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President

The Equity Market

Trudging Through a Soft Patch

By Craig Cairns

After a very strong stock market the previous two quarters, the market took a break this past quarter as the global economy hit a soft patch and struggled to work out some kinks that have been building beneath the blistering returns of the prior three quarters.

As we mentioned in our client letter a couple of weeks ago, while still positive for the year, recent economic turbulence, cited in headlines and talking points daily, has certainly rubbed off on the stock market. The market has given back some of its returns from the first quarter, as concerns about the resolution of the Greek debt crisis in Europe and the end of the Federal Reserve's Quantitative Easing initiative, combined with fragile fundamentals at home, have yet to be allayed.

The atmosphere of worry that prevailed in the quarter provoked a response from investors who proceeded to reduce stock exposure while buying securities with less perceived risk. For the time being, these continue to be US Treasury securities. While the stock market dropped, the US Treasury market rose due to unfortunate depictions globally and the ensuing uncertainty.

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Vince Russo,
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The Bond Market

2nd Quarter Overview

By Vince Russo

The bond market showed strong returns this past quarter, which should not be surprising in light of the weak economic data that has been released over the last three months, as well as the "on again, off again" problems with Greek sovereign debt and refinancing their debt obligations. The biggest negative for our own economy was a much weaker than expected Real GDP (Gross Domestic Product) in the first quarter of 2011: 1.9%¹ versus expectations of 2.5 to 3.5% (annualized) over much of the quarter. This is also disappointing because Real GDP was progressing at an annual rate of 3.1% in the fourth quarter of 2010. The final GDP report stressed positive contributions from personal consumption expenditures, inventory expansion, improving exports, and non-residential real estate. While these components did have a positive impact, they expanded at a slower rate than the fourth quarter of 2010. Real GDP was negatively affected by reduced government spending at the federal, state, and local levels.

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¹ U.S. Department of Commerce – Bureau of Economic Analysis; news release dated June 24, 2011

Greece

For years, Greece has partaken in unrestrained spending, and as a result has reached debt levels that have exceeded the limits set in place by the European Union's Charter. The degree of indebtedness Greece incurred was either unknown or ignored by the EU. Recently, this situation came to a head again for Greece, which faces the prospect of defaulting on its debt obligations within the next year. Because many European banks and nations hold each other's debt, a Greek default could cause a ripple of contagion that could cripple the European financial system. Last year, when Greece faced the probability of default, the International Monetary Fund and neighboring countries such as Germany and France bailed out Greece to stop this contagion.

However, in June, these lenders put a temporary stop on their bailout payments to Greece because they wanted to be assured that Greece had a plan in place for doing its part to lower debt and deficit levels through serious reform efforts. Late in the last week of June, Greece and foreign lenders came to consensus on a five year austerity plan, to the tune of \$40 billion, which is heavily dependent upon Greece taking measures to help itself. In order for Greece to reduce its debt, it has to raise taxes and/or cut spending. Greece plans to do both, alongside receiving outside assistance and focusing heavily on privatization.

We were comforted to learn that Prime Minister George Papandreou was successful in getting the austerity package passed by parliament even though the act faced a lot of opposition from the Greek people. The alternative of a Greek default on the loans from other euro zone countries and their banks would have been disastrous, considering that France holds 9 billion euros in Greek government debt, followed by Italy with 4 billion euros, and Germany with 3.5 billion. A sustainable resolution is incredibly important, and, fortunately, Prime Minister Papandreou seems very dedicated to following through. We believe that the resolution will bring about increased security for investors who were previously worried about the uncertainty of the situation in Europe. The markets seemed to start reflecting greater optimism by rallying in the last week of June. This encouraging agreement should act as a lesson and guide to other European countries facing similar debt issues, such as Spain, Portugal, and Italy.

QE2

Toward the end of 2010, the Federal Reserve announced its plan to institute a second round of easing, humorously dubbed "QE2," to help our struggling economy. Through this program, the Federal Reserve agreed to buy \$600 billion worth of US Treasury securities from investors to add liquidity to the capital markets to help keep interest rates low and provide the impetus for investors to invest and consume, and as a result, hopefully boost the economy. After being in effect for several months, this initiative came to its scheduled end on June 30.

There has been some concern about the ending of QE2. There is worry among some that the stock market will suffer as this support from the Fed ends. After all, when the first round of quantitative easing ended in 2010, the stock market responded very negatively to its sudden absence.

However, this time around, we believe what many experts are saying—that the end of QE2 will not bring with it much disruption, as investors have already priced that in. As of now, there are no plans in place for the Fed helping the markets with other stimulating programs in the near future, and we don't believe they will be necessary.

Fundamentals, and Where They Are Headed

After some slow improvements in the first quarter, the unemployment rate rose slightly from 9.0% to 9.1% in May, and is estimated to remain at 9.1% for the month of June. Additionally, in May, consumer spending was at its lowest level in months. As might be expected, high expenses are affecting the way Americans are spending. Gas prices reached an average high of \$4 this quarter, but as the price of oil has fallen, this number has in turn decreased. We are hopeful that these gasoline prices should continue to decline somewhat, having a positive effect on consumer spending.

Additionally, automobile manufacturing should improve corresponding with a planned surge in vehicle production in July (and hopefully increased employment as a result), given the substantial recovery from the heavy burden of the March earthquake and tsunami on Japan's parts production this past quarter.

Described as the "Missing Link" in our Spring newsletter, housing remains a struggling piece in our recovering economy. However, if there is a silver lining to the unimpressive Case-Shiller Home Price Index for 2011, it is that housing prices were slightly better than expected this month. The index is down only 0.1%, coming in slightly better than expectations. Perhaps this may mark the beginning of some stability for the housing market.

Despite all the negative headlines, the economy continued to grow. Economic growth remained steady from the first quarter into the second at around 1.9%. Although there is a lot to worry about, we believe that the latter half of this year will bring better growth. We are not as sanguine as the predictions of the White House, but the trends should become encouraging.

Looking Forward

To reiterate what we said in our June 2011 client letter, we are looking ahead with the expectation that the economy will continue to muddle along, slogging through this soft patch with slow, but steady growth. The S&P 500 remains above its 200 day moving average, an important measure of momentum and sentiment, which is consistent with our belief that its general trend of improvement is still in motion. The old adage "Wall Street climbs a wall of worry" seems to once again be in play. Our stock market appears to be reasonably, even cheaply, priced, and our economy is, for the most part, on firm ground.

Start Date: 3/31/2011 End Date: 6/28/2011

Index	Return for Period
Intermediate U.S. Government / Credit	2.39%
U.S Treasury: Intermediate	2.57%
U.S. MBS Agency Fixed Rate MBS	2.38%
U.S. Agency: Intermediate	1.50%
Intermediate: Corporate	2.39%
Intermediate Utility	2.98%
Invest. Grade: Industrial - Intermediate	2.61%
Invest. Grade: Financial Institutions - Intermediate	1.99%
U.S Treasury Inflation Notes: 1-10 Year	2.86%
Municipal Bond: 1-10 Yr Blend (1-12)	2.75%

Source: Barclays Capital

Please note: The returns above are for a 3-month period only.

In some of our previous newsletters, you may recall that we were less sanguine about robust economic growth prospects precisely because of the uncertainty surrounding fiscal policies (government spending), as well as other factors. We have yet to change our opinion on those uncertainties. In fact, it is becoming clearer that the growth in government spending may not be a positive contributor to GDP in the immediate future.

However, these are first quarter economic statistics; how are they impacting GDP forecasts for the second quarter? The median forecast in June for second quarter Real GDP is 2.3% annualized compared to a May forecast where the median was 3.3%.² So, as new economic data has been released over the past three months it is clear that economists are revising their growth prospects down. But many still believe that the economy will reaccelerate in the second half of the year. These downward revisions to GDP forecasts can help explain some of this quarter's positive performance in bonds, but not all of it.

Overall bond performance has been fairly uniform across most market types and sectors, with the exception of financial institutions. Undoubtedly, the re-emerging issues of European sovereign debt and exposure to possible defaults and restructuring of debt (changing the terms of the original obligations) have investors and central banks nervous about the financial sector's direct exposure to bonds of Greece, Ireland, Portugal, Spain, and Italy. Also of concern is the indirect exposure that the financial sector has to counterparty banks that are directly exposed to these same sovereign bonds. As one would expect, there has also been under performance this past quarter in high yield bonds. The quarter to date return for the Barclays High Yield Intermediate Index is only 0.21%. So, credit risk aversion has replaced inflation risk as the prevalent bond market concern.

We spent most of last quarter's article discussing the divergence between total inflation and core inflation, as measured by the CPI and the CPI ex food and energy (Consumer Price Index). While last quarter total CPI was increasing at an annual rate of 5.75%, the core CPI was only growing at a 2.05% rate. For the first two months of the second quarter (June data will not be available until July), total CPI grew at an annualized rate of 3.66% and core CPI was growing at 2.92%. Most of the moderation in total CPI was a result of energy prices falling precipitously in the month of May and continuing its decline for the better part of June. Since the end of April, when spot prices for West Texas crude reached a high of almost \$114/bbl, it is down more than 18% over the last two months. Another indicator of inflation expectations is the difference between nominal treasury bond yields and the yield on inflation protected treasury bonds. Inflation expectations peaked on April 11 at a spread of 2.66% to a spread of 2.35% as of June 28. Both measures point to lower inflation and are consistent with Federal Reserve Chairman Ben Bernanke's outlook that the most recent spike in inflation is transitory and not likely to have a long lasting effect. However, the topic of inflation will likely have the markets worried again in the near future, and we will surely be addressing inflation in upcoming newsletters.

Debt, Deficits, and Rational Behavior

Particularly notable this quarter are the latest updates regarding the Greek Parliament passing a new austerity plan that is a prerequisite demand made by major European Union members enabling the Greek government to refinance its maturing debt obligations and continue to service its debt with the help of (guarantees from) the European Union, European Central Bank, and the International Monetary Fund. Additionally, many major European banks will extend commitments to renew loans to Greece or voluntarily restructure current loan obligations to avoid an outright default. So, the immediate problems for Greece creating a systemically significant event in Europe (and perhaps elsewhere) has passed for the time being. What happens the next time Greece needs to meet its debt obligations if the confederation of nations in the European Union is not willing to guarantee them? We may be talking about this again.

In March of 2010 we addressed the issue of the European sovereign debt crisis and particularly that of Greece. While a most accurate measurement of debt to GDP ratio may be difficult to verify, most sources estimate that it approaches 150% (excluding other public pension obligations and contingent liabilities). This does not sound very alarming when looking at an economy that is still growing or whose prospects for growth are realistic, but Greece is neither growing nor are its prospects very good.

²Source data - provided by Bloomberg L.P.

Unemployment is greater than 15%, Real GDP is -5.5% from last year (still in recession), and continued deficit spending is making matters worse. In last year's article we wrote:

We all know now that the chosen solution to address the financial crisis of 2008 was for central banks and governments, globally, to "re-liquify" the banking system and soften the shock of collapsing demand through easy monetary and fiscal policies. While the actions taken were deemed necessary to prevent greater destruction of economic wealth and well being, the capital markets may be sending a "signal" that it's time to address the longer term structural problems inherent with overspending and excessive borrowing by governments around the world. This "signal" should not be disregarded and has been echoed by Moody's in a statement issued on March 15. They warned that Western governments that currently enjoy the highest of credit ratings have moved "substantially" closer to losing that edge. The ratings are "stable," but "their 'distance-to-downgrade' has in all cases substantially diminished." They also commented on the social impact of these nations' debt burdens.

"Growth alone will not resolve an increasingly complicated debt equation. Preserving debt affordability at levels consistent with Aaa ratings will invariably require fiscal adjustments of a magnitude that, in some cases, will test social cohesion."

It should not be surprising to anyone that such divisiveness will continue, as governments begin to seriously confront the fiscal realities of these debt burdens. As it relates to our own economy in the United States of America, the fiscal realities require reducing expenditures and raising taxes at all levels of government. Regardless of political ideology, there is no "magic" solution to our structural problems. While there may be different approaches to addressing our nation's fiscal imbalances, the end result is that we will all feel the negative effects of our unsustainable obligations.

Consider this example of the potential problems that lie ahead for countries that are currently receiving European Union and IMF guarantees, as well as those that have high debt to GDP ratios and not very good growth prospects, including the United States.

This is topical because, soon after the passage of the Greek austerity plan was announced, President Obama was holding a White House news conference relating to the current US deficit negotiations that are taking place in both houses of Congress. The time for talking about a solution is over and it is time to start implementing a plan that will curtail our deficit spending. Right now our government's debt to GDP is approaching 100% (again, not counting entitlement programs and other contingent liabilities).

In fairness, this, too, does not sound alarming. For example, think of an average household that earns \$50,000 a year (GDP) and has debt of \$50,000 total. It is very realistic to think that this amount of debt is perfectly serviceable at current interest rates. The problem arises when the income stops or is reduced. What seemed to be manageable debt may no longer be manageable. It is also a problem if interest rates were to significantly increase without a commensurate increase in income prospects. In that situation, more and more of the after-tax income (discretionary income) is utilized for debt service, leaving less and less for other needs. One may be forced to use up savings as a last resort to "make ends meet." However, it is certainly questionable to continue to borrow money (over an extended period of time) in order to maintain a lifestyle that is not sustainable. Right now our government is doing just that—but hopefully not for long or there may be negative consequences to pay in the future.

Howe & Rusling as a Historical Landmark

As Rochester's first investment advisor, Howe & Rusling has been featured in the Rochester Historical Society's latest exhibit:

All Busine\$\$: 190 Years of Rochester Ingenuity. Alongside other Rochester businesses such as Harris Beach, Gleason Works, and Hickey Freeman, Howe & Rusling was chosen as one of a select number of successful, longstanding Rochester businesses that are still in existence today.

The exhibit opened on June 21st at the Historical Society's new home: The Rundel Memorial Library in Rochester. Large open rooms in the upstairs of the grand library are full of artifacts and pictures from the various featured companies. The Society put together beautiful wall hangings for each company, featuring a description of the business, its history, pictures from its early days, fun facts, and a depiction of where it is today.

For those clients in the Rochester area, keep on the lookout for an invitation to a special reception we will be holding at the Historical Society to celebrate our history, success, and tradition. We are incredibly proud and grateful to not only be a part of such a wonderful exhibit, but to be a part of Rochester's deep and rich history!
