OVERVIEW

Economic Analysis and Market Review Q2 — 2011

Is there a trend anywhere?

YAWN. A nice April in the stock market led to a disappointing May and early June and then a brief rally to get us back to where we started at the beginning of the quarter. If the stock market is a leading indicator, then it would seem that the U.S. economy is going to tread water for a while until some of the massive economic headwinds facing our economy are behind us. Domestically, we've hit a soft patch. This was evident in weaker-than-expected May data from the purchasing manager index (PMI) for manufacturing and the employment situation report. With government budget cuts likely on the way, especially at the state and local levels, and Federal Reserve liquidity in the form of quantitative easing or QE2 over at the end of June, growth and inflation estimates are being ratcheted down. The Institute for Supply Management (ISM) manufacturing PMI fell from 60.5 in April to 53.5 in May. While it's above 50, indicating ongoing expansion, it does imply a sharp slowdown in business activity. Some would attribute much of this decline to the nuclear disaster in Japan causing disruptions in the supply chain, but the new orders component fell 10.7 points to 51, suggesting barely any future growth in manufacturing. In addition to the ISM reading, the Federal Reserve districts of New York, Dallas and Chicago all reported a cooling of business activity. The non-manufacturing or services sector however, behaved a little better. The ISM services sector index actually rose about 2 points to 54.6. This is important since the bulk of our economy falls in this category.

The headwinds we face are some of the most powerful we've faced in over 70 years. Most economists would say we are still in uncharted waters with no foolproof strategy to get us back to terra firma. At the beginning of this financial crisis, we were told that we would see the end when the housing market and the banking industry are solid. Well, we aren't there yet. The housing market is our single-most important generator of gross domestic product (GDP) and the housing market is sick. The Case-Shiller Home Price Index for 20 large cities is now down 33% from its peak in 2006. The Department of Housing and Urban Development counts 3.45 million homes being foreclosed from 2007 through 2010. Current estimates of pending and potential foreclosures range from another 4 million to as many as 14 million. Bankers, mindful of these statistics, are appallingly stingy with their lending. And, perhaps they had better be if staying in business is the desired outcome. With the new accounting rules that allow banks to assume that the collateralized debt obligations (CDOs) that they hold will go to maturity, the banks look to be very profitable. In fact their profits are the highest since 2007. But with the old mark-to-market rules where the assets had to be priced at current market prices, the too-big-to-fail banks would still be under water.

So what does all this mean for the investment markets? Corporate profits in the U.S .reached a record high this past quarter. Manufacturing profits in this country have also reached record highs and corporate executives are back to paying themselves like the good old days. 2011 is on track for the highest S&P 500 corporate profits in history! Earnings estimates for these companies was $96 per share six months ago. Today that figure has climbed to $99.20 — a small but meaningful rise. These are the earnings estimates from Wall Street investment bankers. The truth is in the markets where all the investment decisions are sorted through and they tell a story of good valuations. Looking at the P/E ratio of the market, dividing $99.20 into the current S&P index, stocks are trading at a respectable 12.8 times earnings compared to the average historical level of 14 to 15. If the process is reversed to derive the earnings yield (E/P), the figure is 7.8%. Compared to the yield on Treasury bonds, this is most attractive. Another measure of the stock market's attractiveness is subtracting inflation from the earnings yield. Over the last 50 years, 2.4% has been the critical level. With core inflation running around 1.5%, the current figure is 6.3%, well above the historical number. Even using the higher non-core inflation number of 3.4%, the figure still ranks favorably on a value scale.

With the economy stuck in stormy uncharted waters and the equity markets showing good value — where does that leave us? I think the news on the global economies will continue to shock and surprise causing more and more investors to run to the sidelines until a more clear, muddle through picture emerges. Then stocks will look very oversold and a rally to higher levels should carry us into the end of the year.

INDEX	Q2'11	YTD
S&P 500	0.10%	6.02%
Russell 2000	-1.61%	6.21%
Europe, Aust., Far East	0.33%	3.00%
Barclays Agg. Bond	2.29%	2.72%
Wilshire Real Estate	3.97%	10.93%
Treasury Bills	0.04%	0.08%

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of the developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Wilshire Real Estate Index is an index of commercial real estate properties

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