OVERVIEW

Economic Analysis and Market Review Q2—2012

"Whither thou goest I will go." This isn't Ruth talking in the Bible, it is what all of us around the world are feeling about our respective country's economy. Reading the major newspapers like the New York Times, The Wall Street Journal or the Financial Times, you certainly get the impression that things are not right with the world today. Europe's debt crisis, high unemployment in Greece, Spain and Italy as well as the U.S., China's economic engine that was supposed to pull us all out of trouble is slowing down — all components of the "Great Recession" that was supposed to have ended three years ago. And yet in various journals there continue to be comments from knowledgeable and reliable sources that give the distinct impression that this is all part of a slow moving train wreck, that the tools at the Fed's disposal — interest rates lowered to almost zero, Quantitative Easing 1 and 2, various stimulus packages, bailout packages for banks, government intervention in business (e.g. GM and Chrysler) — have only "kicked the can down the road" and won't work given the magnitude of the crisis.

Nouriel Roubini, professor of economics and international business at the Stern School of Business at New York University says that the "perfect storm" that he foresaw last year is now unfolding and will be worse than 2008 — "Worse because like 2008 you will have an economic and financial crisis but unlike 2008, you are running out of policy bullets. Today, more QEs are becoming less and less effective because the problems are of solvency not liquidity. Fiscal deficits are already so large and that you cannot bail out the banks because there is a political opposition to it and governments are near insolvent — they can't bailout themselves." Peter Praet, chief economist at the European Central Bank said "the eurozone crisis is now much more profound and fundamental than at the time of Lehman." Paul Krugman, Noble laureate economist and columnist for the New York Times is quoted "There are a lot of ugly forces being unleashed in our societies on both sides of the Atlantic because our economic policy has been such a dismal failure, because we are refusing to listen to the lessons of history. We may look back at this thirty years from now and say, 'That is when it all fell apart.' And by all, I don't just mean the economy." Ominous indeed and what does he have in mind when he says "ugly forces being unleashed"?

There's no doubt that the world's economies have slowed considerably. In fact 80% of the world is in recession and it would seem that the U.S. is very close. Unemployment is a major issue everywhere and here in the U.S., the trend is going in the wrong direction. In the first quarter we were able to create over 200,000 jobs a month and in the last quarter, it has declined to around 75,000. Just to keep up with population growth, we should be creating 150,000 per month.

With all of this as backdrop for the capital markets, one would think that the stock market would be approaching all-time lows and the bond markets would be reflecting much higher inflation with much higher yields due to the rampant money creation over the last few years. But that's not the case in either market. If there's fear in the stock market, it's not reflected in the Chicago Board of Options Exchange (CBOE) volatility index or VIX. It's near its lowest levels indicating investor complacency or a lack of fear. And yields in the bond market in the U.S. are hitting new lows. The most recent auction of the 10-year Treasury closed at 1.46%. One year ago the rate was 3.16%. The consumer price index (CPI) is currently at 2.2%, almost 50% higher than the 10-year yield, so the income from this note won't keep up with the rise in prices over the next ten years. Gary Schilling, president and founder of his own economic consulting firm and noted for the accuracy of his forecasts which are often outside the mainstream, forecasts the yield on the 10-year Treasury to go as low as 1%! If that rate is achieved, could home mortgages drop below 3%? Very likely.

With all the uncertainty about the fate of the euro and the European Union, the stock market has been held hostage to news from across the Atlantic. First it was what to do about Greece and whether they should or could remain in the union and whether it would be an orderly separation. Then Spain was in the headlines and the bailout they would need to keep their banks solvent. Each newly revealed problem caused huge declines in our stock markets and each proposed solution brought about a huge spike. This seems to be the only logical activity in the markets at present as it's apparent that if the euro declines in value relative to the dollar, this will affect corporate profits significantly as so much of corporate sales are generated overseas. Only Germany, the engine of Europe, appears to have their financial house in good order and everyone looks to Germany to backstop the requested bailouts, but there's little public support for this among Germans so Angela Merkel, who is up for re-election this year, is loathe to support any proposal that would impact their financial strength.

It is very apparent that growth is the solution to everyone's problems but growth is an elusive commodity. Fed Chairman Ben Bernanke has tried numerous tactics from lowering interest rates to facilitate bank borrowing and lending to printing more money to provide liquidity to the system and yet after three years, the economy is still below the trend line of 3.4%. Perhaps the message of the markets is that deflation, not inflation should be our focus.

Market Indexes
Second Quarter, 2012

INDEX	Q2'12	YTD	12 MONTHS CHANGE
S&P 500	-2.75%	9.49%	5.45%
Russell 2000	-3.47%	8.53%	-2.08%
Europe, Aust., Far East	-7.13%	2.96%	-13.83%
Barclays Agg. Bond	.30%	2.37%	7.47%
Wilshire Real Estate	2.06%	14.91%	13.29%
Treasury Bills	0.03%	0.04%	0.06%

- 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