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2ND QUARTER 2012

Market Commentary

After a volatile spring that echoed the mid year declines of 2010 and 2011, equity markets showed signs of stabilizing toward the end of the quarter. The most important economic news was the June 29 announcement by European leaders to address the recapitalization of Spanish banks and to move toward a Eurozone-wide bank regulatory system. The S&P 500 returned -2.8%, reducing the year to date gains to 9.5%, making it the best performing major equity market. Despite the positive year to date returns, investors continue to reduce their equity portfolios and add to bond funds. Non-US developed markets continued their lackluster performance with the MSCI EAFE Index up 3.4% for the year. Emerging Markets gave back much of their gains, declining 8.9% during the quarter. The Alerian MLP Index returned -2.2%, leaving returns flat for the year. The bond market reacted to the slowing economy by sending Treasury yields to a record low of 1.47% in early June. Municipal bond yields generally did not follow treasuries, with yields on comparable maturity bonds remaining above 2%.

The US economy continues to struggle to remain above stall speed. Recent employment and manufacturing data disappointed markets. Employment growth is positive, with 80,000 jobs added last month, but not sufficient to put a dent in the current 8.2% unemployment rate. Manufacturing data turned slightly negative in June, the lowest reading since July 2011. The US still benefits from being the strongest large developed economy, the "cleanest dirty shirt" as some have described it and this has supported capital flows into dollar-denominated assets and helped maintain current low interest rates. However, high debt levels and an unwillingness of business to invest in new ventures continue to stymie a full recovery. There are a few bright spots. US domestic energy production is undergoing a technological boom and low natural gas prices provide a competitive advantage to manufacturers through lower energy costs. Oil production within the continental US is projected to increase by four million barrels per day, the first significant increase since the early 1970s. Additionally, the housing market is finally recovering and beginning to contribute to economic growth. The upcoming election and "fiscal cliff"(the expiration of Bush tax cuts and other programs equal to over 2% of GDP) adds additional uncertainty to the economic picture. The upside of the lack of corporate investment over the past three years is that there is a lack of the cyclical excesses that typically lead to deep recessions and bear markets. Corporate balance sheets remain flush with cash, debt levels manageable and no significant excess investment or inventories. The same frugality and lack of investment which has prevented a robust recovery also provides a large cushion should the economy slide back into recession.

Clarity in Europe?

The picture in Europe has improved somewhat with the June 29 announcement of steps toward a Euro-wide banking union. Among the many flaws of the Euro, one of the most recently glaring was the guarantee of free movement of capital across the Eurozone combined with no overall deposit guarantee scheme. Local sovereign credit was assumed to be risk free, so this was not perceived as a potential problem. This means that bank deposits in Spain or Greece are backed only by the local government, not the Eurozone as a whole. However a Spanish or Greek citizen has a constitutional right to move their deposits to any Eurozone bank. One wonders why there are any deposits left in these countries, with German and Dutch banks actively marketing in Southern Europe to draw deposits away from local institutions. This is another step toward a tighter fiscal and political union in Europe, which is the only alternative to a messy dissolution. Either option will cost Germany and the other solvent members of the Eurozone a great deal, either in explicit support for the periphery or in damage to their economic and financial systems in case of a breakup.

(continued)

Cyclical Risk in Emerging Markets

The disparate group of countries loosely termed emerging markets has begun to show signs of weakness. While these are normal business cycles and not the generational debt bubbles that collapsed the developed world in 2008, they have the potential to inflict a great deal of economic pain on a global economy grown accustomed to sustained high levels of demand for commodities and other capital goods from these countries. The problem is most acute in China, where a massive boom in real estate and infrastructure investment is running out of steam and rising labor costs and social demands necessitate the transition from an export driven model centered on cheap labor to an economy more driven by domestic demand. Whether this transition can be accomplished under the current political and financial system in China remains open to debate. Economies dependent on commodity exports to China such as Brazil and Australia face significant risks over the next few years. The best performing emerging markets, both from a stock market and economic perspective have been outside the major BRIC countries, most notably The Philippines, Turkey, Mexico and Poland.

High Yield Bonds as an Equity Alternative

One area that looks attractive in this environment is high yield bonds. Historically, the performance of non investment grade bonds has been cyclical, with yield spreads and defaults rising and falling with the economic cycle. In the mid 2000s, yield spreads reached record lows and there was a large amount of low quality issuance followed by record levels of defaults during the2008-2009 Financial Crisis. Since 2009 new issuance has been modest and balance sheets remain in good shape. Interest rate risk is manageable with most maturities under ten years and the higher coupon bonds naturally have a lower duration than comparable maturity Treasuries. B-rated industrial bonds, which fall in middle of the high yield credit quality universe, currently yield over 7%. According to Moody's these bonds have experienced credit losses (defaults less recoveries) of 300 basis points annually. Given the general health of the market, historical levels of credit losses are unlikely to be realized, but even if they were net yields would still remain above investment grade bonds. While the volatility and economic sensitivity of high yield bonds makes them a poor substitute for investment grade for meeting liquidity needs, they do offer a lower risk option for a portion of the equity portfolio. For taxable investors, the value proposition is more nebulous with a 7% return from high yield bonds translating, net of taxes at 35% ordinary income rates, to a 4.6% return - equivalent to a 5.3% pre-tax return from common stocks at the lower capital gains rates. Notwithstanding the disadvantageous taxation, it makes sense in many portfolios to consider a 5-10% allocation to this sector.

Perspective

The sluggish performance of the US economy since 2009 is emblematic of how economies recover from financial crises. It is small consolation to note that the US has performed better than most other historical examples – either the Great Depression of the 1930s or more the early 1990s crises in Japan and Scandinavia. While risks linger, the lack of speculative excess and strength of corporate balance sheets mitigates the potential for wealth destruction should the economy slide into recession over the next year. The Federal Reserve's ongoing policy of financial repression translates to negative real returns on safe assets such as shorter term investment grade bonds. While some ownership of these assets are necessary to maintain adequate liquidity reserves, longer term assets should remain invested in high quality stocks and other real assets. Withstanding short term volatility is unfortunately the price one has to pay for the opportunity to outperform inflation over longer time periods.

- By Steve Browne, CFA, CIO

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Smart Investing Webinar

Recorded Tuesday, July 24, 2012

Listen as Paul Comstock, Chairman, and Steve Browne, CFA, Chief Investment Officer as they discuss the highlights of the second quarter's market performance and perspective to help investors understand its impact on investment portfolios going forward.

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