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Financial Market Commentary: 2nd Quarter 2012

The Endless Can-Kicking Continues to Make it Difficult for Investors

As mentioned during the previous quarterly commentary, the upward pace of the equity markets from the lows of March 2009 has been at times volatile and nerve-wrecking. Despite the bull market experienced in many parts of the world there is still plenty of uncertainty about the short term path of the global economic recovery. In fact, plenty of potential potholes lie in the road ahead and the 2nd Quarter volatility demonstrated some of these uncertainties.

Congressional dysfunction remains a threat as the U.S. heads toward a "fiscal cliff" — a set of expiring provisions that, left unaddressed, could lead to severe fiscal drag beginning in 2013. A last-minute compromise involving some tax hikes and spending cuts is likely, but long-term solutions will be elusive in an election year. Overseas, renewed threats of a Spanish banking crisis and a potential Greek exit of the Euro reignited risk concerns and caused many to avert risk altogether judging from the flow of funds into fixed income assets during the 2nd Quarter. While it is expected a tighter fiscal union may emerge eventually in Europe, present risks continue to weigh on market sentiment.

State of Global Economies

Sluggish Growth in the US, Yet No Recession

U.S. companies' balance sheets are healthy, with corporations sitting on $2 trillion in cash. Debt levels have risen, but servicing that debt has become easier as maturities have lengthened and interest rates have fallen. Earnings growth is likely to moderate but should remain fairly robust.

Regarding inflation, the economy is enjoying significant advantages: gasoline prices are about 30% below their 2012 highs which is a welcomed relief; interest rates remain very low; and inflation is anemic. The Federal Reserve has again eased financial conditions with Operation Twist however it is likely the effects will be modest. Commercial and industrial loans continue to rise amid falling interest rates, and U.S. financial institutions have grown healthier. Housing prices are stabilizing and affordability is near record levels. The housing sector is now on pace to start contributing to economic growth instead of detracting from it.

While uncertainty about taxes and federal spending next year is probably restraining growth for now, a messy Congressional compromise on taxes and spending is likely, perhaps even before the Times Square ball begins to drop. For lawmakers in either party, inaction would be highly unattractive; they don't want to risk unleashing the confusion that would result from doing nothing. We experienced the effects of Congressional inaction in July 2011 with the S&P downgrading U.S. debt causing the markets to plummet. Whatever governing configuration results from the November election, expect Congress to buy time to impose a set of tax and spending changes that make the fiscal cliff feel gentler than jumping from the Grand Canyon without a parachute.

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Longer term, of course, the U.S. must address its swelling debt levels. International experience tells us that debt reduction requires a combination of (mostly) spending cuts and (some) tax increases. Ultimately, growth and a little inflation — and at all costs, the avoidance of deflation — will help us begin this task.

Eurozone Struggles to Continue

It appears that the Eurozone's political project has resulted in an economic problem however policymakers will continue to act when forced. In May 2010 the European Financial Stability Facility (EFSF) was created. The EFSF's objective is to preserve financial stability of Europe's monetary union by providing temporary financial assistance to Euro area member states if needed. In May of 2011 the EFSF was granted extended powers because of the lingering crisis. In August 2011, the European Central Bank (ECB) began a bond buying program to Italy and Spain to stabilize those bond markets. In December 2011, the ECB cut interest rates in an effort to spur economic activity. Despite these efforts, the two-and-a-half-year-old Eurozone crisis persists.

Recent Greek election reduced fears of an imminent Greek Eurozone exit; Spain, Italy and their banking systems have become more vulnerable. For countries like Greece, Spain, Italy and others to address their debt problems, they, like the U.S., need growth. Pro-growth measures such as labor market reforms must move forward, as should efforts to encourage greater consumption in the stronger economies. Since the beginning of this crisis, Eurozone policymakers have consistently done just enough to keep the ship afloat, and it is expected this modus operandi will persist through the rest of the year and beyond.

While it is likely Europe may avoid a full-fledged disaster like a prolonged banking crisis or breakup, the endless can-kicking will continue to make it difficult for investors (and many corporations) to act with conviction. Consequently, valuations on many leading European companies are very low based upon a price to book ratio. This can present an opportunity for long term European stock buyers as it is less important where a corporation is headquartered compared to where its customer base is located. Many leading European companies are global and derive tremendous profitability from the U.S. and Asia.

Emerging Markets Gaining Traction

Governance and institutions have improved across much of the emerging world, and effective, independent central banking is representative of such improvements. In emerging markets, it is possible we may be seeing the "Great Moderation," which the U.S. enjoyed from the mid-1980s to the advent of the financial crisis.

Despite some concerns in India and Brazil, growth in many emerging markets continues to outpace that of the developed world, and some of these economies — especially China — are working to derive a smaller share of growth from domestic investment and exports to the developed world and a greater share from internal demand and trade with other emerging markets. Countries' ability to make this transition work — few have historically been successful — may prove in the long run to be the most important economic development of this decade.

Potential Potholes Ahead

Uncertainties of 2012

The uncertainty that made 2011 such a wild year very much remains in the marketplace. The developed world is still figuring out how to handle its debt hangover and the U.S. continues to battle budget deficit woes and the ever lingering concern of higher income tax rates. Elections across the globe are likely to have an impact on investor confidence going forward. In Europe, many of the underlying issues remain, and the crisis can flare up in the months ahead.

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Keep Expectations Realistic

While equity markets did not have the same rally in the 2nd Quarter as experience during the 1st, the first six months of the year has certainly had its ups and downs. Investors across the globe are looking for peace and quiet in the financial markets but may be unlikely to find it in the remaining six months of 2012 because of the aforementioned uncertainty.

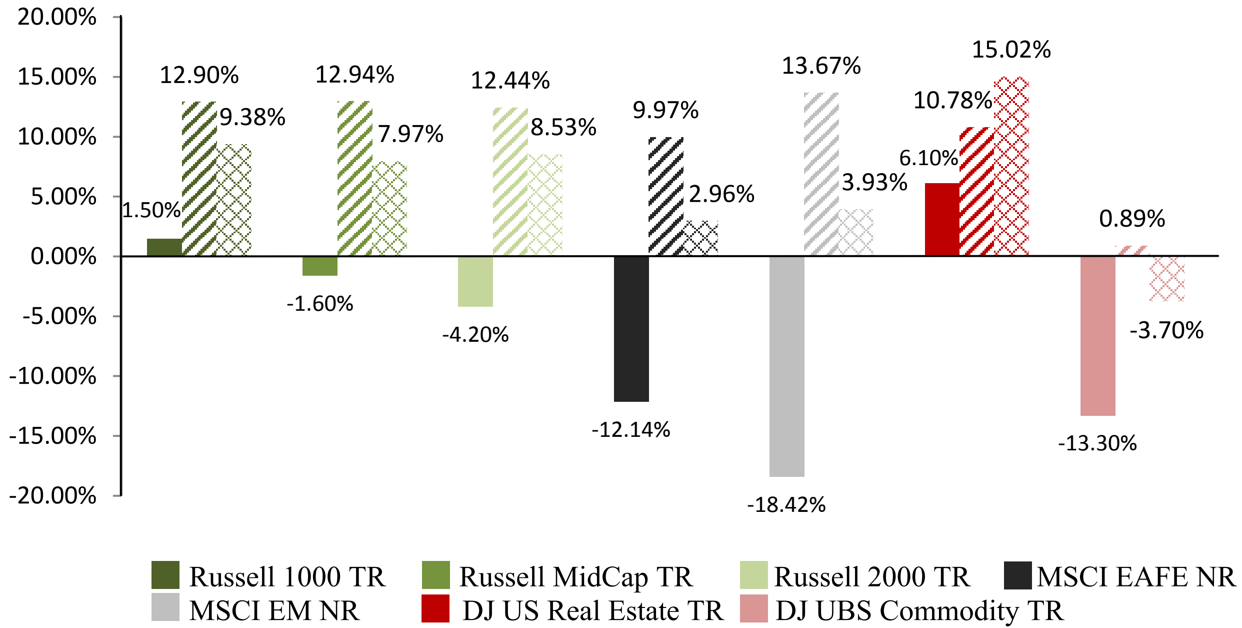
In a post-financial crisis world, it's easy to let your feelings get in the way of the facts. By many measures, excluding Europe, the global economy and the equity markets are on the mend. This recovery seems to have something in common with the late comic Rodney Dangerfield — it gets no respect.

Despite positive economic reports and fairly impressive returns, especially considering the state of the economy three years ago, it is easy to get sucked into the notion that recovery has not occurred. Although volatility can be expected to persist, the global outlook is presently moving at a snail's pace however showing signs of improvement and that is always welcomed.

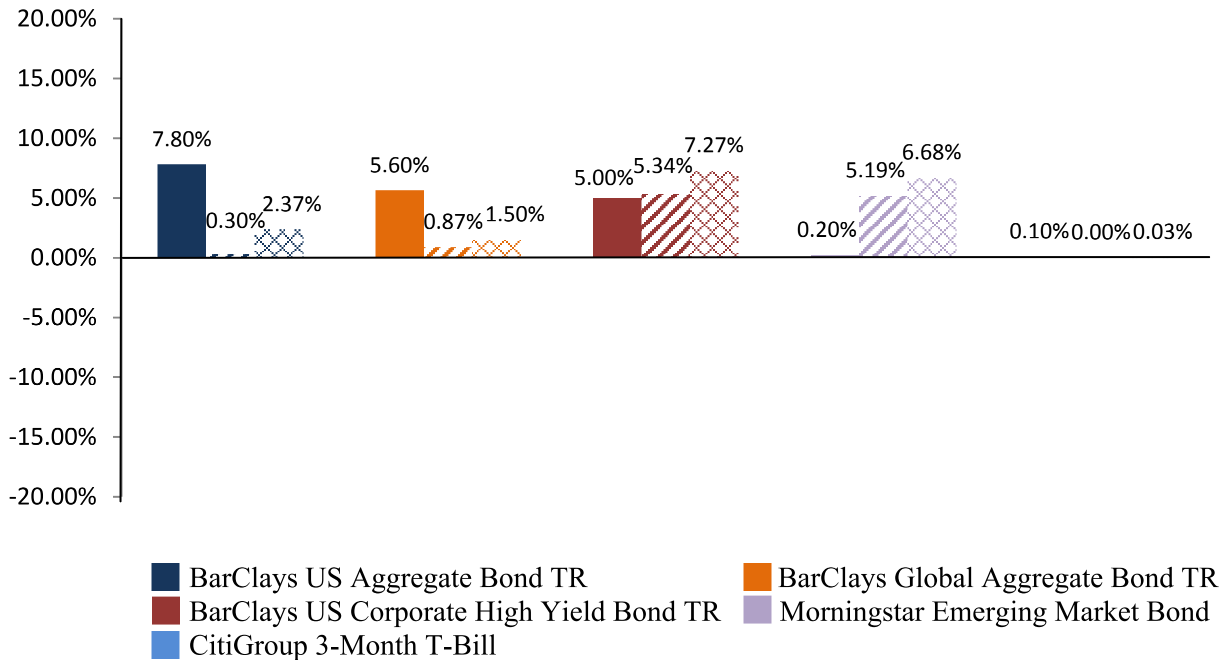
Disclosure: Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moodys, Fitch, and S&P is Ba1/BB+/BB+ or below.

Solid Bar	Annual Return for 2011
Diagonal Bar	YTD Return as of 3/31/2012
Diamond Bar	YTD Return as of 6/30/2012

Equity Performance



Fixed Income Performance



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