast for what the end of this easy monetary policy will mean for the bond markets. Expecting the Fed's exit will cause a large drop in demand for government bonds, he is betting that Treasury bond prices will fall. He believes that yields will have to rise enough to attract new buyers. Whether Gross is right or wrong, we are cautious. Our bond portfolios remain concentrated in short-duration positions, floating rate, and actively managed funds with adequate flexibility.

Equity investors should view the end of QE as a glass half-full. Although the end of the program will signal withdrawals of monetary stimuli, investors should remember the reason why it is disappearing. The Fed was not hesitant to act when it felt action was necessary, so the removal should be paired with the Fed's belief that the economy is now self sustaining.

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Other Notes

Annual ADV Offer:

Each year, the SEC requires that we notify clients when we have updated our disclosure brochure, known as the Form ADV Part II. This year, we have prepared a completely new Form ADV in a simpler plain-English format. You can download the PDF file for the updated form from our new website. If you would like a hard copy sent to you directly, please call our office. We will be happy to mail you one.

IRA Contrbutions for 2010:

It is not too late to make your IRA or Roth IRA contributions for 2010. You have until your regular tax filing deadline. Please contact us before April 15 to be sure you get your deposit credited.

Japan after the Earthquake and Tsunami

Japan has endured a human and environmental catastrophe of epic proportions, with more than 18,000 deaths attributed to the earthquake and resulting tsunami. The environmental damage from the nuclear reactor, the destruction of infrastructure, the effects on clean water, food production and manufacturing facilities will affect Japan years into the future. Despite the human suffering, we have to put this tragedy into economic terms to look at the financial impact.

After 20 years of sluggish growth, Japan's economy had dropped in size from second to third (after the US and China). The Bank Credit Analyst, a global research firm, concludes that Japan accounted for an average of 2-3% of global growth for the past five years. Accordingly, the crisis in Japan is unlikely to push the world back into a recession. In the US, Japan accounts for only about 5% of our exports. Among the developed nations, only Australia has significant economic exposure. Japan represents 19% of Australia's exports.

In client portfolios, direct investment in Japan is also limited. Approximately 15% of international developed-market indexes are composed exclusively of Japanese companies. If a portfolio has a 20% allocation to developed market international stocks, that investor likely has an exposure to Japan of about 3%, and possibly less because a number of managers have stayed away from the Japanese markets.

Japan will have to use fiscal and monetary stimulus to fund rebuilding. This week alone, the Bank of Japan purchased $184 billion of new assets to stimulate the economy and announced its commitment to doubling this initial amount. Although Japan already has an extremely high level of current debt compared to their domestic product (225.8% compared to the US at 58.9%), Japan is still able to finance its debt by borrowing locally. Most Japanese debt is held by Japanese citizens, as opposed to being financed externally like most US debt. After the initial economic trauma, the disaster could actually add to Japan's growth as money to rebuild flows through the Japanese economy.

While the aftermath from the earthquake and tsunami will be felt across the world, the global economy is still on track to grow 3-4% in 2011. Japanese growth this year will be much lower, but could rebound significantly in 2012.

Current Phase of the Economic Cycle

An economic cycle has four identifiable phases: recovery, then expansion, then maturation, and finally contraction or recession.

During an initial recovery, economic signals begin to improve but remain below historic norms. This recovery phase is often accompanied by lower interest rates and low inflation, symptoms remaining from the recession that ended the previous cycle. Today, in its attempt to stimulate a recovery, the Fed has played a major role in keeping rates low through Quantitative Easing. As the recovery gains momentum, we move into the expansion phase. Stocks rise and increasing confidence reinforces the economic recovery. We typically see increasing growth across most sectors of the economy.

When evaluating how the economic cycle affects your portfolio, we must monitor the effects on the various asset classes. Riskier assets are the fastest to fall during a recession, so it is no surprise that they are first out of the box during the initial recovery—at least the ones that survive. As the recovery moves into expansion, stocks continue to rise, and managers focus more on the valuation and quality of earnings. Money shifts away from riskier stocks that out-performed and seeks opportunities that still have room to run. For example, during this recovery phase, the small-cap index rose 119% from its March 2009 lows. By comparison, large-caps increased by 86%.

The Price/Earnings ratio (P/E) for the small-cap index has increased almost 150% since March 2009, while the P/E ratio large-cap index has only increased by 56% (Source: *Bloomberg.com)*. While both small- and large-cap stocks have increased in price, the large-cap stocks appear to have more appreciation potential for the near future.