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Review and Outlook
Second Quarter 2011

Stock prices continued to rise in April, tipped over in May, then fell sharply in June, but only until the last four days when they staged a remarkable recovery. The total return of the S&P 500 Index in the second quarter was +0.1%. Year-to-date the return of the S&P is 6.0%. In contrast to stocks, high quality, intermediate-term, taxable bond prices *rose* sharply in the second quarter until the last four days when they dropped precipitously. The total return of the Bar-Cap Intermediate-Term US Government/Credit Index was 2.1% during the quarter and 2.5% year to date. The reversals in both stock and bond prices in the final days of June were the result of the perception that a Greek default had been temporarily avoided.

First quarter corporate earnings reported in April and May generally showed continued strong growth. Much of US corporate earnings growth over the past year (excluding the finance sector) has come from foreign operations. The earnings growth achieved by companies listed on US exchanges provided the basis for investor confidence that fueled rising stock prices through May. Investor confidence in future earnings growth may be waning because of a number of different factors.

China appears to be quite serious in their efforts to slow the rate of growth in their domestic economy. To the extent they are successful it will result in slower growth in US exports to China, and slower growth in the earnings of US-listed companies doing business in China.

The Greek debt/Euro zone issue appeared to be on the brink of a very messy default. This has been at least temporarily deferred. European banks agreed to roll maturing debt and pretend it will be paid off sometime. It is highly likely that some sort of default/debt restructuring is inevitable. No amount of feasible "austerity" – lower pensions, lower salaries for government employees, increasing the required years of employment to be eligible for state pensions – could possibly result in enough savings to pay back the total sovereign debt. Tax avoidance is apparently imbedded in the Greek culture. Raising tax rates have almost no impact on revenue. Both decreased spending and increased revenue are required to avoid some form of default. It is highly unlikely that both the culture and tax collection infrastructure can change in time to have sufficient impact on revenue.

The exposure of US financial institutions to the Greek mess is not clearly understood. US institutions apparently only hold nominal amounts of Greek debt. However, there could be considerable exposure to German and French banks that have significant direct holdings of Greek debt. Potentially more worrisome is the level of derivative insurance of Greek debt that may have been issued by US financial institutions. The uncertainty about these issues is at least partially responsible for the sharp drop in financial sector stocks during the quarter. Financial sector stocks have dropped more than 6% since the end of March.

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Worries about the domestic economy and the US debt/deficits are also increasing investor uncertainty. Housing will likely remain in the doldrums for a relatively long period. The housing bubble resulted in a large increase in the housing inventory and a large increase in employment in fields related in one way or another to housing. Mortgage lending criteria are more rigorous since the meltdown. We saw one estimate that this has reduced the total pool of those eligible for any mortgage by one third. This obviously should result in fewer defaults, but it will also have profound impacts throughout the economy. There will be a permanent reduction in the demand for new occupant-owned housing. Construction of occupant-owned housing tends to have a greater economic multiplier impact than the construction of rental housing. The multiplier effect includes the total number of people employed. Part of the conundrum of the current economic problem is that a large number of the unemployed were employed in jobs related in one way or another to the housing industry. Other industries will have to absorb the unemployed for employment to significantly improve. Levels of actual unemployment will likely remain relatively high for a longer time. In addition to the social costs, this will impact corporate earnings growth rates.

August 2 is the deadline to raise the federal debt ceiling. For some reason, negotiations to raise the debt ceiling are tied to deficit reduction agreements, even though Congress controls both spending and taxes through the budget process. Deficit reduction can be achieved by cutting Federal spending, or increasing revenues, or both. However, at the time of the writing of this report, negotiators are unable to agree on raising revenues. If significant deficit reduction is achieved solely through spending cuts, economic recovery will likely be delayed. The resolution of the deficit issue is extremely important for our long term economic health. Holding the debt ceiling hostage to this issue is dangerous. The political strategy of allowing a couple of days of "default" would likely result in a permanent small (perhaps very small) increase in US borrowing costs. Even a small increase would result in a significant permanent increase in federal spending on those borrowing costs. The fear of a Greek debt collapse drove international investors to Treasuries. With this issue moving to the back of investor's minds, the ugly "debate over the debt" issue moved to the forefront and investors started abandoning Treasury securities, driving interest rates higher.

We believe that the recent high volatility in stock prices is at least partially a result of investor concern over these issues. Looking forward, we have some confidence that Congress will raise the debt ceiling prior to the August 2 deadline and may even begin to deal with the deficit. If both of these happen the investment climate may improve substantially. While the second quarter corporate earnings growth rate will likely be lower than during the first quarter, they will probably continue to grow. Current price earnings ratios are moderate. The economy is growing slowly, but it is growing. The recent jump in stock prices illustrates investors' craving for good news. We could all use some.

Michael F. Ryan
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Vice President

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