Economic & Market Review

~ Second Quarter 2012 Investment Newsletter ~

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Executive Summary

As the quarter began, investors were feeling more comfortable. The euro-zone had stepped back from the brink of collapse, the U.S. economy was showing signs of life (particularly employment) and central banks had been actively supportive in the first quarter. China announced its purchasing managers' index hit its highest level in a year and global high yield bond issuance hit a first quarter record.

The celebration was short lived. Faced with its most stringent budget in over 40 years, Spain's economic woes were deepening. Youth unemployment was over 50% and manufacturing activity continued to contract. A rough government debt sale in April, both in a lower amount and at a higher yield than expected, evidenced a lack of foreign buyers. The resulting rout in Spanish bonds weighed heavily on financial markets and revived euro-zone debt worries. This nearly-failed auction proved to be just an opening act in a brutal quarter for Spain. The country followed with disappointing deficit reduction news, a trifecta of debt downgrades from each of the major ratings agencies, and a bailout request of €100 billion to recapitalize its banks. Bond yields surged at one point to over 7%.

Greece had its own set of problems. The nation's failure to reach a coalition government following elections in May raised concerns about the country's continued membership in the euro-zone. A governing coalition was eventually formed following a second election, but the process caused tremendous uncertainty around the globe. For now, Greece remains in the euro-zone and bows allegiance to the austerity camp. It is, however, attempting to get some relief in the form of a two year delay in meeting deficit targets.

Europe was not the only concern for investors this quarter. Growth in the emerging markets, including the BRICs, is slowing. Additionally, the fourth warmest winter on record distorted normal economic seasonality in the U.S. In short, the phenomenon created an illusion of stronger economic activity in Q1 than was truly the case.

Investors took a step back to let the dust settle. Risky assets, led by emerging markets, declined. A flight to safety drove the U.S. dollar higher and Treasury yields during the period fell to the lowest level in history.

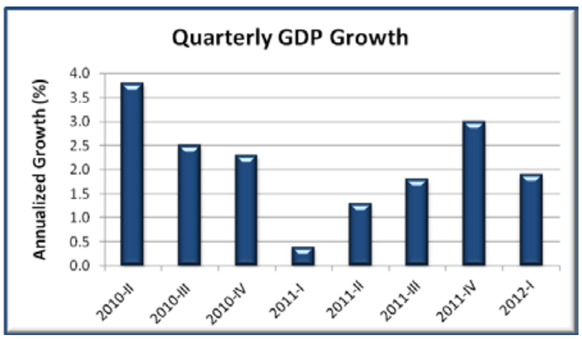
Despite the second quarter pullback, year-to-date returns remain fairly attractive. All major asset classes, with the exception of commodities, finished the first half of 2012 in positive territory and risky assets have outperformed the bond markets.

As the quarter drew to a close, the 19th European Summit ended quite favorably. Generally speaking, the group is more open to a balanced approach between austerity *and* growth. Perhaps even more important, Germany backpedaled considerably from a hard stance against several key initiatives desired by the IMF, the OECD, France, and other key countries and constituencies. The Summit ended with three important conclusions. First, European bailout funds will be able to provide capital directly to troubled banks. This will prevent banks' sovereign nations from being saddled with an extra burden of debt. Second, private debt will not be subordinated to new European bailout loans. This helps to prevent private creditors from exiting bailout situations. Third, the euro-zone will speed up plans to create a single supervisor to oversee all euro-zone banks. This oversight, presumably to be carried out by the ECB, could be in place by year-end.

Economic Review and Outlook

Economic Growth

Annualized U.S GDP growth was 1.9% in the first quarter of 2012. Durable goods purchases, up 13.7%, drove a 2.5% increase in consumer spending and accounted for over half of the economy's total growth during the period. Residential housing, accelerating from a strong showing in last year's fourth quarter, grew at an annualized clip of 20% in Q1. Although housing investment accounts for only 2.6% of total economic output, the sector's rapid rate of growth accounted for nearly ¼ of the nation's total GDP growth.



Data Source: U.S. Department of Commerce

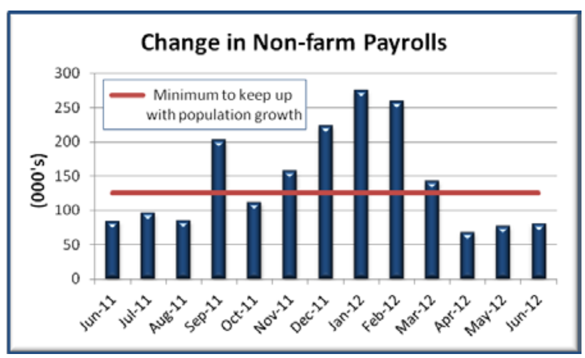
Offsetting the positives above, Government spending was a drag on economic growth for the eighth quarter out of the past ten. Lower defense spending shaved nearly 0.5% from economic growth and a decline in state and local outlays drove the government's total drag on GDP to 0.8%. Incidentally, this was the same level of government contraction from the previous quarter. So much for countercyclical government spending.

Largely due to weakness in consumer spending, U.S. growth in the second quarter is tracking at a rate of 1.6%. Full year growth is expected to be 2.0%, slightly better than the 1.7% rate in 2011.

On a global basis, expectations for full-year growth continued to be ratcheted down throughout the quarter. A recession in Europe and a slowdown in major economies including China, Brazil, India, Russia, and Canada will likely take worldwide growth from 3.7% in 2011 to an expected 3.3% in 2012.

Employment

Job creation was surprisingly strong as 2012 got underway. Private economists warned that the first quarter's rate of job creation was out of step with otherwise tepid economic growth and Ben Bernanke grew concerned in early April that the pickup in employment was not sustainable. They were correct. The U.S. employment report for March, released in early April, was disappointing. U.S. payrolls grew significantly less than expectations and at nearly half of the average rate of the previous three months. As many believed at the time, it seems that unseasonably mild winter weather created an anomalous, and yes, unsustainable spike in employment. Unfortunately, the weak release in April was not a one and done. As the following graph depicts, the decline was also not as bad as it would get in subsequent months. Weak employment numbers became a consistent theme for the entire second quarter, including the recently released numbers for June.

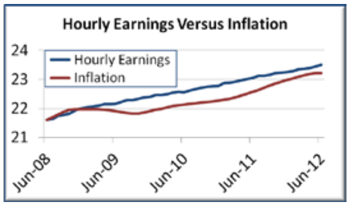


Data Source: U.S. Department of Labor

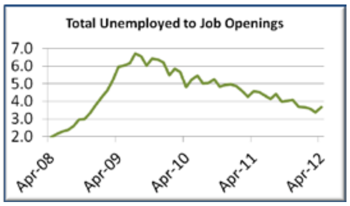
As much as we might have hoped, the unfortunate reality is that employment remains weak. As Chairman Bernanke articulated, the employment situation is unlikely to show strong, sustained progress in the absence of more rapid economic growth.

That being said, two labor market "wins" are worthy of mention:

Contrary to chatter of "low paying jobs," wage growth has outpaced inflation.



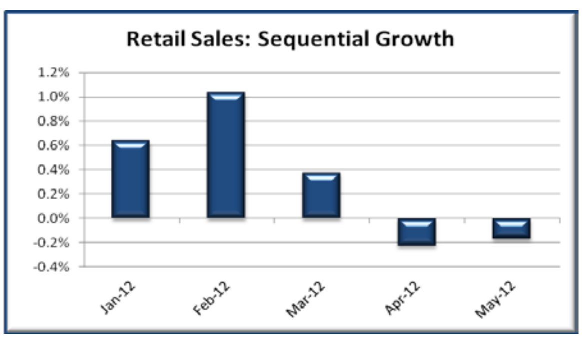
Unemployed workers for each job opening has shown steady, significant progress.



Data Source: U.S. Depart. of Labor (all graphs)

The Consumer

The economy drives employment, employment drives the consumer, and the consumer drives the economy. This economic version of the chicken and egg riddle took a turn for the worse in the second quarter. In lock step with lower payroll growth in recent months, retail sales ticked lower in March and outright contracted in April and May.



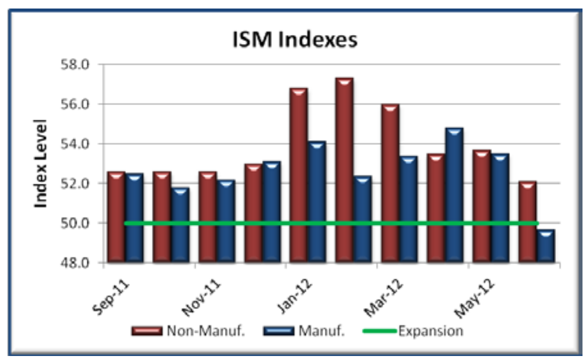
Data Source: U.S. Census Bureau

The weak June employment situation and continued economic slowing during the month portend a third month in a row of retail sales contraction. We last saw this in December 2008, albeit with a far more severe magnitude.

In terms of consumer firepower, we see a mixed bag. As previously discussed, employment is not helping. However, the 15% decline in gasoline prices since early April provides welcome economic and psychological relief. If sustained, on an annual basis this puts $75 billion back into the pockets of the consumer. As for the willingness of the consumer to spend, the personal savings rate has averaged 3.7% this year following 5.3% and 4.6% in 2010 and 2011, respectively. While neither out of the question nor beyond historical experience, a further drop from here is a tough bet to make. Furthermore, we are well below the 6.9% average savings rate over the past 50 years at a time when consumer debt relative to GDP is 40% above the average for the same period. The savings rate clearly needs to go up, not down.

Manufacturing and Service

Following an upward spike earlier in the year, the manufacturing and service sectors slowed markedly through June.



Data Source: Institute for Supply Management

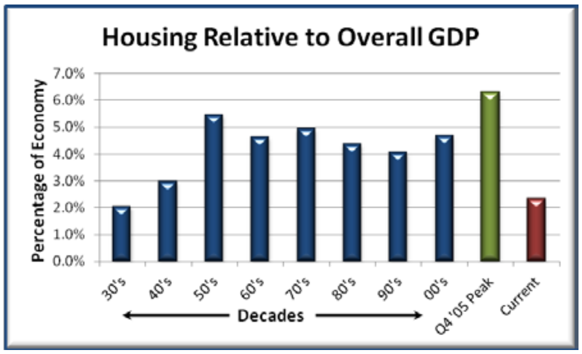
The service sector has now retreated to a level last seen over two years ago and manufacturing is in contraction for the first time since July 2009, the first month of the recovery.

To some extent, the spike and contraction, particularly in the service sector, parallels the weather driven pattern of the labor market. Construction and real estate service industries were clearly key beneficiaries of mild winter weather.

However, the decline of both ISM indexes likely goes beyond just atypical weather patterns. The new orders and export components of the manufacturing index dropped sharply in June, suggesting the Asian slowdown and European crisis are spilling over to the U.S. Furthermore, the fact that purchasing manager surveys have fallen globally is testament to broad global slowing, to heightened worldwide concerns, and to the impact of the euro-zone recession.

Real Estate

One must go back to the 1930's to find a time in history when housing contributed less to U.S. economic output than it does today. Even then, it's almost a tie.

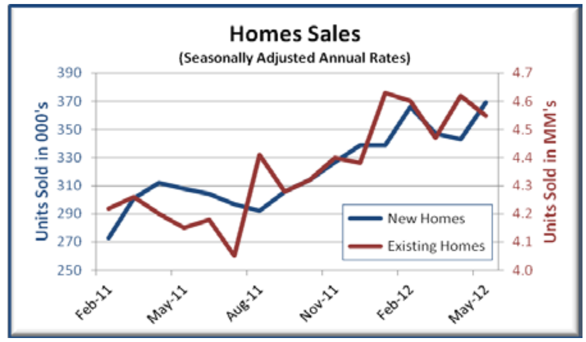


Data Source: U.S. Department of Commerce

As a result, it will likely be some time before anyone could characterize housing as "strong." Having said that, there have been real signs of improvement lately in the housing market. While the landscape is littered with economists that incorrectly attempted to call a housing turn, economic data today is more substantive of an upturn than at any point over the past few years.

Of course, the caveat to the remainder of this real estate discussion is the parallel that must be drawn to the false start in the labor market this year. Weather permeates every aspect of the real estate industry. Consideration must be given to the fact that this past winter was the fourth warmest in the past 102 years. That being said, it has been some time since we have been able to point to much in the way of housing positives, so we'll take the opportunity now.

Inventory of new homes, at 4.7 months of supply as of May, is well below what is considered to be adequate, 6 months. Realtors and home buyers have reported a dearth of existing home listings and bankers have characterized what they are seeing as the start of a turn in housing. In terms of units, new and existing home sales are up 20% and 10%, respectively, over the past year.

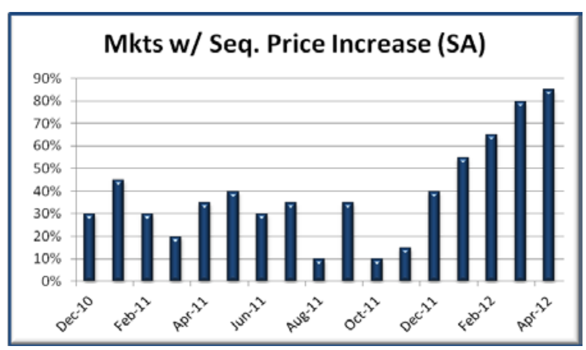


Data Sources: U.S. Department of Commerce & National Association of Realtors

In accordance with the previous discussion and graph, large U.S. homebuilders have reported sizable gains in sales and new orders.

Evidence goes beyond units, inventory, and anecdotal reports. Residential housing grew at an annualized rate of 11.6% in the fourth quarter of 2011 and 20.0% in the first quarter of this year. Those were the first back-to-back quarters of elevated growth since 2005!

Prices have also ticked higher. The Case-Shiller Home Price index rose from February through the most recent release in April. The organization also reported a strong uptrend in the number of markets experiencing sequential monthly price increases (see graph). The housing market has not seen that kind of sequential pricing behavior since 2006.



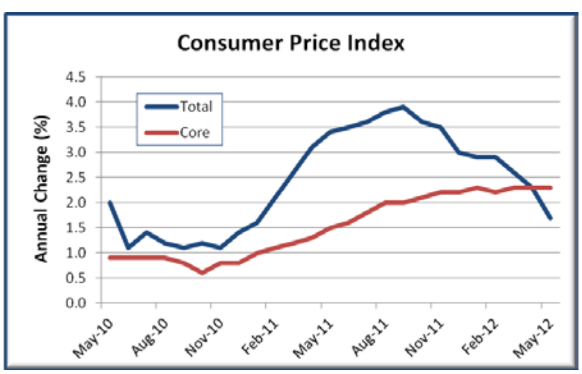
Data Source: S&P/Case-Shiller

In the final analysis, the data presented is certainly encouraging and there are valid economic reasons why the housing market could be rising from the ashes. Rising rents and declining rental vacancy rates are just two of them. However, considering the most recent data set encompasses the height of the mild winter weather, for now, we will reserve judgment pending a few more months of data.

Commodities and Inflation

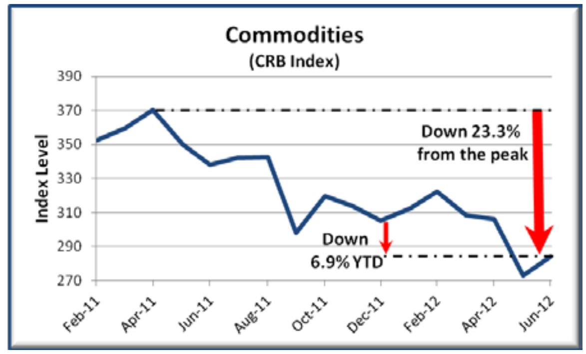
Last year at this time, inflation was a global concern. U.S. inflation was over 3.5%, food costs were a key driver behind the Arab Spring, and related oil disruptions were putting upward pressure on energy prices. Furthermore, the natural disasters in Japan were impacting global supply chains, and solid emerging market growth was taxing raw material sources. At that time we wrote, "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."

Fast forward to today. U.S. consumer price inflation has been cut in half (see graph), the world is awash in oil, the price of which has fallen by 19% from June-end of last year, Japanese related supply chain problems have eased, emerging market nations are aggressively deploying monetary stimulus to combat multi-year lows in economic growth, and the ECB has both flooded the market with cheap euros and cut its policy rate to an all-time low. What a difference a year can make!



Data Source: U.S. Department of Labor

In reflection of easing pricing pressures, TIPS implied inflation expectations have fallen from about 2.5% to 2.1% over the past 12 months and commodities have dropped 23% since their peak last year.



Data Source: Reuters/Jefferies

Perhaps temporarily, it appears inflation concerns are a thing of the past.

U.S. Monetary and Fiscal Policy

The Fed started the quarter rather sanguine about the growth prospects for the U.S. Their Beige Book from March reported the economy was expanding at a modest-to-moderate pace, manufacturing was picking up, and autos were a particular bright spot for the economy. Key concerns for the Board at that time were rising energy prices and inflation, the sustainability of the Q1 employment spike, the looming year-end fiscal cliff, and, of course, developments in Europe. Weighing everything, the central bank reaffirmed its plan to keep short-term rates near zero through 2014, but saw little need for additional measures to support growth. Investors were disappointed.

As the quarter progressed, U.S. growth slowed, the labor market cratered, commodity prices and inflation fell, and the European crisis flared anew. The Fed acknowledged they had overshot expectations for economic growth, employment gains, and inflation. They also extended Operation Twist through year-end and opened the door for additional monetary stimulus. A third round of quantitative easing is high on the list for many investors, but with the

10-year Treasury at 1.6%, such a program has doubtful potential.

As far as fiscal policy goes, the key issue is the so called fiscal cliff at year-end. While the ramifications are large, considering election year dynamics, there will be plenty of posturing but probably little action prior to November.

Governments, Politicians & World Developments

Europe took center stage this quarter. There was great debate over fiscal unity, joint bond liability (euro bonds), direct capital injection into European banks, whether bailout funds were large enough, if ECB bond buying should resume, and if the region had the right balance between growth and austerity. Key pressure points for the region centered around developments in Greece and Spain. We will briefly touch on each.

In its fifth year of recession and under strains of austerity, Greece is looking for relief. The failure in May of Greek elections to achieve a governing coalition resulted in a second round of voting in June. In essence, the second election became a referendum on Greece's membership in the euro-zone. A governing coalition was eventually formed, but generated an exceptional amount of uncertainty along the way. The new government is supportive of the euro and the austerity measures that go along with it. For now, this means Greece will remain in the euro-zone, but the situation is tenuous. The new government needs to simultaneously come up with additional deficit cuts while fulfilling its election promise to negotiate a two year extension of the deficit compliance timetable. Europe is willing to listen.

Spanish government bond yields soared to over 7% in the quarter on three key events. First, Spain dropped the bomb that its deficit last year was wider than previously thought and that it planned to postpone some of its budget targets. Next, all three rating agencies downgraded Spain's government debt closer to junk due to a) economic contraction, b) anticipation of missing deficit targets, c) rising potential of a banking sector bailout, d) tightening credit, and e) rising government debt. Finally, the country became the fourth euro-zone nation to request European and IMF assistance after a recapitalization of its third largest bank morphed into a full blown banking system bailout to the tune of €100 billion.

At quarter end, European leadership kicked off their 19th Summit to discuss the points outlined at the beginning of this section. The outcome of the two day event was well received. In summary, officials agreed to the following:

- Bailout capital will flow directly to banks rather than through the sovereign nations. This prevents ballooning of government debt and helps to break the vicious cycle whereby a weak government drags down its banks and vice versa.
- Bailout loans will not be senior to existing creditors. The potential for €100 billion of Spanish bailout funding to be senior to existing creditors was probably the single biggest driver of the spike in Spanish rates. Issue resolved.
- The euro-zone will speed up plans to create a single supervisor to oversee all euro-zone banks.

The Summit ended similarly to most of the 18 that came before it - smiles, handshakes all around, and a market rally. We have seen this movie before and the ending suggests a prudent dose of skepticism. Following past Summits, some strategies have been ineffective, others were distorted or watered down in the execution, while others were either delayed or completely scrapped. As typical, the framework looks good, but the devil's in the details and much work needs to be done. In particular, direct bank loans cannot happen before regional bank supervision and the earliest that will be in place is year-end. Unfortunately, Spain’s banks will need funding well before that time. Stay tuned.

Capital Markets Review and Outlook

Overview

The quarter was challenging for investors. Growth slowed across the globe and uncertainties in Europe intensified. Policymakers managed to push through, or at least delay, a number of issues, but many remain. The U.S. dollar rallied moderately, interest rates dropped to new lows in the U.S. and Germany, and risky assets, for the most part, had negative returns. The two exceptions were junk bonds and real estate. Both of these categories were up by about 2% in the quarter.

Despite the tough quarter, on a year-to-date basis all major asset classes, other than commodities, delivered positive returns. Stocks outperformed bonds and domestic markets bested their international counterparts.

Capital Market Returns

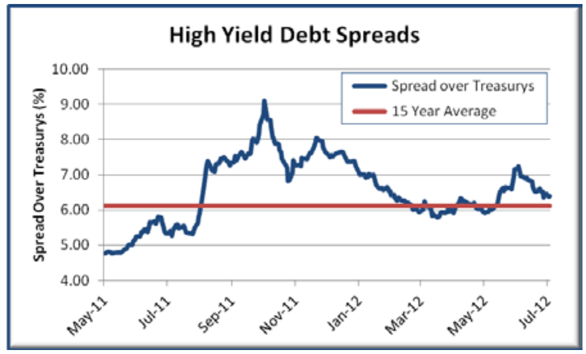
	2rd Qtr 2012	Year-to-Date
U.S. Treasury Bills	0.0 %	0.0 %
Barclays Aggregate Bond	2.1 %	2.4 %
Barclays Municipal Bond	1.9 %	3.7 %
Wilshire 5000	-3.1 %	9.4 %
S & P 500	-2.8 %	9.5 %
MSCI ACWI ex. U.S.	-7.8 %	2.9 %
MSCI EAFE (Int'l Equities)	-7.1 %	3.0 %
MSCI EM (Emerg. Mkts)	-8.9 %	3.9 %
DJ UBS Commodity Index	-4.5 %	-3.7 %

Data Source: Morningstar

Fixed Income Markets

After a modest rise in the first quarter, U.S. interest rates fell to new all-time lows in the second. After briefly flirting with a level below 1.5%, the 10 year U.S. Treasury ended the quarter with a yield of 1.67% - down 56 basis points.

Credit spreads expanded slightly for the quarter providing a slight edge to investment grade bonds. For the year-to-date, however, higher yields and credit spread compression of nearly 79 basis points enabled junk bonds to outperform the Barclays Aggregate index by 4.9%.



Data Source: BofAML High Yield Master II

International bonds, down 0.4% for the quarter, were the laggards of the group. The U.S. dollar's 2.5% gain during the period accounts for the relative underperformance.

Equity Markets

First quarter earnings, driven by industrials, technology, and healthcare, came in reasonably well. Year-over-year earnings growth for the S&P 500 was 7.4% versus an expectation of 5.2%. Operating profit margins were 26% above the average - impressive, but concerning on a reversion to the mean. As the chart below shows, earnings growth is expected to slow in the second and third quarters.

Data Source: Standard & Poor's

For Q2 and Q3, healthy earnings gains in technology, healthcare, and industrials will find it hard to overcome headwinds in the materials and energy sectors.

As with bonds, and for similar reasons, domestic stocks outperformed international in the second quarter. Value stocks outperformed growth and no particular market capitalization range was favored.

Alternatives and Hedge Funds

While all risky assets were challenged in the second quarter, the only major asset class to be down for the year-to-date was commodities. Aside from grains (corn, soybeans, and wheat) all key commodity components were flat to down for the year through June.

In contrast to commodities, publicly traded real estate has been a standout positive performer among risky asset classes this year. The DJ U.S. Real Estate index was up 3.8% for the second quarter and 15.0% for the first six months of 2012.

The HFRI Fund of Funds Composite index was down 2.3% for the quarter and up 1.0% for the year-to-date. Fixed income and quantitative strategies have performed relatively well this year while energy/materials and short biased strategies have lagged.