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July 2010

ECONOMIC OUTLOOK

Summary

The economy continues to show signs of growth, but the rate of growth has slowed from the strong pace recorded at the end of last year. Some stimulus programs have run their course, such as the home buyer tax credit, which is affecting demand levels. The continued problems in Europe are also having an impact in the form of reduced demand for U.S. exports. But there are signs of a pulse: although the Institute for Supply Management (ISM) manufacturing index was down slightly in June, it remains in positive growth territory.

The larger concern is consumer confidence. June saw a sharp decline in the Conference Board's consumer confidence index, although the Thomson Reuters/University of Michigan consumer survey actually rose slightly. The Conference Board's survey is influenced much more by the health of the languishing job market. Job growth is expected to remain anemic for some time with the unemployment rate staying relatively high for an extended period. Though jobs are a concern, the consumer is benefiting from a combination of low interest rates, low inflation and low mortgage rates. Personal income has been increasing, and on an inflation-adjusted basis consumers should be feeling better. As a result, consumer spending has continued to rise, just at a slow rate.

Going forward, the key factor will continue to be the consumer. Although slow growth in the job market will weigh on the mind of the consumer, gradual improvement may help sustain current spending levels. The Federal Reserve's commitment to low interest rates should also provide additional positives. The end result should be continued economic growth through at least the end of the year, even though it may be a little slower than what we have experienced in the first half.

POSITIVES

- Continued low interest rate policy from the Fed
- Low mortgage rates helping create some stability in the housing market
- Consumer spending and personal income both rose in May

NEGATIVES

- Decline in payrolls even though the unemployment rate fell slightly
- Factory inventories declined in May
- Small decline in ISM manufacturing index even though it remains above the 50 level

UNKNOWNS

- Ultimate impact on our economy of the European financial crisis
- Influence on the economy of political rhetoric related to upcoming elections

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EQUITY OUTLOOK

Summary

Over the last two months there have been clear changes in investor sentiment, the economy and the technicals of the equity market. Fear continues to drive the market. Other headwinds facing equity investors include disappointing economic reports, the perception that second quarter earnings will be lower than expected, the unknown impact of the oil spill in the Gulf of Mexico, a slowing economy in China and unresolved sovereign debt issues in western Europe. The question is how much of this bad news is already factored into the market? Regardless of what is or is not factored in, we believe we are in a trading range market and that we are near the bottom of this range. Recently there has also been a flight to quality for equity investors, a situation that has historically favored our investment style.

We currently have a cautious near-term outlook for equities, but our longer-term view remains intact. As some of the headwinds are removed, an improving economy, low interest rates and stronger corporate balance sheets should be positives for stocks in the long term.

As of June 30, the S&P 500 was down 5.24 percent for the month and down 6.66 percent for the year.

POSITIVES

- Interest rates are still relatively low
- Economy is generally improving

NEGATIVES

- Impact of sovereign debt issues in western Europe
- High domestic unemployment could last longer than anticipated
- Expectations of higher tax rates
- Global slowdown

UNKNOWNS

- Impact of reduction in government monetary and fiscal stimulus

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FIXED INCOME OUTLOOK

Summary

The Barclays Capital Aggregate index returned 1.57 percent in June, bringing the rolling 12-month return to 9.50 percent. It was the best month in nearly a year for bonds. Within the index, corporate bonds returned 2.13 percent and U.S. Treasury Notes returned 1.86 percent. The bearish sentiment of professional and retail investors with regard to the level and direction of interest rates was roundly challenged during the month as 10-year Treasury yields declined more than 30 basis points to below 3.00 percent. Mortgage rates also hit historic lows, approaching 4.375 percent on 30-year fixed rate loans. Although interest rates may not move much lower, they may remain at historically low levels for longer than market participants believe.

The hand-off of the economic recovery from the public sector to the private sector does not appear to be going well: nongovernment payroll growth has disappointed markets, with a loss of 125,000 jobs in June. A renewed focus by businesses on technology spending and fixed investment has lead to the substitution of labor for capital. As a result, although productivity and profitability have soared, companies appear reticent to add new hires. As the cyclical tailwinds of government spending and inventory replacement begin to fade, structural headwinds from demographics, continued financial deleveraging and regulatory oversight are weighing on the prospects for more robust economic growth. We note that the credit markets are currently functioning well for both investment grade and high yield borrowers. Therefore, with fortress like balance sheets and increased profitability for corporate America, we continue to favor high-quality intermediate-term corporate bonds, while maintaining a neutral to slightly defensive interest rate position.

POSITIVES

- Low to non-existent inflation
- FOMC maintaining language about keeping rates low for an extended period of time

NEGATIVES

- Weak private-sector hiring
- Residential real estate market; housing inventory beginning to rise again

UNKNOWNS

- Impact of impending financial regulation
- Influence of slowdown in the euro zone on global economy

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