

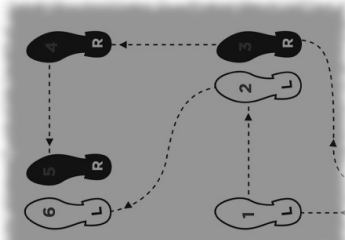
Perspective

JULY 2011 • VOL. 27, NO. 3 • A QUARTERLY REPORT ON INVESTMENT AND ECONOMIC TRENDS

ECONOMIC STUTTER STEP

“One cannot make the incredible credible by endless delay.” – Martin Wolff

Up to this point we have had an investment led economic recovery, stoked by government stimuli and easy money policy. In turn, the stock market has responded over the last several quarters on hopes that the economy will reach a self-sustaining acceleration. However, the ascending stock market took somewhat of a breather during the second quarter as investors were once again reminded the post-crisis world is still rife with macro imbalances and political instability.



The temporary nature of forces that have helped buoy the stock market since 2009 is weighing on investors as economic data has trended discernibly lower, uncertainty exists about the size of the stimulus, and the European debt crisis has flared up once again. At the same time, the approach of the federal debt ceiling deadline highlights the challenges of attempting to restore fiscal order during periods of persistently sluggish growth.

From a broad fiscal perspective, we have just entered the point where the bulk of the federal stimulus rolls off. However, the reality is economic growth is lower now than before QE2 was implemented, and artificial stimulus is not a long-term solution. You can't get rid of the debt quickly and you can't get rid of the debt nicely. Pumping money into the financial system doesn't stop the need for the private sector to heal itself. If measures to rein in stimulus are not taken, we'll continue to trade the future for today. Can't dance around the issue forever, eventually it needs to be addressed.

A European contagion was averted, but the inevitable Greek debt restructuring has only been pushed off to a later date. In the meantime, sovereign budget challenges remain as most think Italy is the next crisis in line and both Portuguese and Irish debt were downgraded to junk status by Moody's. Excluding Germany and France, the rest of the Euro-zone is contracting. A weakening Europe will not be in a position for future bailouts.

At home, the U.S. economy will remain mired in an environment of slow growth, high unemployment and looming inflation. Market sentiment can shift quickly depending on

economic or political news, geopolitical events, or even natural disasters. However, a weaker recovery shouldn't be taken as a sign of impending ruin. As the country slogs along, history suggests the cyclical backdrop remains constructive for stocks. A sustainable, low inflation, economic expansion persists. The economy is on a very slow path, but it is still on the way to stable recovery despite short-term gyrations.

The economy may have taken a stutter step, but it's still two steps forward and only one step back. The reality is underlying factors that determine long-term performance continue to improve, albeit at a glacial pace.

Market

Strength from the first quarter carried into April, but May and June brought with it renewed volatility due to a slowdown in economic growth and geopolitical concerns.

Market Measures*	% Change	% Change	% Change
	2Q Ending 6/30/2011	6 Mo Ending 6/30/2011	1 Yr Ending 6/30/2011
Dow Jones Industrial Avg	1.35%	8.48%	30.16%
S&P 500 (Cap Wtd)	0.08%	5.89%	30.60%
NYSE Composite	-1.02%	4.46%	28.59%
NASDAQ Composite	-0.03%	5.01%	32.82%
Russell 1000 Large Cap	0.12%	6.37%	31.93%
Russell 2000 Small Cap	-1.61%	6.21%	37.41%
Russell 1000 Growth	0.76%	6.83%	35.01%
Russell 1000 Value	-0.51%	5.92%	28.94%
S&P CitiGroup Growth	1.64%	6.79%	33.53%
S&P CitiGroup Value	-1.47%	5.23%	27.90%
Lipper Large Cap Value Fd	-0.69%	5.18%	28.84%
Barclays Capital Int Bond	2.12%	2.47%	3.77%
U.S. T-Bills (90 days)	0.06%	0.13%	0.13%
Consumer Price Index	1.54%	3.53%	4.11%

*Total Return

At one point the stock market had been lower seven consecutive weeks, which put into question the duration of the existing bull market. But a major rally in late June lifted stock prices such that performance of the S&P500, Dow Jones and Nasdaq was essentially flat for the quarter.

Ultimately, earnings growth drives stock prices. From the 1Q2009 lows that culminated in a 92% plunge, S&P 500 earnings have surged back near pre-crisis peak levels. The only time when

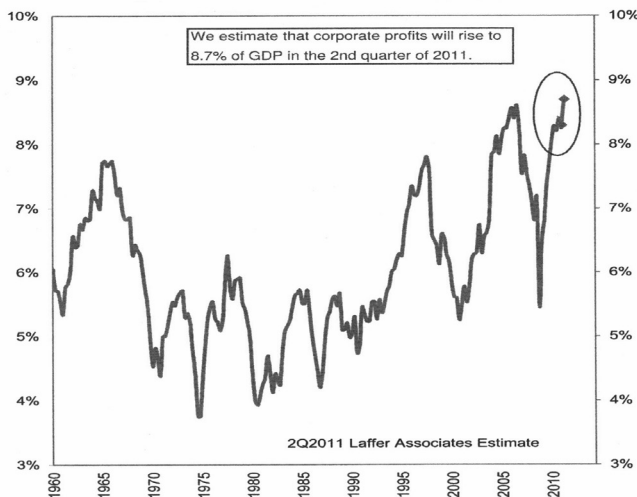
In This Issue:
Market
Debt / Deficit
Economy
The Fed

inflation-adjusted earnings have been higher than current levels was during an 18-month period from late 2006 to early 2008.

Stocks usually lead the economy and typically perform best when the economy is weak and getting stronger. However, the overall effect of recent “two steps forward – one step back” economic output is to suggest earnings growth may be due to level off. While corporate earnings for the S&P 500 are projected to be up 15% over the same quarter last year, earnings expectations for the rest of 2011 may be tempered.

Not only are S&P500 earnings near all time highs, but corporate profits as calculated by the National Income and Product Accounts (NIPA) as a percent of GDP are near a 50 year high. A high NIPA Profit to GDP ratio implies a sluggish economy or abnormally high profitability – either way suggests the pace of earnings growth will slow to a moderate pace. In fact, when NIPA profits have been greater than 7% of GDP, five-year annualized profit growth has not exceeded 5%

High NIPA Profits to GDP Imply Moderating Earnings



Source: Laffer Associates

On the other hand, stock valuations are still within long-term averages, and corporate balance sheets remain as healthy as ever. Corporate profits are resilient and even modest gains in earnings would support increases in stock prices from current levels.

Debt and Deficit

While the actual drop-dead date isn't written in stone, the approaching Aug 2 deadline to breach the federal debt ceiling poses a significant risk to stock and bond market stability. Federal receipts in August will be about \$200 billion and mandatory expenditures due will be over \$350 billion.

A resolution becomes more imminent the closer we get to the deadline, as the implications of a default on U.S. obligations would be horrendous. However, it may take a negative reaction from the market or a development of another painful economic indicator to induce policymakers to compromise in the coming weeks.

Negotiations are expected to result in an agreement that will ultimately reduce the future debt by \$2 trillion, but will take several years to implement. According to the Congressional Budget Office, the budget deal reached last April will cut this year's deficit by \$352 million, not very significant relative to the size of the estimated \$1.6 trillion annual deficit.

Even if the debt ceiling is temporarily increased, spending needs to be cut. Government payouts now make up more than one third of total wages and salaries of the U.S. population, and comprise an estimated \$2 out every \$10 the U.S. consumer spends.

According to the IMF, the U.S. government's debt-to-GDP ratio will hit 100% this year, up from 62% in 2007, and the highest since WWII. Like all things, there is a limit that should not be reached. It's been shown that when the debt-to-GDP ratio is 90% or greater, economic output is stymied.

GDP % Growth Based on Debt/GDP

	Central (Federal) Government Debt/GDP			
	Below 30%	30% - 60%	60% - 90%	90% and Above
Average	3.7	3.0	3.4	1.7
Median	3.9	3.1	2.8	1.9
# of Observations	866	654	445	352
Select Emerging Market Economies (1900-2009)				
	Central (Federal) Government Debt/GDP			
	Below 30%	30% - 60%	60% - 90%	90% and Above
Average	4.3	4.1	4.2	1.0
Median	4.5	4.4	4.5	2.9
# of Observations	686	450	148	113

Source: Charles Schwab

It is estimated that the current average cost of U.S. debt is 2.5% and the thirty year average is 5.7%. Interest costs today amount to about \$350 billion, or roughly 10% of the 2011 budget. If we were paying 5.7%, interest costs today would be closer to 22% of the budget – and government debt is expected to grow over 50% in the next ten years.

A clear fiscal blueprint for reducing debt is mandatory. Government policies that add uncertainty into the market and stymie risk-taking and innovation will only make the future bill more difficult to pay. Increased regulation and government interference have already weighed on business and are a large contributor to the reluctance of companies to put their massive cash balances to work.

Economy

The worst recession since the Great Depression officially ended two years ago, but the ensuing recovery has also proven to be one of the worst since WWII. Similar to the 1991 and 2001 post-recession periods, the current recovery is characterized by gradual output growth and lack of job creation. What distinguishes this recovery from the others is that it has been largely stimulus driven without the organic drivers that are necessary for long-term economic health.

Last year at this time there were concerns about falling back into a double-dip recession and the Fed responded with QE2. Currently, while the majority of economic indicators remain

in expansionary territory, many of them have peaked or are leveling off. With the end of QE2, combined with subdued economic data, there have been renewed concerns about the economic recovery. From a fiscal standpoint, there seems to be little political latitude for further attempts at stimulus.

The ISM Manufacturing Index, which often precedes movement in corporate earnings and GDP, is resting just above the critical 50 level. In addition, other ISM data shows an increase in inventories, with declining order backlogs and stagnant new orders. This build-up of inventories, combined with sluggish new orders, suggests over capacity and slower growth ahead.



Source: Wells Fargo Securities

Nonfarm payrolls have had 11 consecutive monthly gains through June – but the current number of U.S. jobs is still at a level first reached in early 2000. Concern over the healthcare bill and resultant costs, regulation in the financial sector, environmental decrees that raise the cost of doing business, and an uncertain tax policy have been brick walls to employment. Weekly jobless claims have again risen above the key 400,000 level, and only 550,000 jobs have been gained since the official end of the recession in the summer of 2009 – the third lowest in terms of jobs added nationally 23 months into a recovery based on the 12 official recessions since 1940.



Source: J.P. Morgan

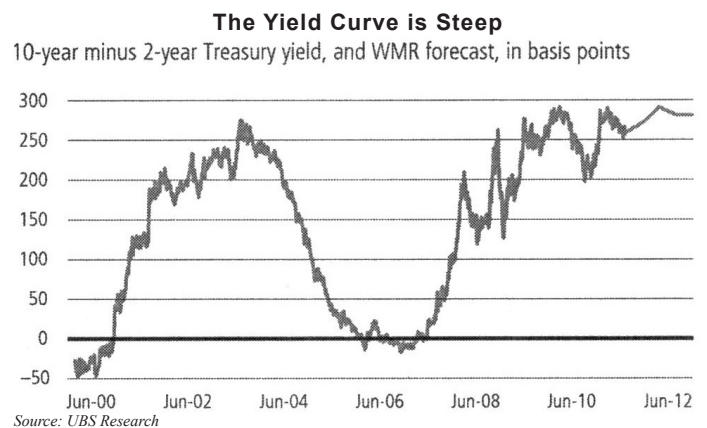
The Fed

For the 20th consecutive meeting, the Federal Reserve's Open Market Committee left its benchmark interest rate in a range of zero to 0.25%, where it's been pegged since December 2008. The committee members also retained their pledge to keep rates "exceptionally low" for an "extended period." Interest rates can stay low for an extraordinary amount of time. Interest rates have been essentially zero in Japan since

1995. During the Great Depression, the Fed cut the discount rate below 2% in 1934, and it held at those levels for 20 years.

The Fed's loose monetary policies have penalized savers and investors at the expense of borrowers – namely the US Treasury. Real returns are negative out to maturities of 5 years, meaning the government bond returns are less than the rate of inflation. Relatively speaking, stocks still represent good value when compared to bonds.

The yield curve remains relatively steep, which has typically been a good indicator of steady economic growth. In addition, there have never been bear markets when real interest rates were negative, as is the case today. Bond yields and stock prices are generally negatively correlated. However, in the current environment, they are moving together. Slowly rising interest rates from historically low levels would signal strength in the economy and be a positive for stocks.



Source: UBS Research

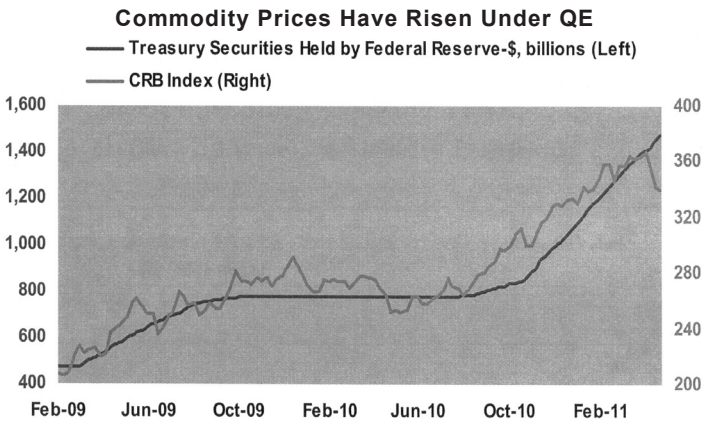
The Fed's second round of quantitative easing, where it spent \$600 billion on Treasury bond purchases over eight months, ended in the second quarter. Since the summer of 2008, both QE programs combined for over \$2 trillion in asset purchases.

The Fed's goals were to lower mortgage rates to boost housing, reduce corporate bond rates to encourage investment, and raise stock prices to increase confidence and spending. However, instead of an uptick in lending, the vast majority of the money wound up back at the Fed in the form of deposits made by the banks who had sold their bonds to the Fed.

While interest rates for mortgages and corporate borrowing are still near all time lows, the QE programs did little to address the underlying problems of sluggish lending or uneven recovery. Home buying remains muted and business spending has shown signs of fatigue. Undoubtedly, the programs also help raise stock and commodity prices as investors sought higher returns.

The Fed is attempting to inflate its way out of its debt problems, hoping to raise the level of asset prices, and its primary mechanism has been through quantitative easing (QE). Although it is not currently an issue, asset prices can only inflate so far before they become a major problem in and of themselves by creating a headwind for the economy. Inflated input prices hurt companies' profits, and in turn hurt

consumers. At the same time, high inflation forces investors to look outside the US for higher real returns.



The Fed is the largest holder of Treasury securities, larger than China and larger than the entire U.S. commercial banking system. The Federal Reserve has been purchasing 85% of all new Treasury issuances, and the end of QE2 signals the end of most of this marginal demand for Treasuries. The Fed will maintain the size of its current balance sheet by purchasing Treasuries in the future, but in significantly smaller amounts than the past couple of years. Ultimately interest rates will rise as bidding for new Treasury issues will be less aggressive on the part of the private sector and foreign buyers because the Fed won't be there to take unwanted Treasuries off their hands.

The ability to borrow from the Fed at near-0% and invest proceeds in Treasuries (whose prices are propped up by the Fed), have enticed banks to hold Treasuries instead of making loans. The end of QE signals an eventual move to a more normal monetary policy and in turn, should push banks to increase loans.

Outlook and Conclusion

The following is a summary of some of the indicators that guide our equity investment policy:

Commodity Prices	Turning
Earnings Growth	Positive
Fiscal Policy	Negative
Earnings Momentum	Turning
Inflation	Positive
Interest Rates	Positive
Monetary Policy	Positive
Yield Curve	Positive
Price to Book	Neutral
Price to Dividends	Neutral
P/E Ratio	Neutral
Volatility	Neutral
Technical Outlook	Turning

To summarize our current thoughts:

- Inflation outlook still positive in intermediate term
- Expanding economy, but two steps forward one back
- Unemployment persistently high
- Corporate profits strong, growth leveling off
- Resilient stocks continue to make modest gains
- Treasuries are overvalued
- Dollar in trading range
- Euro debt situation to increase volatility
- Price of oil easing without QE program
- Budget deficit and debt expanding

The global economy remains on a self-sustaining but unspectacular expansion course. The fiscal and monetary stimuli in both Europe and the U.S. have largely run their course, but stimuli has not been sufficient to bootstrap either consumers or exports up to the status of follow-through on the investment led recovery.

As anticipated, QE2 did little to help spur economic activity, but did inflate the price of risk assets. In fact, consumers have shown signs of strain due to the rise in commodity costs. Further QE programs are not anticipated as the tradeoff between costs and benefits is not attractive.

However, while many economic indicators are leveling off, they are still in expansionary territory. In addition, many of the underlying fundamentals of the economy are in better shape than a year ago. The economy is growing, albeit at sub-par growth rates.

Europe has thus far been able to avert a sovereign debt crisis, but there is no solution on the horizon and future flare ups will increase volatility in global stock markets. Here at home, the size of the federal debt relative to GDP is too high. While it's not nearly as urgent a situation in the U.S. as in the Euro-zone, there's a mountain of evidence that suggests economic growth will continue to have stutter steps as long as debt is not reined in.

Stock valuations are still reasonable and corporate balance sheets remain very strong. In addition, stocks are attractive relative to bonds. We anticipate continued, but moderating corporate earnings growth. This, combined with a steep yield curve and an environment in which real interest rates are negative, should help sustain further stock market gains.

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