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ECONOMIC OUTLOOK

August 2010

Summary

The economy grew at a seasonally adjusted 2.4 percent annual rate in the second quarter. While the first quarter was revised higher to 3.7 percent, other quarterly growth numbers going back to the beginning of 2007 were revised lower, indicating that the recession was deeper and longer than previously thought. This may be why the recovery is a bit slower and why it will take longer to "fully recover". Second-quarter growth was helped by business investments and exports, contributors that are often short term in nature. Consumer spending, which accounts for the majority economic growth, did not provide much of a contribution to growth in the second quarter, a trend that appears to be continuing in the first part of the third quarter. The manufacturing sector continued to expand due in part to inventory rebuilding, but the inventory cycle appears to be maturing and may not be as much of a positive going forward. Even though private-sector employment is showing some growth, it has not been substantial or enough to offset the drop in employment on the public side. As a result, the unemployment rate remains relatively high. Concerns about the job market and general business conditions continue to weigh on consumer confidence. Lower confidence has led to a slowdown in personal consumption expenditures and an increase in the savings rate. While not positive for the current period, this could be a positive down the road as consumers repair their financial position and have increased flexibility to spend.

The Federal Reserve continues to keep interest rates low and is expected to maintain this policy through at least the end of the year, a benefit to the housing industry and corporate America and ultimately to the consumer and the economy. The economic news continues to be a combination of some positives and some negatives with neither overshadowing the other. As a result, it remains our expectation that we will continue to see economic growth into at least the first half of next year, even though it may be relatively slow growth compared to historical averages.

POSITIVES

- Institute for Supply Management index of non-manufacturing businesses rose in July
- While slightly lower, ISM manufacturing index continues to indicate good growth
- The Federal Reserve remains committed policies promoting economic growth

NEGATIVES

- Drop in nonfarm payrolls and continued high unemployment rate
- Consumer confidence has weakened with the softness in the labor market
- Factory orders and durable goods orders have slowed and even declined slightly

UNKNOWNS

- Impact of new financial regulations and expected higher taxes on consumer spending

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EQUITY OUTLOOK

Summary

July brought a welcome change in direction to the equity markets. The S&P 500 was up 7.01 percent for the month and is now down 0.12 percent year-to-date. A few of the stories that have dominated news headlines in the last few months, such as the bank stress tests and sovereign financial woes in Europe and the Gulf oil spill, have moved off of the front page and taken some negativity out of the air. Other recent positive developments for equities include positive insider trading activity, excessive pessimism in the investor sentiment indicator, improved valuations, lower bond yields and a decline in the volatility index (VIX). Also, market lows in early July lacked confirmation among technical indicators. Many of the recent earnings reports have been better than expected. Some companies have even reported positive earnings, revenue and forward guidance. These reports and generally stronger corporate balance sheets should be good news for stocks in the long run.

Increasing concerns about deflation, consumer and government debt levels and housing softness could all contribute to slower economic growth in the second half of 2010, which should concern equity investors. However, equity markets tend to be a leading indicator to future economic activity and may already reflect some of the expected economic softness ahead. Midterm elections this fall may also have an impact on equity markets. We still believe that equity markets will trade within a relatively narrow range for the rest of year. For now, the trend appears to indicate equity markets moving higher–at least in the short term.

POSITIVES

- Interest rates are still relatively low
- Economy is generally improving
- The majority of corporate earnings are exceeding expectations

NEGATIVES

- Impact of sovereign debt issues in western Europe
- Expectations of higher tax rates
- Global slowdown

UNKNOWNS

- Impact of reduction in government monetary and fiscal stimulus

August 2010

FIXED INCOME OUTLOOK

Summary

The Barclays Capital Aggregate index returned 1.07 percent in July, bringing the rolling 12-month return to 8.91 percent. Nearly all sectors in fixed income contributed to the return. Corporate bonds were the standout performer for the month, returning 1.96 percent in aggregate, with the financial sector leading the way at 2.35 percent. Reduced uncertainty in the markets during the month was a strong contributor to the positive returns in fixed income. A few items with improved clarity include the Senate passage of the Dodd-Frank Act, Goldman Sachs settling with the SEC, and BP finally stopping the oil leak in the Gulf of Mexico. With some uncertainty gone, the performance of the fixed income market over the next few months will likely be driven by economic data announcements.

Market rates have remained extremely low due to the sluggishness of the economic recovery. Helping to maintain the low rates, economic indicators were mixed in July and the Federal Reserve Chairman, Ben Bernanke, gave a bleak outlook in his semi-annual monetary policy testimony. Corporate reluctance to hire led to nonfarm payrolls adding only 71,000 private sector jobs in July. However, the financial crisis in the European Union seems to have abated, and domestically, the Institute for Supply Management indexes showed expansion in manufacturing and services for another month. With economic figures painting a mixed picture and corporate balance sheets continuing to strengthen, we favor high-quality intermediate-term corporate bonds, with 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

- Commodity prices beginning to creep up
- Dissent within the FOMC; some seek change in policy language and higher rates

UNKNOWNS

- Likely expiration of the 2003 Bush tax cuts at the end of the year
- Federal Reserve may purchase securities again, also known as quantitative easing