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August 2012 Commentary

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The Economy: Slow But Steady

The U.S.

Politics and government policy dominated the financial markets in August, pushing economic data and fundamentals to the background. Economists and investors focused on three macro themes during the month: Fed policy and the potential for more quantitative easing, economic ramifications of the impending U.S. fiscal cliff and European action (or lack thereof) in the face of a continued fiscal crisis among the Eurozone periphery.

At the Federal Reserve's annual policy retreat in Jackson Hole at the end of August, Fed Chairman Ben Bernanke delivered remarks on the economy and the Fed's role in improving conditions. In anticipation of further action from the Fed, equity markets and commodity markets creeped upward throughout the month. While Bernanke didn't explicitly commit to more quantitative easing, his speech left little doubt that there will be future Fed action should the U.S. economy continue to stagnate.

Much happened politically in August. Republican presidential candidate Mitt Romney selected Paul Ryan as his Vice Presidential running mate. Ryan's proposal in Congress for overhauling the U.S. budget has brought fiscal policy to the forefront of the national discussion. The Republican convention in August focused much of its energy on the economy and fiscal policy. The presidential race has placed on hold any agreement between Congress and the President on tax increases and budget cuts in 2013. Financial markets remain wary of the "fiscal cliff" if an agreement on taxes and the budget were not to be reached.

Second quarter GDP in the U.S. was revised marginally higher to a 1.7% annual rate, reflecting better than expected consumer spending. Though a positive revision is good news, the revised growth number is still far below a healthy growth rate.

The Labor Department released a mostly disappointing August jobs report. For the month, American employers added 96,000 jobs. The consensus estimate was an addition of 125,000 jobs. Persistent unemployment remains stubbornly high among America's workforce.

Consumer confidence touched its lowest point in 2012, declining to 60.6 in the latest Conference Board survey. The report highlights that Americans are increasingly worried about the future, reflecting renewed concern about employment and the potential for rising consumer prices. Despite the drop in consumer

confidence, consumer spending actually posted an upside surprise in August. Encouragingly, consumer spending has stayed on course in 2012.

Manufacturing in the U.S. declined again in August. The ISM Manufacturing index for August was 49.6, a reading that disappointed slightly to the downside. A reading above 50 indicates expansion. Manufacturing activity has slowed as new orders have weakened and inventory has grown.

Housing, once the most worrisome part of the U.S. economy, is now a modest bright spot. The latest numbers from the Case-Shiller index showed housing price gains in all twenty metropolitan areas that are surveyed. U.S. housing prices experienced their first year-over-year increase since 2010 in June. Notably, 2010 was a housing market fueled by the expiring homebuyer tax credit and provided an artificial bump in demand. The uptick in 2012 is actually supported by improving fundamentals.

The World

Barbara Tuchman's The Guns of August remains the most engaging narrative to describe Europe's inescapable descent into World War I during the summer of 1914. Competing European political interests and a strong Germany were the backdrop for a continent at war. Diplomatic rigidity and nationalist self interest drove the countries of Europe ever closer to World War I over that summer. The war started in August.

Fast forward to the summer of 2012 and Europe is still faced with intra-continental political difficulties, though admittedly on much smaller scale. In the Eurozone's latest crisis, competing economic interests and sovereignty issues have created a seemingly intractable political stalemate. Both Spain and Greece will require continued, massive financial assistance from their European counterparts to stay in the Eurozone. German, French and Dutch economic nationalism and, frankly, reasonable self-interest, remain huge obstacles to sharing credit risk with Europe's periphery. As was the case in 1914, Germany is the most important actor. The guns of 1914 have given way to the bailouts of 2012.

Europe has entered into a recession over the course of the summer. In August, the Eurozone's Purchasing Managers' Index (PMI) fell to 46.6. Germany, previously an economic stalwart, registered a 47.0 PMI for August: the lowest since 2009. On the bright side, the downbeat economic data will likely serve as motivation for the European Central Bank to take more accommodative monetary action.

The European Central Bank created some much needed good news on September 6th, when it announced a bond buying program for European sovereign debt. The announcement was welcomed by the markets, as sovereign debt yields fell and equity markets rallied. While monetary policy cannot solve all of Europe's problems, it can at least provide short term relief.

Investors look ahead to a court ruling in Germany on September 12th. Germany's Constitutional Court will rule on the legality of Germany's role in the European Stability Mechanism (ESM), Europe's permanent bailout mechanism. While legal experts predict that the court will rule in favor of the ESM, a negative ruling would be harmful to the future of the existing Eurozone.

China's economic slowdown continued in August, as manufacturing activity hit a nine month low. In the second quarter, China reported GDP growth of 7.6%, the lowest level in three years. The Chinese

government has been slow to ease monetary conditions. The European Union is China's top destination for its exports. As Europe has fallen into a recession, China has felt the impact. The world's second largest economy has not been immune to a global economic slowdown.

The Markets: Up Again

The summer has been a strong one for equity markets, both at home and abroad. For the month, the S&P 500 registered a 2.25% gain, bringing the year-to-date return to 13.51%. Through August 31st, on a one year basis the S&P 500 is up 18%.

Foreign equities also gained in August, defying headlines in Europe once again. Increased rhetoric for substantive action-taking from Margio Draghi and the European Central Bank has calmed European debt and equity markets for the time being. For August, the MSCI EAFE Index was up 2.69%. The index is up 6.92% year-to-date. Emerging market equities were down slightly in August, losing 0.33%. Developing markets such as Brazil and China face increasing economic headwinds.

Bonds were relatively flat for the month. Yields on U.S. Treasuries ticked up from their record lows of July. The Barclays U.S. Aggregate Index was up 0.07%, while the Barclays Global Aggregate Index registered a 0.86% gain. The Barclays Global Agg index outperformed its U.S. counterpart for the month, though on a one year basis U.S. bonds have rallied much more. U.S. high yield bonds built upon gains from July, gaining another 1.17%.

The Dow Jones UBS Commodity Index gained 1.3% in August. Food and energy prices are trading close to yearly highs. While industrial metals suffered, precious metals went higher in August on further expectation of quantitative easing by the Fed. This summer's drought in the Midwest continues to influence agricultural commodity prices.

August 31, 2012

	Performance(%)				
Equities Index	1 Month	Year To Date	1 Year	3 Years	5 Years
S&P 500	2.25	13.51	18.00	13.62	1.28
S&P MidCap 400	3.48	11.61	12.75	15.73	3.97
S&P SmallCap 600	3.79	11.21	16.90	16.18	3.12
MSCI EAFE (net)	2.69	6.92	-0.04	2.40	-4.81
MSCI EM (net)	-0.33	5.62	-5.79	6.64	-0.36
Fixed Income Index					
Barclays Aggregate	0.07	3.85	5.78	6.51	6.66
Barclays Global Aggregate	0.86	3.56	1.40	5.35	6.44
Barclays 1-10 Yr. Muni	-0.01	2.73	4.76	5.07	5.54
CSFB Leveraged Loan	1.05	6.64	9.81	8.52	4.57
Barclays US Corp: High Yield	1.17	10.59	13.89	14.47	9.60
Other Index					
HFRI Fund of Funds Composite Index	N/A	N/A	N/A	N/A	N/A
Dow Jones-UBS Commodity Index	1.30	3.86	-11.14	5.22	-1.86
Wilshire US REIT Index	-0.18	16.88	19.94	24.27	2.89
S&P Developed Property	0.30	19.50	12.45	14.59	-1.24
LPX 50 TR	3.38	16.16	3.32	10.07	-10.03
Citigroup 3 Month T-Bill	0.01	0.05	0.05	0.08	0.71

Closing Thoughts

Amazingly, volatility in the stock market has been extremely low over the past few months—not what one would expect from a market with so many clouds on the horizon. In August, the S&P 500 Volatility Index (VIX) hit a five year low of 13.3%. What to make of the low volatility? August is a typically sleepy month for the stock market and this year was no exception. Light trading volumes, European officials on vacation and the seemingly daily rise of Apple's stock price have all contributed to more stable markets.

We could see an uptick in volatility in the markets this fall. Historically, September has been the worst month for stock market returns. Germany's court ruling on September 12 and the Fed's meeting on September 13 could move the markets significantly, both to the upside and downside. In October, the troika (The EU, IMF and ECB) will report on Greece's progress in meeting austerity targets. Should little progress be made, future bailouts to Greece may be in question. Finally, political uncertainty in the U.S. will loom over the markets until at least November.

Still, markets continue to churn higher. Global equity, fixed income, real estate and commodity indices are all solidly positive for 2012. Price to earnings ratios for the stock market, both in the U.S. and globally, remain below long term historic averages. A new round of quantitative easing, a likely outcome of the Fed meeting in September, will likely push asset prices higher.

As volatility picks up this fall, it becomes more difficult to know which direction markets will go. Without the benefit of a crystal ball, a diversified investment portfolio remains as important as ever.