Economic & Market Review

~ Second Quarter Investment Newsletter ~

Steven W. Lieberman, MBA, CFP® Summit Financial Resources, Inc. (973) 285-3637 slieberman@sfr1.com

Executive Summary

Global economic engines slowed in the second quarter leading the IMF to warn that downside risks have grown. Japanese related supply chain disruptions resonated worldwide resulting in weakness in areas from autos to electronics while higher food and energy prices negatively impacted consumer spending. Rising inflationary pressures have led to monetary tightening in countries such as Brazil, India, and China as well as the European region through actions taken by the European Central Bank. In many cases these measures are hitting home. Growth expectations for Brazil have been cut and global manufacturing has decelerated. Slowing in China, the world's second largest economy, has been substantial enough for some to question whether the country will experience a hard landing. Japan, fighting its own set of challenges, contracted 3.7% in the first quarter. This drop exceeded expectations and landed the world's third largest economy squarely back into recession.

Closer to home, the ISM indexes have shown marked deceleration. Indeed, May's drop in the manufacturing index was the most dramatic since 1984. Challenges remain in the real estate market as housing prices dropped to new lows in April. The labor market, which had shown substantial improvement in the first quarter, hit a wall. Initial jobless claims jumped, the unemployment rate moved back to 9.2%, and payroll growth stalled in May and June.

U.S. monetary policy is on hold following the completion of QE2 at the end of June but remains tremendously accommodative with the policy rate at essentially zero. Considering the ongoing debt ceiling debate and corresponding political posturing, fiscal policy is on course to become more restrictive. In short, when it comes to further economic stimulus, policy options are few and political will is lacking.

As the aforementioned economic challenges unfolded, ever present European debt issues remained. In Greece, a deeper set of austerity measures were passed and the EU and IMF agreed to the next installment of financial assistance. Debate regarding a completely new bailout package raged resulting in no conclusion yet as we go to print. The key dilemma is finding a route to relief/assistance that will not be labeled as a default.

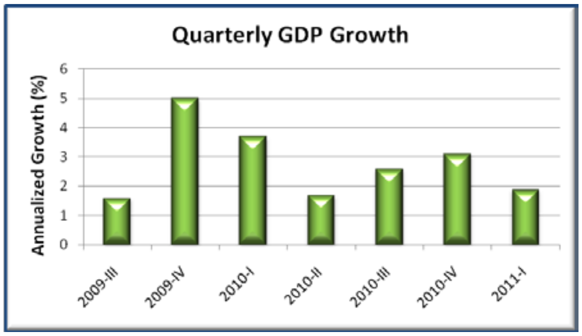
Considering the economic and political backdrop, the capital markets faired exceptionally well during the quarter. Though commodities and emerging markets declined, all other major asset classes were in the black. Domestic and international developed market stocks were positive and bonds gained on a decrease in Treasury yields. Credit spreads widened, but modestly enough to generate further gains in high-yield debt.

Looking forward, many of the pressures outlined are transitory in nature and may suggest there is pent up consumer demand to be met in the future. On that point, recent reports out of Japan point to a jump in activity and a strong v-shaped recovery. That being said, thus far the capital markets have been relatively good natured in light of the challenges and uncertainties thrown at them. In order for a continued favorable path, the U.S must show evidence of a solid rebound, the European debt crisis has to stabilize, Japan needs to turn the corner, and China, India, and Brazil cannot hit a bigger speed bump.

Economic Review and Outlook

Economic Growth

Gross domestic product (GDP) in the U.S. grew a disappointing 1.9% in the first quarter of 2011.



Data Source: U.S. Department of Commerce

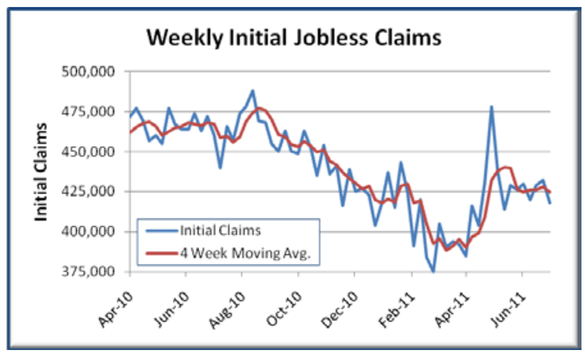
This result, nearly half of original expectations, was primarily driven by diminished government spending. On an annualized basis, total government expenditures contracted by 5.3%, the first absolute decline for this GDP line item in two years.

A somewhat disconcerting pattern established in the first quarter appears to have played out in the second quarter as well. Specifically, over exuberant initial growth expectations have been steadily reigned in to arrive at a more realistic, albeit disappointing, forecast. In the case of the second quarter, revisions have now taken 4% initial growth expectations down to a current consensus of about 2%. The impacts of high energy prices and lingering Japanese supply disruptions dashed hopes for a spring acceleration.

The forecasting challenges evident thus far this year leave us with diminished confidence as to the accuracy of the current generation of expectations. That being said, a rather tight dispersion of forecasts has emerged from the typical cast of characters. The IMF expects total U.S. growth of 2.5% for this year and next with Europe and Japan growing significantly slower. For the same periods, the organization believes developing and emerging economies will grow at a 6.5% pace. These numbers are much in-line with those of the ECB, the World Bank, and various investment banks. One notable outlier is the U.S. Federal Reserve which recently acknowledged that the U.S. economy "is settling into a disappointingly weak recovery." Despite said proclamation, the Fed remains true to recent form with GDP expectations on the high side of consensus. Should second quarter growth come in at 2%, the Fed's full year numbers in excess of 3% will be very difficult to achieve.

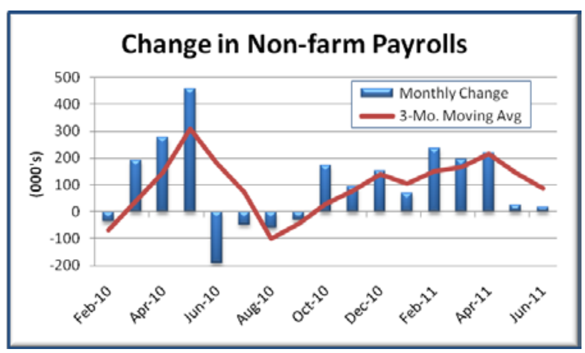
Employment

After a fairly robust first third of the year, the U.S. labor market hit a wall. Weekly initial jobless claims moved back into the 400,000's and have consistently exceeded that threshold for 13 weeks in a row.



Data Source: U.S. Department of Labor

Payroll growth all but flatlined in May and June



Data Source: U.S. Department of Labor

and the unemployment rate has steadily ticked higher over the past three months to 9.2%, a level last seen in 2010.

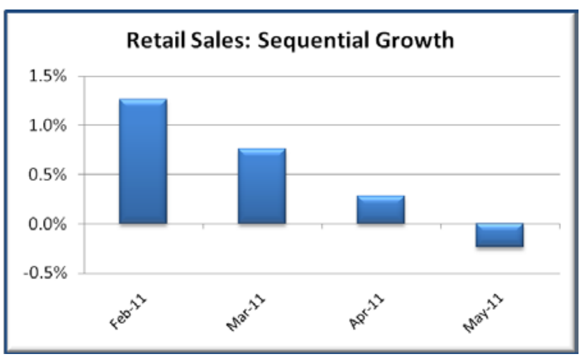
Other employment metrics are equally troubling. For example:

- Over 14.0 million people are unemployed, 45% of whom have been without work in excess of 27 weeks, the so-called "long-term unemployed."
- Average hourly earnings, up 1.9% over the past year, have failed to keep pace with inflation which was up 3.4% for the year.
- Over 25 million individuals are either unemployed or underemployed, representing 16.2% of the labor force.

It is little wonder why a growing number of economists are suggesting a new normal for the labor market where unemployment remains 7% or higher for years to come.

The Consumer

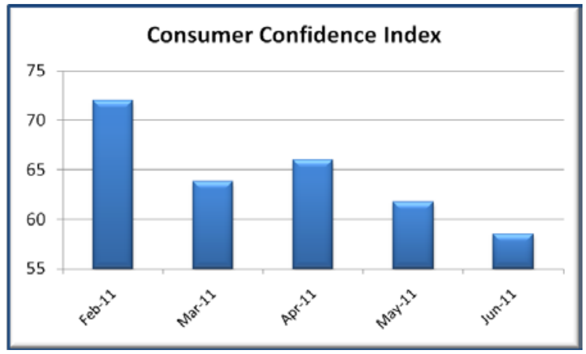
As employment goes, so goes the consumer. Retail sales growth has trended down since February, culminating in a sequential decline in May, only the second since last June.



Data Source: U.S. Census Bureau

While weak employment certainly contributed to the decline, a rise in food and gasoline prices along with supply disruptions out of Japan were no doubt factors as well. Indeed, the categories showing the worst sales trends were automotive and electronics. These industries were the most adversely impacted from Japan's supply chain disruptions.

Consumer confidence, presently at the same level it was two years ago during the recession, has followed a similar path as retail sales.



Data Source: The Conference Board

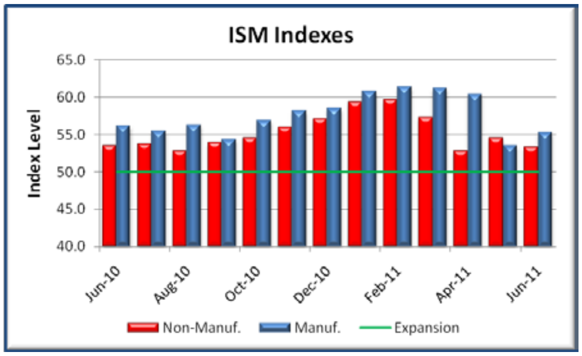
Clearly the consumer has taken some lumps and is a bit shell shocked. But what might lay in store for the future and where might we see positives?

Households have regained over half of the $16.4 trillion they lost during the financial crisis. Delinquency rates on consumer credit have improved materially and positive trends continue. The same can be said for the absolute amount of debt carried by the consumer. Gasoline prices have backed off and this year's payroll tax cut more than offsets higher levels. Several commodities have retreated from exceptionally high levels and may provide relief over time at the checkout counter. Furthermore, decreased spending as a result of supply chain disruptions will act as pent up demand in future periods as system stress is alleviated. Lastly, corporate cost cutting has run its course and profit margins are at a historical high. This suggests a reduced likelihood for further headcount reductions. In fact, going forward, companies will increasingly need to add to payrolls to meet future economic demand.

Manufacturing and Service

The manufacturing and service sectors have shown a dramatic deceleration this year. In the case of the service sector, slowing began in

March. The manufacturing slowdown in May, illustrated below, was the largest since 1984.



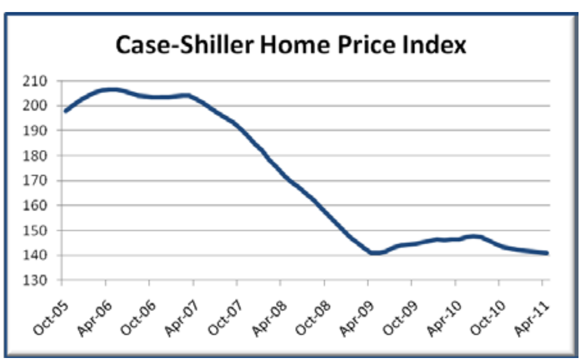
Data Source: Institute for Supply Management

The U.S. is not the only country to be experiencing weakness. Globally, manufacturing has slowed to levels not seen since last September. Slower expansions are being seen in the euro-zone, China, U.K., and India. Japan's economy, perhaps the epicenter of the pressure, contracted 3.7% in the first quarter and is officially back in recession.

Relief may be on the way, however. Some emerging market central banks are backing away from tightening measures, Japanese production is showing a strong v-shaped rebound, and several commodities have retreated from recent highs.

Real Estate

The U.S. housing market remains mired in recession. Indeed, as of the latest data in April, it has double dipped to a new low, off 32% from the peak.



Data Source: S&P/Case-Shiller

Banks and mortgage lenders now own over 870,000 homes, double the pre-crisis level. The foreclosure process is underway on an additional 1.7 million properties and several million more will join them in the years ahead.

Foreclosures and short sales now account for 40% of housing transactions, the highest level in two years. Unfortunately, there is no shortage of distressed inventory in the pipeline and it acts to hold down prices and restrict transaction volumes.

Commercial real estate remains weak but data is a bit more mixed than that of residential. Office occupancy inched higher in the first quarter and rents rose for the second quarter in a row. National vacancy rates for apartments dropped to 6.2% in the first quarter versus 8% in the comparable prior year period.

All is not roses, however. Mortgage backed commercial loans hit a record delinquency rate in March with 9.24% missing payments. Multifamily delinquencies were the worst with a whopping delinquency rate at 16.2%.

Clearly, real estate, both residential and commercial, will be challenged for some time to come.

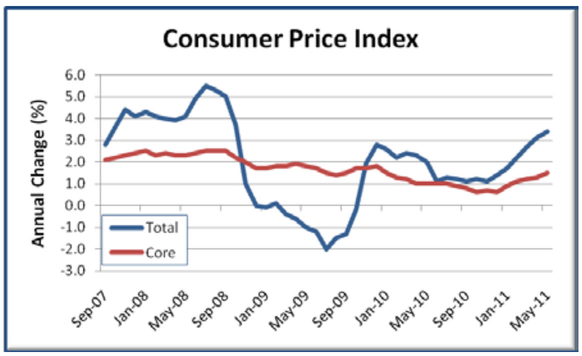
Commodities and Inflation

Inflationary pressures are evident on a worldwide basis. World food prices were up 37% year-over-year in March with the OECD warning on inflation and the IMF stating that price increases are hurting the global economy. Both organizations highlighted the acute impacts on developing and emerging markets where inflation is expected to average 6.9% this year.

Energy prices heated up with Brent crude rising to a high of $126.64 during the quarter. This was near a three year high and more than 50% over prior year levels. Although it retreated to $112 by quarter end, economists warned that these levels are near those that will restrain growth and thus demand. Indeed, both the IEA and OPEC expressed concern over elevated prices and reported weakened demand.

In an attempt to alleviate pressure, the IEA announced the release of 60 million barrels of oil from the emergency stocks of the U.S. and 27 other countries. After a dramatic, albeit brief, drop, oil prices rose to higher levels than prior to the announcement.

In the U.S., the rate of consumer price inflation is nearly back to a three year high.



Data Source: U.S. Department of Labor

Acknowledging the trend, the Federal Reserve raised its inflation expectations to a range of 2.1 – 2.8% for this year, but its members believe the jump in prices is transitory.

Monetary and Fiscal Policy

Central banks have diverged in their approach to monetary policy. A brief summary:

Restrictive

- Surging inflation across the euro block in March led the ECB to raise rates early in the second quarter and again following quarter end.
- Brazil now carries the highest short term rates of any major world economy. Commensurately, forecasters have cut growth expectations to a range of 3.5 – 4%, about half that of last year.
- India raised rates for the ninth time in just over a year and signaled it would do more.
- China increased reserve requirements for the 12th time since the start of 2010 and raised rates for the fifth time in less than six months.

Expansionary

- The Bank of Japan is looking for new ways to ease further.
- The Bank of England reversed a hawkish posture as inflation slowed in March and new pockets of economic weakness surfaced. Another round of quantitative easing is on the menu in England.

Neutral

- Despite the Fed's acknowledgement of a disappointingly weak recovery, the U.S. central bank has done all it is prepared to do for now. Rates will stay low, QE2 was completed at the end of June, and maturing mortgage debt will be reinvested into Treasuries.

The Fed's less aggressive monetary stance heightens investor uncertainty from two perspectives. First, the Fed's withdrawal after purchasing 85% of government issued debt since last November leaves many wondering who will step up to purchase newly issued Treasury debt. Second, in light of recent economic weakness and some commodity price relief, the timing of eventual tightening will likely be delayed. How long of a delay is unknown, but for now economists have pushed back expectations for the timing of a Fed rate hike to mid to late 2012.

On the fiscal side of the U.S. government, a budget resolution was achieved early in the second quarter. Despite modest cuts at that time, the U.S. deficit of 10.9% this year will be the largest among major developed economies.

The most pressing fiscal issue currently is the government's continued collision course with the maximum congressionally allowed level of debt – otherwise known as the "debt ceiling." The inability to go beyond this limit, estimated to be reached on August 2, will likely result in the U.S. being declared in default by creditors as well as rating agencies. The ramifications of such an event would be catastrophic to the U.S. dollar, the global capital markets, and the U.S. government's financial standing.
Unfortunately, political posturing on this issue is

so intense that it is impossible to assess the likelihood of resolution and/or what the outcome might be.

Lastly, we would be remiss in discussing fiscal issues without at least a mention of what is in store for state and local governments in the next year. More specifically, federal stimulus to states will amount to only $2.8 billion in the coming fiscal year compared to this year's $51 billion and last year's $61 billion. In short, the challenge of balancing state budgets will get even harder.

Governments, Politicians & World Events

The fiscal challenges for Greece, Ireland, Portugal, and Spain (among others) continued this quarter.

Ireland is on track to nationalize its banking sector after uncovering a €24B capital shortfall in their latest round of stress tests. Moody's downgraded the country, with a negative outlook, citing weak growth prospects and increased borrowing costs due to the ECB rate increase.

Portugal restated its budget deficit and asked for a financial bailout, which was granted.

Spain is battling its own banking crisis after a real estate collapse. While Spain's overall debt levels are reasonable, an unemployment rate of 20% is not. Spain lowered its growth expectation to 1.3% this year, 2.3% next year, 2.4% in 2013. Banks in Spain, along with those in other financially shaky countries, are relying on the ECB to finance daily operations. For now, Spain is not expected to follow Greece, Ireland, and Portugal in needing a bailout.

As Greece continues to miss fiscal targets, there is a widespread belief by the majority of euro-zone countries (along with most investors and economists) that restructuring of Greek debt is inevitable. S&P, in yet another rating downgrade, declared Greece's debt issues appear to be more of a solvency problem than a liquidity crisis (no kidding!). The concept of debt rescheduling or "re-profiling" for Greece gained in popularity although such a move would be declared a default, which poses its own set of challenges. Meanwhile, a premature credit event could be catastrophic for a number of reasons.

- Restructuring while running a primary deficit does nothing considering the continued need for credit life support, which might not even be available post-default. In short, fiscal health is necessary prior to restructuring.
- European banks are not yet strong enough to absorb losses on government bonds – this could lead to another financial crisis.
- Early debt restructuring by one country would ease pressure on other countries to reform and would increase investor angst regarding the potential for additional country defaults.

As talks of a new Greek financial package continued, the latest installment of financial aid was approved by Europe and the IMF.

Finally, delayed European bank stress test results are due for release on July 13. A delay was necessary after banks and national supervisors submitted what was considered "overly optimistic data." Regulators also requested the 91 financial institutions to provide information as to the likely impact of a government debt default. Unlike last year's test, this year's round has been advertised to be tougher and more transparent. Analysts and rating agencies expect 10% to one third of tested banks to fail and require capital raises.

Capital Markets Review and Outlook

Overview

The quarter began with 50.6% of advisors bullish and margin debt at one of the highest levels on record. Positive momentum, bullish sentiment, and robust earnings reports initially helped push the market higher. However, as the quarter progressed, lackluster U.S. economic data and troubling European sovereign debt issues took hold to drive down stocks and other risky assets. Treasury yields fell and the U.S. dollar rose on a flight to quality.

Commodities were troubled by the same factors along with bearish supply dynamics and slowing in China. Volatility was high. As April ended, Gold hit an all-time high and silver reached a 31 year peak. While gold essentially stagnated at the top, silver's encore was a precipitous 20% three day drop along the way to a total one week decline of 27%. Other commodities offered a gut wrenching ride as well with wheat dropping 23%, corn down 20% from a June high, and oil down modestly for the quarter.

Capital Market Returns

	2nd Qtr 2011	Year-to-Date
U.S. Treasury Bills	0.1%	0.2%
Barclays Aggregate Bond	2.3%	2.7%
Barclays Municipal Bond	3.9%	4.4%
S & P 500	0.1%	6.0%
Dow Industrials	1.4%	8.6%
MSCI EAFE (Int'l Equities)	1.6%	5.0%
DJ UBS Commodity Index	-6.7%	-2.6%

Data Source: Morningstar

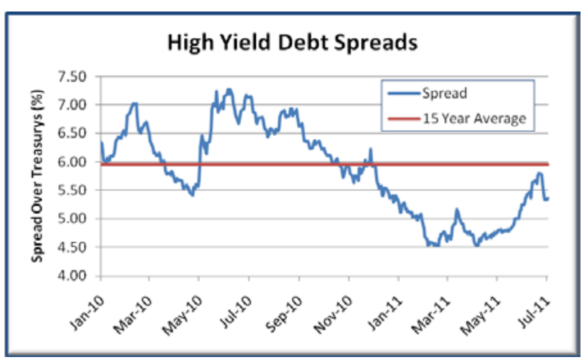
The U.S. dollar vacillated during the quarter. After hitting a record trade weighted low in April, the currency rallied in May on a favorable U.S. payrolls report and news the ECB would temporarily hold off on additional rate hikes. In June the dollar once again reversed course to end the quarter at the lowest level since currencies began floating in 1973.

Continued currency volatility is likely going forward. Loose monetary policy generally translates into currency weakness. On the other hand, any favorable U.S. economic developments and/or global turmoil will lead to dollar strength. Expectation of tighter U.S. monetary policy would be meaningfully positive for the dollar and would significantly alter the dynamics of the investment markets. For now, investors expect the Fed to be on hold for at least a year.

Fixed Income Markets

Bonds modestly outperformed stocks for the quarter. The Barclays Aggregate was up 2.3%, high yield bonds gained 1.1%, and TIPS returned 3.7% for the period. Due in part to a dearth of supply (the slowest issuance in 11 years), municipals were the asset class leader, rising 3.9%. The 10-year Treasury yield started the quarter at 3.47% and finished at 3.18%. At one point the 10-year yield dropped as low as 2.88%, but ensuing Treasury auction weakness suggested the rally was overdone.

Risk aversion was increasingly evident in the fixed income markets as investors balanced tight credit spreads against a weakening economy. High yield credit spreads backed up from post-crisis lows and now stand closer to the 15 year average.



Data Source: BofAML High Yield Master II

Furthermore, outflows from junk bond funds, particularly ETFs, suggest relatively large and sophisticated investors may be using these vehicles to hedge less liquid junk bond portfolios. This is not a favorable sign.

Equity Markets

A powerful late quarter rally enabled stocks to eke out a gain for the period. The S&P 500 index rose 0.1% while the MSCI Developed Market index finished 1.6% higher. Emerging markets were not as fortunate, however, with the corresponding MSCI index falling 1.2%. Domestic stocks have outperformed year-to-date.

As the new quarter progresses, investors will turn their attention to corporate earnings releases. S&P 500 companies are expected to post 15.6% earnings growth for the second quarter. Key issues to watch include the influence of energy and commodity prices, progress in Japan and related supply chain disruptions, and the impact of recent economic slowing. On that note, earlier in the year analysts' expectations were built upon anticipation of 4% economic growth in 2011. These estimates will have to be revised lower. As a result, analyst downgrades and cautious management comments should not come as a surprise this earnings season.

Hedge Funds and Alternatives

Publicly traded REITs were up 2.7% for the quarter while commodities gave back 6.7%. The HFRI index of fund of funds hedge funds lost 1.3% for the quarter.