

# Economic & Market Review

~ August 2011 Investment Newsletter ~

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

## Monthly Summary

Economic pressures and evidence of diminished growth witnessed in recent months continued throughout August. GDP growth in the second quarter was revised down to 1.0%, the labor market remains weak, consumer confidence has been declining, and housing is still troubled. Of particular concern of late has been a dramatic slowdown in worldwide manufacturing growth, a previous bright spot on the global economic landscape. At the Federal Reserve's August meeting, the board concluded the U.S. economy would remain weak for some time and unemployment will fall only gradually through 2012. Their policy response was to provide the unprecedented assurance that short term interest rates will be held steady for the next two years. Investors will be keenly focused on the September Fed meeting for what appears to be a heightened expectation of more aggressive monetary action.

A cobbled together and thoroughly unimpressive 11<sup>th</sup> hour agreement to raise the debt ceiling enabled U.S. lawmakers to sidestep a U.S. default. The process, however, managed to undermine global confidence in U.S. lawmaking to a sufficient enough degree that Standard & Poor's downgraded U.S. government debt to AA+ with a negative outlook. Oddly enough, in the ensuing market bedlam, investors clamored to buy the downgraded debt in an apparent flight to "safety." This response, along with recognition of stalling global economic growth, drove Treasury yields to unprecedented lows.

European debt issues continued in August with contagion spreading from peripheral nations to Italy, Spain, France and European banks. While policymakers debated various strategies and packages, the ECB aggressively bought troubled nation bonds in an effort to contain interest rate spikes. The potential for an ECB rate cut in the near term is high.

## Market Returns

Risky assets were significantly challenged in August and market volatility spiked. The market's fear gauge, the VIX, rose to levels depicting extreme volatility.



Data Source: Yahoo Finance

Volatility was indeed the case as the S&P 500 index gained or lost more than 2% for nearly half of the month's trading days, finishing the roller coaster ride with a loss of 5.4%.

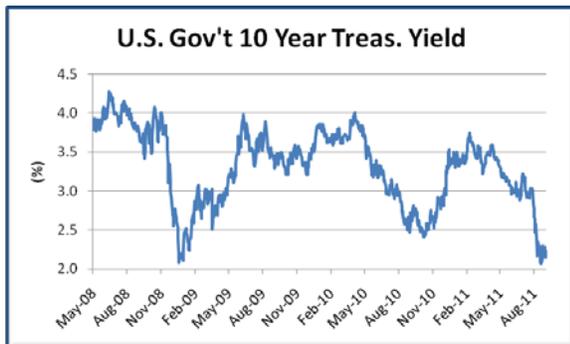
Notably, despite the exceptional volatility and what is now a modest year-to-date loss, the S&P remains up 18.5% for the trailing 12 months.

Internationally, the MSCI EAFE Developed Markets index dropped a staggering 9.0% in August while the corresponding Emerging Markets index gave up a similar 8.9% for



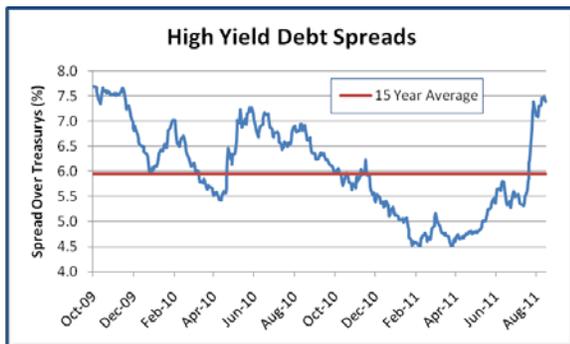
the period. Dollar strength during the month, particularly against emerging market currencies, significantly added to weak international equity returns. Year-to-date, international developed and emerging markets have lost 6.0% and 8.6%, respectively.

In an apparent flight to safety, the U.S. 10-year Treasury yield dropped below 2.0%, exceeding records reached in the depths of the financial crisis.



Data Source: U.S. Department of the Treasury

On the heels of this interest rate rally, safer areas of the fixed income market fared well. The Barclays U.S. Aggregate index gained 1.5% for the month and commands a year-to-date gain of 5.9%. The riskier end of the fixed income market, on the other hand, showed significant deterioration. High yield credit spreads blew out to levels last seen in 2009.



Data Source: BofAML High Yield Master II

High yield bonds paid the price, losing 4.0% for the month.

Commodity performance varied widely among subgroups. Generally speaking, economically sensitive commodities showed weakness while precious metals were strong. Gold, perhaps forming a bubble, continued a string of new all-time highs prior to backing off modestly at month-end. In aggregate, the category gained 1.0% this month.

Publicly traded REITs dropped 5.2%, essentially cutting their year-to-date gains in half.

We would love to suggest that market volatility has peaked and clear skies lie ahead. Unfortunately, what had been tepid economic growth has now deteriorated, policy uncertainty remains high, and several major economies and regions remain embroiled in extraordinarily challenging battles against debt and deficits that will last for several years. As a result, we continue to expect an environment of sub-par economic growth, lower than historical asset class returns, and high levels of volatility.

In light of these challenges, our continued investment advice is to focus on maintaining a properly diversified portfolio designed to meet, but not exceed, risk tolerance. This approach will help to control overall portfolio volatility while avoiding decisions based on emotional reactions.



## August's Economic Releases

| <u>General</u> | <u>Prior</u>    | <u>Current</u>   |
|----------------|-----------------|------------------|
| GDP growth     | 0.4% (Q1)       | 1.0% (Q2)        |
| Trade balance  | -\$50.8 B (May) | -\$53.1 B (June) |

| <u>Employment</u>      | <u>Prior</u> | <u>Current</u> |
|------------------------|--------------|----------------|
| Initial jobless claims | 421,000      | 409,000        |
| Continuing claims      | 3.8 MM       | 3.7 MM         |
| Nonfarm payrolls       | 85,000 (Jul) | 0 (Aug)        |
| Unemployment rate      | 9.1% (Jul)   | 9.1% (Aug)     |
| Average weekly hours   | 34.3 (Jul)   | 34.2 (Aug)     |

| <u>Consumer</u>                         | <u>Prior</u>  | <u>Current</u> |
|---|---------------|----------------|
| Consumer confidence index (Conf. Board) | 59.2 (Jul)    | 44.5 (Aug)     |
| Retail sales growth (YoY)               | 7.5% (Jun)    | 5.4% (Jul)     |
| Consumer credit                         | \$5.1 B (May) | \$5.5 B (Jun)  |

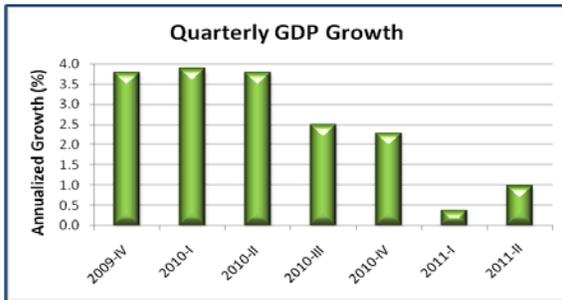
| <u>Manufacturing &amp; Service</u> | <u>Prior</u> | <u>Current</u> |
|------------------------------------|--------------|----------------|
| ISM manufacturing index            | 50.9 (Jul)   | 50.6 (Aug)     |
| ISM non-manufacturing index        | 53.3 (Jun)   | 52.7 (Jul)     |
| Durable goods orders growth        | -1.1% (Jun)  | 4.0% (Jul)     |
| Industrial production growth       | 0.4% (Jun)   | 0.9% (Jul)     |
| Capacity utilization               | 76.9% (Jun)  | 77.5% (Jul)    |

| <u>Real Estate</u>                  | <u>Prior</u>  | <u>Current</u> |
|-------------------------------------|---------------|----------------|
| New home sales                      | 300,000 (Jun) | 298,000 (Jul)  |
| Existing home sales                 | 4.8 MM (Jun)  | 4.7 MM (Jul)   |
| Case-Shiller home price index (YoY) | -4.6% (May)   | -4.5% (Jun)    |

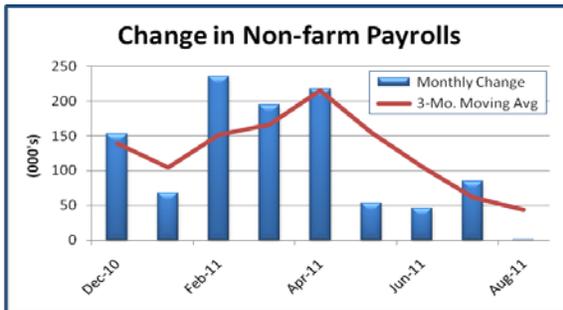
| <u>Inflation</u>                       | <u>Prior</u>    | <u>Current</u>  |
|--|-----------------|-----------------|
| Consumer price index/Core (YoY growth) | 3.6%/1.6% (Jun) | 3.6%/1.8% (Jul) |
| Producer price index/Core (YoY growth) | 7.0%/2.4% (Jun) | 7.2%/2.5% (Jul) |



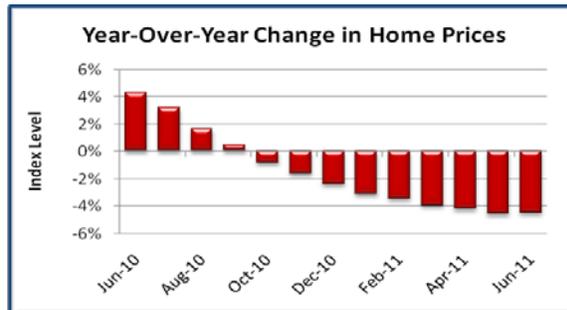
Data Source: U.S. Bureau of Economic Analysis



Data Source: The Conference Board



Data Source: U.S. Department of Labor



Data Source: S&P/Case-Shiller



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