

August 2012

ECONOMIC OUTLOOK

Summary

The pace of economic growth slowed further in the second quarter as real gross domestic product grew at an annual rate of only 1.5%. This compares with first quarter growth of 2.0%. Real final sales were up only 1.2% in the quarter — the weakest since the first quarter of 2011. The decline in sales has a lot to do with the consumer and consumer confidence, which have been weak in large part as a result of the continued weakness in the labor market.

Nonfarm payrolls rose by 163,000 in July, an improvement over the less than 100,000 average per month in the second quarter. However, this growth is not enough to lower an unemployment rate that ticked up slightly to 8.3% in July. The Conference Board's consumer confidence index rose slightly in July as consumer expectations improved. Consumers may have felt better in part due to a pickup in housing and a decrease in energy prices. Rising payrolls may have also helped.

The Institute for Supply Management (ISM) indexes have been hanging around the critical 50 level that indicates growth, with manufacturing showing a slight contraction and the more important non-manufacturing sector remaining slightly above 50.

The Federal Reserve remains committed to providing all it can to keep economic growth in positive territory. The Fed has reiterated its intention to keep short-term rates near zero until late 2014.

We expect the economy will continue to show slow-to-moderate growth until there are sustained positives from the labor market.

POSITIVES

- ❑ Growth in non-farm payrolls improved in July
- ❑ Stability in housing and lower energy prices helping consumer confidence
- ❑ Benign inflation rate allows the Fed to keep interest rates low

NEGATIVES

- ❑ European sovereign debt crisis
- ❑ Real final sales and consumer spending have slowed
- ❑ Orders for nondefense capital goods excluding aircraft fell again in June

UNKNOWNNS

- ❑ Resolution of the tax debate to avoid the "fiscal cliff" at the end of the year

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EQUITY OUTLOOK

Summary

Equity markets advanced in July, even as the “wall of worry” around Europe climbed higher. As first noted last month, size continues to matter in U.S. markets. The S&P 500 Index gained 1.26% in price in July. When the component companies are weighted equally, the index produced a return of only 0.12%. It appears a new “Nifty Fifty” has emerged! The largest 50 members of the S&P 500 jumped 1.99% in July and lead U.S. equity returns this year, up 12.1%.

Defensive sectors were dominant in July, driven by telecommunications (+5.5%), staples (+2.6%) and utilities (+2.5%). More cyclical sectors lagged: materials were off 1.3% and consumer groups were down 0.3%.

The second quarter corporate earnings report season is nearly behind us, and, as expected, a majority of companies performed in line with previously lowered expectations. Slower growth overseas, a stronger dollar and weaker commodity prices all weighed heavily on corporate revenues and profits. Nonetheless, with consensus earnings estimates for the S&P 500 at \$102 this year, the market, trading at roughly 1,400, remains modestly valued at 13.7 times earnings.

Skepticism surrounding the future of equity investments is running rampant. Money continues to flee from equity mutual funds in favor of bond funds, where current yields don’t begin to cover the impact of even modest inflation rates. Recently, a well-regarded institutional bond manager proclaimed “the cult of equity is dying.”

Although the wall of worry grows, we know that markets have historically climbed these walls. We remain focused on a “barbell” approach, favoring income-oriented investments on the one hand, and high growth domestically focused equities on the other.

POSITIVES

- ❑ Global monetary policies in expansion mode
- ❑ Equities significantly under-owned
- ❑ Modest valuations

NEGATIVES

- ❑ Slipping global growth
- ❑ Election rhetoric
- ❑ “Fiscal cliff” in 2013 when taxes may increase automatically

UNKNOWNNS

- ❑ Euro debt resolution

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FIXED INCOME OUTLOOK

Summary

Proving that all eyes are focused squarely on the European financial crisis, on July 24 another new multi-generational low yield of 1.39% was set on the 10-year U.S. Treasury note, just as Spanish government bonds set a new post-euro high of 7.62%. Two days later, Mario Draghi, the head of Europe's central bank, pledged that they will do "whatever it takes" to safeguard the euro. That strong statement led many to believe that a master plan to ease the funding crisis engulfing two of the continent's larger economies would come soon. By month's end, Spanish and Italian yields had fallen, equity markets around the world advanced, and the yield on safer government bonds, including Treasury notes, rose modestly. But instead of a real plan emerging in the last week of the month, there was another "plan for a plan". The new plan calls for funding resources to be available based on certain criteria being met and monitoring performed. The more unsolvable the European crisis appears to be, the more the demand for the safety and liquidity of U.S. Treasury notes will be.

Closer to home, the Federal Reserve offered little to investors who were expecting additional asset purchases ("QE3") sooner rather than later. While reiterating their ability and willingness to take further accommodative action if necessary, the Fed pushed out a decision until their meeting in September. When you combine the effects of the economy's waning momentum, the possibility of large-scale purchases by the Fed, the European mess, political uncertainty and the looming "fiscal cliff" at year end, it seems like Treasury note rates are unlikely to change much until there is more clarity on the outcome of these factors.

Corporate bonds were the best performer last month as yield spreads declined by almost 20 basis points in aggregate. Corporate bonds still represent an attractive relative value in the high-grade market.

POSITIVES

- ❑ Global economic growth is moderating and the inflationary outlook is benign
- ❑ Fed is prepared to purchase assets if economy weakens further
- ❑ Fiscal cliff could send economy into a recession

NEGATIVES

- ❑ Current yield levels lower than expected inflation; negative yields on TIPS
- ❑ Elevated bond price/depressed yields due to significant "flight to safety"

UNKNOWNNS

- ❑ Uncertainty in European financial markets and path to resolution
- ❑ U.S. election cycle, policy uncertainties and the potential fiscal cliff