



MARKET WATCH

Second Quarter 2011

THE
NAPLES  TRUST
COMPANY

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PORTFOLIO REVIEW & STRATEGY

If investors ever needed confirmation that the equity markets are still attractive to those with a long-term time horizon, the first quarter of 2011 should have provided it. Despite the tragedy in Japan, riots in the Middle East, and the continued European sovereign debt crisis, money flowed into U.S. stocks. Although volatility, particularly in March, was much higher than investors had grown accustomed to, the total return, including dividends, of the Standard and Poor's 500 was +6% in the quarter.

Bond prices fell slightly, with the Barclay's U.S. Treasury index posting a slightly negative return in the three months ending March 31. After a brief period of "safe haven" buying in mid March, investors focused on the low potential return of Treasuries as compared to stocks and commenced selling. Continued improvement in the domestic employment picture also supported equity prices, as the private sector steadily rehires workers. The

chart below shows the monthly change in non-farm payrolls, in which more than 200,000 new jobs were added in four of the past five months.

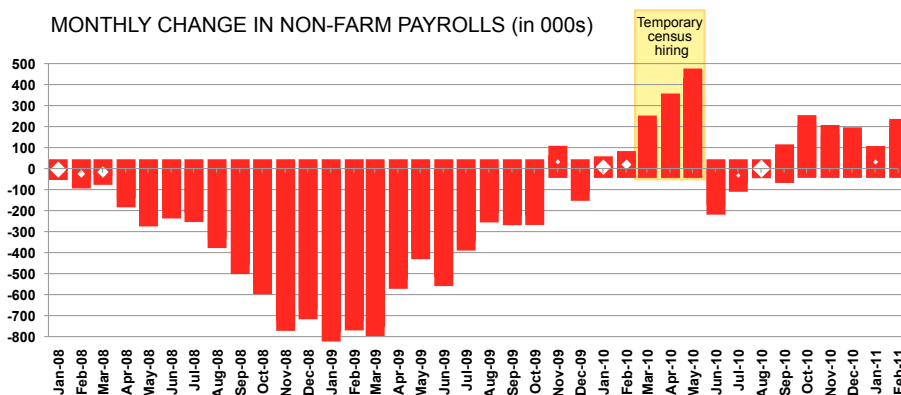
The turmoil in Libya and other volatile countries did have a major impact on

commodity prices, and in particular oil. Crude oil prices broke through the \$100 per barrel, and rose 17% in the quarter, as fears of supply disruptions took center stage. The broader Reuters / Jeffries Commodities Index rose 8% as the U. S. dollar index fell 4%.

All sectors of the S&P 500 finished higher in the first quarter, but the energy group was a major outperformer. These companies rose 16% in the first quarter of 2011, benefiting the most from spiking oil prices. The industrial sector also had a strong quarter, up 8%, as global growth, particularly in the emerging market countries, boosted those companies' earnings. Oversized dividends, along with extremely attractive valuations, pushed the Healthcare Sector up 5% in the quarter. We are still comfortable owning these companies at current low prices, as we are excited by the total-return potential going forward.

Telecom stocks, normally viewed as moderate-growth, high-dividend investments, attracted much investor attention this past quarter. AT&T's proposed merger with rival T-Mobile shed new light on the value of these companies, and the sector increased more than 5% in March alone. These stocks, along with utilities, still offer an attractive alternative to low yielding bonds.

The consumer staples sector, although still positive in the first quarter, underperformed the other sectors in the S&P 500 as rising commodity prices may adversely affect the profit margins of these companies. It is for this reason that we favor companies which possess real pricing power and are able to pass along higher input costs to customers.



source: Bureau of Labor Statistics

CURRENT OUTLOOK

Many signs are currently pointing to evidence that a self-sustaining economic recovery is unfolding in the United States. Recent readings on employment, retail sales, manufacturing activity and personal incomes suggest that further quantitative easing (QE2) by the Federal Reserve beyond their June, 2011 target ending date may not be necessary. At the same time, world economic and natural upheavals (think the Euro-zone debt questions and Japan's historically unprecedented earthquake not to mention the foment in North Africa and the Middle East) are creating more uncertainty as to this hopeful United States outlook.

We have clearly transitioned to a different phase in the capital markets from one of worry of deflation and economic calamity during the financial crisis to one of assessing how fast future growth will be around the globe. We have experienced these transitions before. Coming out of the steep recession(s) of 1980-1982, equity markets had a sharp rise through 1983, cooled down in 1984 and then rocketed higher through August of 1987 as economic growth proved sustainable. Likewise, coming out of the mild recessions of 1990 and 2001, equity valuations improved off the bottom, paused for a bit in 1994 and 2004, only to be propelled higher by improved corporate profits.

We now must look at what shape this self-sustaining economic recovery will take and which asset classes offer the most potential. We expect the U.S. economy to grow between 3% and 4% in 2011 and 2012. This growth rate is somewhat below average for an economy that recently went through the recession of 2007-2009. The debt bubble created during the previous 10 years is being addressed, but it will act as a "headwind" to normal growth. Strong areas of growth over the next 2 years will come from exports and business spending while consumer spending growth will be only modest. The weakest areas will be public sector and construction spending. Corporate profit growth this year and next should be in the mid-to high single digits.

World economic growth will be higher than that of the U.S., fueled again by good growth in emerging markets (despite generally rising interest rates). The weakest areas of the world will continue to be the developed markets, particularly Europe (with its debt issues) and Japan (for obvious reasons). Growth in Japan should accelerate meaningfully in the last half of 2011 and all of 2012 based on spending to recover from the earthquake destruction.

We will be monitoring closely two areas of concern that could cause this "Goldilocks" scenario ("not too hot, not too cold") to prove incorrect. The first area of concern is the continuing fiscal challenges to government units here in the U.S. The fiscal deficits at the state and local level will have to be addressed, resulting in most likely higher taxes and less spending by these units of government. The fiscal deficits at the national level will have to be addressed to keep the "bond vigilantes" at bay. In both cases, the choices suggest either lower spending or higher inflation.

The second area of concern is the big increase we have seen over the past six months in input costs to Corporate America. Typically these increased costs have been recouped via price increases to maintain profit margins. Those increases were possible because consumer incomes were growing strongly. That is not the case at the current time. With unemployment still hovering at levels double what is considered full employment, the ability to pass on those costs is restricted. Profit margins will be a major determinant of the health of corporate profits for the balance of this year and all of 2012.

MORE TRANSPARENT BUT MORE VOLATILE...

As if the markets weren't volatile enough with the crisis in Japan, unrest in the Middle East, and more European debt fallout, defined benefit pension accounting at some companies is about to create even more volatility. Some blue chips are opting to change their valuation methods from one that smoothes returns from pension assets over a period of years to one that accounts for swings in the current year.

Why now?

The reasons are two-fold. By switching their valuation method to mark-to-market (MTM) accounting in 2011, companies with billions of dollars in losses from the financial meltdown can retroactively credit those losses to their 2008 earnings. Since most investors don't put much weight into three year old earnings, the shortfall basically disappears rather than being a drag against future earnings. Secondly, if corporations make the change now and rates rise from current low levels, future earnings will benefit. Future pension obligations are discounted back to present values, since they are not paid out for many years. In a low interest rate environment like today, there's not as much discounting and therefore obligations are higher. But in a higher interest rate environment, there's more discounting which lowers the long-term pension obligation. Lower pension obligations equate to lower pension costs, better pension performance and therefore better earnings.

There are some advantages for corporations and investors to the accounting change. Not only does it simplify the process, but annual earnings will certainly be more transparent.

So where should it go?

The Financial Accounting Standards Board (FASB) recommends that if a US corporation chooses to use MTM then the adjustment should be reported directly on the income statement. IASB, the international equivalent of FASB, proposed this change last year and recommended that the market-based adjustment be recognized on the balance sheet so it doesn't directly affect earnings. Investors should keep this in mind when comparing US equities to international equities, since one affects earnings and the other doesn't.

Which names should we watch?

For most corporations it doesn't make sense to make the switch. In fact according to The Analyst's Accounting Observer, there are only 74 companies in the S&P 500, or about 15%, that have both an underfunded pension plan and unrecognized losses that equal more than half of their pension assets.

Three companies that have decided to use MTM are AT&T, Honeywell, and Verizon. Starting this year, fourth quarter earnings will be adjusted by the full year return of their pension assets for better or worse. Either way, investors need to be aware of this change when looking at P/E ratios, earnings growth, etc.

Other firms like General Electric and IBM are taking baby steps towards more transparency by removing some pension-related items from their operating earnings, although they don't plan to restate past earnings.

As always, do your homework.

As diligent investors, we have factored in pension obligations and underfunded plans long before this accounting change. But now we will take our analysis one step further to account for the added volatility. As always in investing, it pays to do your homework.

JAPAN AND THE INVESTING NEWS CYCLE

When an earthquake last leveled Tokyo in 1923, it was said that the Japanese emperor released 400 carrier pigeons to spread the word throughout Japan and to China about the city's destruction. Such was the state of news gathering and dissemination when communications failed. The world's investors at the time could react only as fast as birds could fly. In contrast, the entire world became privy to hundreds of videos, photographs, and commentaries within hours of the March 11 earthquake and nuclear crisis in Miyagi prefecture. Investors could, and did, react almost instantaneously to the catastrophe, "selling first, asking questions later," as pundits later would say.

We all benefit, of course, from the ability to witness and cross-examine news at ever-faster rates. But round-the-clock journalism remains a rough "first draft" of history, and initial news reports and commentaries – whether they forecast further disaster or success – are often later proved flawed, premature, or unnecessarily provocative. As such, the Japan earthquake – like Middle East rioting, the BP oil spill, or the Greek fiscal crisis – shows yet again that the desire to accumulate information quickly doesn't spare investors the obligation to interpret facts soberly.

Recent history shows that financial markets quickly rebounded from the shock of natural and man-made disasters, including the 9/11 attacks, hurricane Katrina, Chernobyl, Bhopal, and earthquakes in California, China, and Sumatra. In deciding how to respond, an investor's time horizon, as always, plays as crucial a role as the ability of victims to recover. Investors who made macro bets on Asian stocks, the yen, oil, and gold suddenly were jeopardized by the Japan quake and forced to liquidate positions as the story unfolded. Those with much longer horizons, however, should focus on Japan's ability to rebuild its infrastructure and the extent to which business values around the world drop then recover. Among the impacts to business we see:

Supply-line disruption – Japan is the linchpin for several important supply chains in the world economy, most notably for automobiles and auto parts, semiconductor components, aircraft parts, electrical machinery, and consumer electronics. Japan exported more than 1.2 million vehicles to the U.S. in 2009, many of which were partially built or shipped from the earthquake zone. Companies as diverse as IBM, Boeing, Hewlett-Packard, and Intel source parts from Japan, and an estimated 35 larger U.S. companies derive more than 15% of their sales from Japan. In the coming weeks, we expect a few U.S. companies to revise their earnings guidance based on temporary supply or sales disruptions.

Insurance fallout – Estimates of quake and tsunami damage remain preliminary, but already are assumed to exceed the \$132 billion in damages sustained during the 1995 Kobe quake. Such losses would greatly cut into the capital reserves of Japanese carriers and a number of their foreign reinsurers. We would expect large-scale selling of stocks and bonds by insurance companies to cover earthquake losses. This may, in fact, already have exacerbated stock market declines in the days after the quake.

GDP growth stunted – Japan constitutes about 8% of the world's economy, and the earthquake inflicted damage on about 7% of the island's consumers and infrastructure. Initial estimates have Japan's GDP falling between 1% and 4% as a result of the quake and expected drop in consumer sentiment, enough to strip a few tenths of a percentage point off worldwide growth in 2011. However, when you include sluggish Eurozone growth, then upwards of 30% of the world's economy could stagnate this year, which would have larger impacts on sales growth, profits margins, and returns on capital for U.S. importers and exporters.

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If you would like to learn more about our investment approach, we welcome your call at (239) 774-4000.

Warm Regards,



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