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July 2012 Commentary

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The Economy: Slow Growth Here to Stay

The U.S.

Once again the U.S. economy continues to sputter along in low-growth fashion. This summer, economists and Wall Street analysts alike have begun lowering their estimates for total GDP growth in 2012. We recently learned that for the first half of the year the U.S. economy grew at a rate of 1.7%, much slower than the Fed's official forecast in January. For the full year, we are not likely to see growth above 2%.

The story of The Little Engine That Could comes to mind when thinking about the U.S. economy, though not for the right reasons. In the oft-told story, a small engine succeeds in pulling a massive train over the mountain. The underdog engine, outmatched and seemingly unable, achieves a nearly impossible feat. "*I-think-I-can-I-think-I-can*" is the engine's famous saying. If only we had a world full of "little engine" economies. At the beginning of the story, several larger engines refuse to pull the stranded train up and over the mountain. The U.S. economy is behaving like the largest engine that refuses to pull its weight—the world's biggest economy, but clearly not the strongest.

U.S. economic data from the month was lackluster, though not as grim as the Eurozone. American manufacturing essentially stayed flat for July, registering an ISM reading of 49.8 (readings below 50 indicate declines in manufacturing). Regional manufacturing surveys indicate the potential for a larger slowdown ahead. Housing reports were more optimistic, as we are finally beginning to see a real recovery. Seasonally adjusted, the Case Shiller Index indicated a 0.9% rise in home prices nationally from April to May—the biggest increase in almost three years. While new home sales contracted 8.4% in June, new home sales for the first half of 2012 are up 18.9% from 2011.

Consumer spending, the driver of over two thirds of U.S. GDP, has stagnated. For the month of June consumer spending was flat. Household incomes rose 0.5%. As a result, the average American's savings rate rose to 4.4%—the highest in nearly a year. It is a silver lining to see Americans repair their balance sheets. Wage growth coupled with an increase in consumer spending will be a key driver to a sustained recovery.

There has been much speculation that as the economy has slowed, the Federal Reserve would step in with more accommodative monetary policy. Namely, a third round of quantitative easing has been hoped for by many market participants. After the July 31 and August 1 meetings, the Fed released a statement that was mildly disappointing for the markets. The Fed indicated that it would "closely monitor" the economy and "will provide additional accommodation as needed…" Should the economy continue on its slowdown, the

Fed is likely to take action this fall. Look for an announcement to come out of the Fed's annual policy retreat in Jackson Hole on August 31, should any action be taken.

The World

The Eurozone again dominated the headlines in July. While the Greek fiscal crisis is still very much alive, Spain received the majority of attention from both investors and politicians. Spanish government bond yields reached multi-year highs in July, as their 10-year finished the month around 6.6%. The high yields indicate growing pessimism that the Spanish government has the wherewithal to repay its debts. The higher yields are appropriate; the Spanish government's fiscal situation continues to worsen. As Spain grapples with a new recession, its ability to raise revenues and balance budgets becomes all the more difficult.

The late Israeli statesman Abba Eban once noted: "The Arabs never miss an opportunity to miss an opportunity." The phrase is becoming rapidly more applicable to the Europeans, at least with respect to their monetary union. With every passing month the Europeans lose valuable time in fixing the fiscal woes of the peripheral countries of the Eurozone.

Last week, ECB President Mario Draghi promised to "do whatever it takes" to save the euro. Accordingly, equity markets rallied and sovereign bond yields fell. Unfortunately, Draghi's pledge was more talk than action. On August 2nd, Draghi declined to intervene in the bond market, disappointing markets and sending European bond yields higher. While the ECB cannot solve the euro crisis, it can provide the accommodative policy to keep yields sustainably low until a solution can be achieved. Political difficulties have created sub-optimal monetary and fiscal policies for much of Europe.

Italy is starting to get nervous. Italian bond yields rose in July, as their 10-year sovereign bond eclipsed 6%. The Italian 10 year traded on August 2nd at 5.82%. Yields above 7% for any sustained length will likely lead to fiscal ruin for Italy. While a Greek bailout is sustainable for the Eurozone, a Spanish bailout (likely in excess of €300 billion) would leave little left in the European Stability Mechanism for an Italian bailout. An economic crisis in Italy, Europe's third largest economy, would be felt around the world.

The emerging markets have slowed as well. In July, the IMF released its latest projections for emerging markets growth. Notably, growth forecasts were cut for Brazil, India and China. Of the so-called BRIC countries, only Russia was spared due to the country's vast energy resources. Nonetheless, the IMF estimates that developing economies will grow at a rate of 5.6% this year. Encouragingly, emerging market economies have the fiscal and monetary tools to respond to a slowdown. While the U.S. and Fed Chairman Ben Bernanke are largely "out of bullets," China and Brazil can do plenty to spur growth. Notably, a drop in Chinese inflation has allowed for the Chinese to loosen policy in recent months.

The Markets: Mostly Up

Following a strong June, the U.S. equity markets continued upward in July. For the month, the S&P 500 gained 1.39%, bringing the year-to-date return to 11.01%. Larger, more defensively-positioned companies outperformed mid and small cap stocks during the month.

Foreign equities gained in July as well, despite continued distress from Europe. Markets in Europe and developing countries are trading less on fundamentals and more on the day-to-day political developments of

the Eurozone crisis. For July, the MSCI EAFE Index was up 1.48%. The MSCI EAFE, over 40% of which is comprised of continental European stocks, is up 5.97% year-to-date. Emerging market equities were up as well in July, gaining 1.75%.

Bonds gained in July as yields in the United States again reached record lows. The 10-year U.S. Treasury bond yield hit an all time low in July of 1.43%. The Barclays U.S. Aggregate Index was up 1.38%, while the Barclays Global Aggregate Index registered a 1.16% gain. 30 year fixed rate mortgages also hit new lows on the back of the U.S. 10 year yield. U.S. corporate and high yield bonds experienced large gains for the month, up 2.88% and 1.9%, respectively.

The Dow Jones UBS Commodity Index gained 6.47% in July. Following a number of months of significant decline, commodities rallied globally. Severe drought in the middle of the U.S. has severely harmed corn and soy beans and other crops, sending agricultural commodities much higher. Crude oil prices rose in July, reflecting a drop in inventories and hopes of an improving economy.

July 31, 2012

	Performance(%)				
Equities Index	1 Month	Year To Date	1 Year	3 Years	5 Years
S&P 500	1.39	11.01	9.13	14.13	1.13
S&P MidCap 400	-0.04	7.85	1.20	16.06	3.45
S&P SmallCap 600	-0.77	7.15	3.99	15.62	2.74
MSCI EAFE (net)	1.13	4.12	-11.45	3.31	-5.61
MSCI EM (net)	1.95	5.97	-13.92	6.63	-0.73
Fixed Income Index					
Barclays Capital Aggregate	1.38	3.78	7.25	6.85	6.91
Barclays Capital Global Aggregate	1.16	2.67	1.81	5.66	6.51
Barclays Capital 1-10 Yr. Muni	0.92	2.75	6.28	5.23	5.65
CSFB Leveraged Loan	0.97	5.53	4.15	8.94	4.40
Barclays Capital US Corp: High Yield	1.90	9.31	8.06	14.74	9.64
Other Index					
HFRI Fund of Funds Composite Index	N/A	N/A	N/A	N/A	N/A
Dow Jones-UBS Commodity Index	0.05	-3.65	-16.74	2.42	-4.04
Wilshire US REIT Index	1.90	17.08	13.38	30.11	4.12
S&P Developed Property	3.57	19.14	5.27	17.63	-0.86
LPX 50 TR	1.58	12.36	-12.61	11.76	-11.04
Citigroup 3 Month T-Bill	N/A	N/A	N/A	N/A	N/A

Closing Thoughts

With nearly all financial markets gaining in July, it seems odd that the tone of economic news has been so gloomy. There is a good deal of cognitive dissonance for an investor today. On one hand, the constant barrage of bad news from Europe inevitably leads to worry and pessimism. On the other hand, the U.S. stock market is up over 11% this year, and the U.S. aggregate bond market is up 3.78%—hardly a time to have been sitting on the sidelines.

How to make sense of the dissonance? The answer lies in equity valuations. Quite simply, the stock markets of the U.S., Europe and the emerging markets are all trading below their long term historical averages. Large companies in the U.S. and around the world have experienced record profitability. As investors, it is extremely difficult to predict the day-in and day-out headlines that will move markets. Over the long term, however, we know that buying high quality companies at attractive prices should eventually lead to investment gains.

The band *Counting Crows* performs at Red Rocks amphitheater in Colorado in early August. Lead singer Adam Duritz is known for his excellent, though occasionally sentimental, song writing. In the song *If I Could Give All My Love (Richard Manuel is Dead)*, Duritz writes: "You're a pill to ease the pain of all the stupid things I do/I'm anchor on the line/Of a clock that tells the time/That is running out on you."

It's as if the song is addressing European leaders directly; the short term fixes of the ECB may ease the pain, but the clock is ticking and about to run out. We hope it works out better for Europe than for the lonely lead singer of the *Counting Crows* (though the concert at Red Rocks should be quite good).