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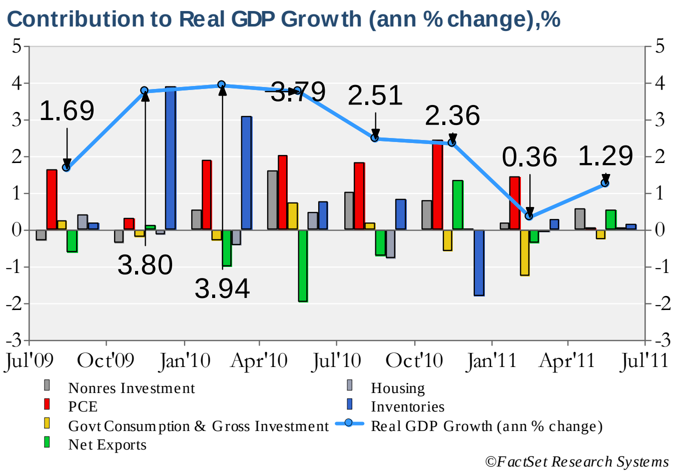
Market Review

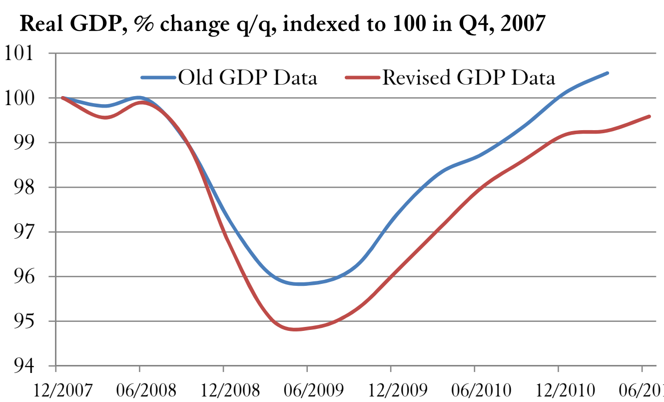
July 2011

Economic Review

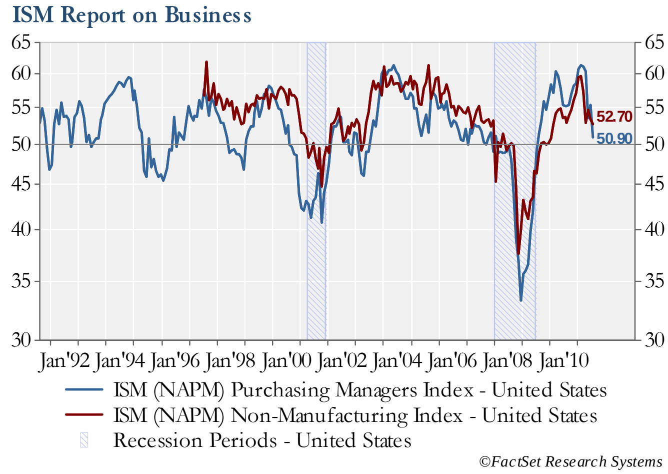
The U.S. second quarter real GDP increased at an annual rate of 1.3%, significantly lower than the 1.8% expected annual growth rate. Consumer spending (red bar in the graph below) decelerated sharply during the quarter, advancing at an annual rate of 0.1%, the weakest growth rate reported since the recession ended two years ago. The real surprise was the sharp downward revision of the first quarter GDP growth to 0.4% from the previously reported 1.9%.



The second quarter "advance" GDP estimate release from Bureau of Economic Analysis also contained revised estimates from 2003 through first quarter of 2011. According to the revised GDP estimates, the recession was significantly deeper than previously reported, increasing the peak to trough decline from -4.1% to -5.1% (shown below). Real GDP is still 0.4% below the peak achieved before the recession. The summary of revisions can be *found here*.

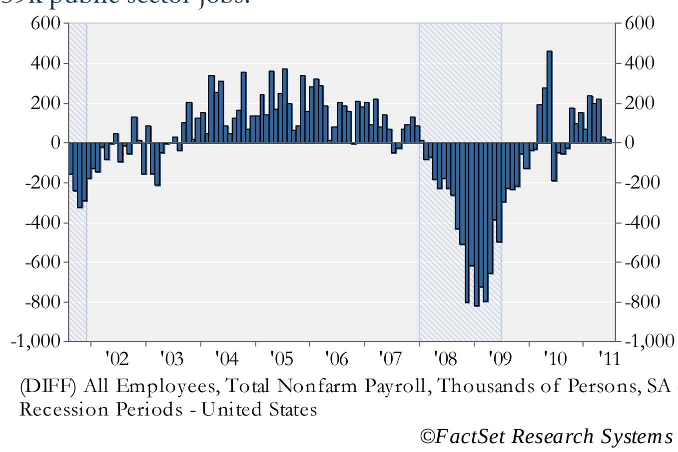


The ISM manufacturing index declined to 50.9 in July from 55.3 in June, the lowest level since July 2009, well below the consensus of 54.5 and barely above 50. Values above 50



indicate an expansion. Except for the export sector, all the sub-indices within the ISM manufacturing report were weak. New orders, a forward looking component of the index, dipped to 49.2 in July. The July ISM non-manufacturing index dipped to 52.7% from 53.3% in June, indicating a slower expansion.

The June unemployment rate increased one tenth of a percent for the third straight month to 9.2%. Equally disappointing, the non-farm payrolls report showed the economy created just 18k new jobs in June compared to last month's 25k new jobs and well below the consensus estimate of 90k. Private sector job gains totaled 57k, the lowest number since 2010. These were offset by the loss of 39k public sector jobs.



Democrats and Republicans failed to reach any agreement on the debt ceiling in July. S&P placed the U.S. debt rating on negative credit watch mid-July and gave a 50/50 chance of a downgrade over the next three months. Congress finally passed a bill in early August to raise the Government's $14.3 trillion debt ceiling by $2.1 trillion to fund the Government until 2013 and to cut deficit by at least $2.4 trillion over the next decade. It is worth mentioning that the agreed upon deficit reduction, in reality, means a slower rate of deficit

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increase than the CBO baseline. In other words, the deficit will continue to rise rapidly.

It is yet to be seen if the debt deal does enough to rein in the deficits to satisfy the credit rating agencies. According to Fitch, the deal reached was "commensurate with its 'AAA' rating, the risk of sovereign default remains extremely low". On August 2nd, Moody's assigned a negative outlook to the U.S. debt rating.

On the international front, the European Central Bank raised the overnight interest rates by 25 basis points to 1.5%, while Bank of England left them untouched. Moody's downgraded Portugal's sovereign debt rating to BB and Ireland's debt rating to Ba1. At the time of this writing, Italian & Spanish sovereign debt yields have crossed 6%, the highest levels since the formation of EU. The UK economy grew at 0.2% in the second quarter of 2011.

Chinese GDP rose a robust 9.5% during the second quarter. Inflation in China was up 6.4% year over year in June, the highest rate since 2008, primarily attributed to an increase in food prices. China Manufacturing PMI reported 50.7 for July versus the consensus of 50.2 and the previous month's 50.9.

Equity Markets

July was a volatile month as the market wrestled with the ongoing European debt crisis and the failure of the U.S. Congress to reach a deal on raising the debt ceiling. All of the uncertainty caused risk assets, especially equity markets, to come under pressure.

The U.S. equity market continued its late June rally on the back of decent domestic manufacturing data (ISM Manufacturing report) and on signs of strengthening labor market (ADP payroll report) in early July. The rally later faltered after a dismal non-farm payrolls report for June. The U.S. budget stalemate, Italian debt concerns and Moody's downgrade of Ireland's Government bond ratings kept any hope of a rally in check through the middle of July. The third week of July saw a brief rally backed by strong corporate earnings, new EU/ECB draft proposals for the sovereign debt concerns and a potential deal in U.S. debt ceiling negotiations. However, continued uncertainty of Congressional negotiations and a surprisingly weak U.S. GDP report (discussed earlier) weighed heavily on equities and dragged the S&P 500 Index down 3.91% during the last week of the month, its biggest weekly drop in a year.

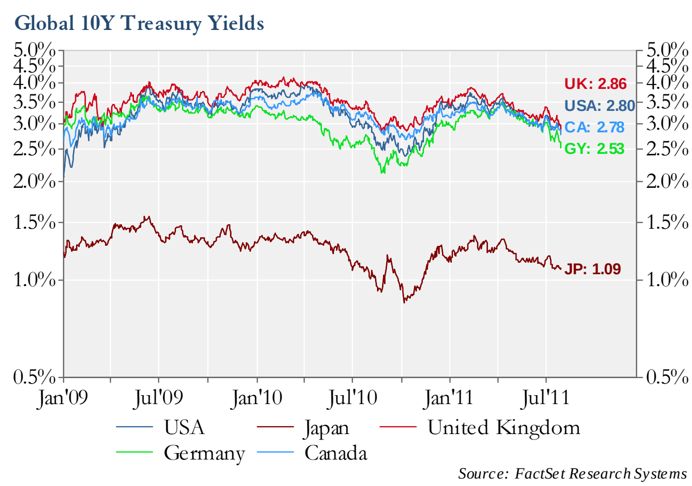
The S&P 500 Total Return Index fell 2.03% in July and trimmed gains to 3.87% for the year. This is the lowest monthly return since August 2010. As in June, small cap stocks continued to underperform large and mid-cap stocks in July. The Russell 2000 Index declined 3.61%, while the S&P Mid-Cap slid 3.53%.

Measured in U.S. Dollars, the MSCI World Index slipped 1.79% in July. The Index is up 3.73% through July 2011. The MSCI EAFE Index lost 1.57%, while the MSCI Emerging Markets declined 0.38% last month. Measured in their local currencies, the FTSE 100 and STOXX 600 indices lost 2.13% and 2.70% respectively. Year to date, the FTSE 100 is up 0.53% while the STOXX 600 is down 1.67%.

Bond Markets

Debt concerns in both the Eurozone and the U.S. coupled with weak economic data led to a rally in the fixed income markets in July. Even with the prospect of a possible U.S. debt downgrade, U.S. Treasury securities posted their biggest monthly gains since August 2010. Barclays Capital US Aggregate Government Treasury Index was up 1.82% in July. The yield on the 10 year Treasury fell below 3% by the second week of July and reached 2.8% by the end of the month, falling 36 bps for the month.

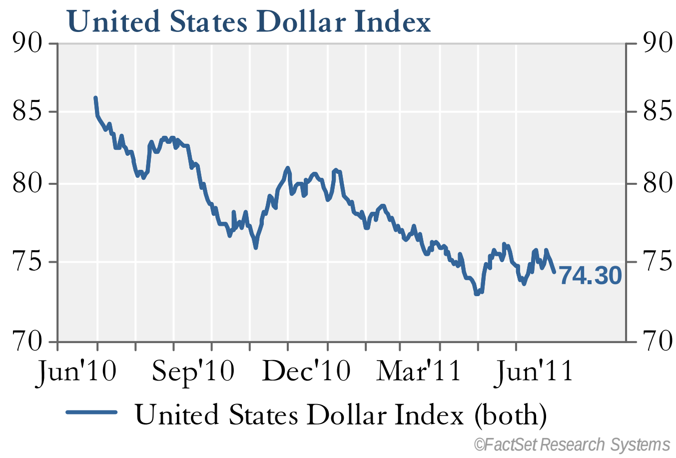
The U.S. bond market, as measured by the Barclays Capital US Aggregate Index, increased 1.59% in July and is up 4.35% for the year.



The yield on the German 10 Year Bund dropped 49 bps and closed at 2.53% for July. The UK 10 Year GILT yield declined 52 bps for the month, closing at 2.86%.

Currency

The U.S. Dollar suffered in July as U.S. lawmakers wrangled with the debt ceiling issue. The US Dollar Index lost 0.55% against a basket of six major currencies in July extending the year to date decline to 6.49%. The Euro was the worst performer amongst the developed countries in July and weakened 0.7% against the U.S. Dollar on concerns over the regional debt crisis. The British Pound appreciated 2.36% vs. the U.S. Dollar in July. The Euro closed at 1.4370 USD and the British Pound closed at 1.6415 USD.

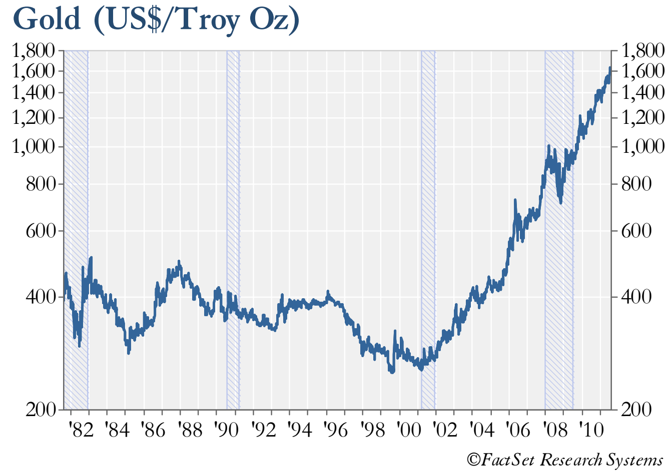


Commodity Markets

Commodities made handsome gains in July amidst escalating sovereign debt issues as investors sought the safety of precious metals and solid assets along with Treasuries. Growth numbers from China and speculation of a third round of Quantitative Easing also helped the commodity markets. The S&P GSCI Index rose 2.43% last month after declining nearly 12% during the previous two months. The index is up 5.21% in 2011. The S&P GSCI Precious Metals index surged 9.49%, outperforming the rest of the S&P GSCI sectors. The Dow Jones UBS Commodity Index gained 2.96% in July and is up 0.31% for the year.

Silver delivered the strongest rally amongst the 24 GSCI commodities gaining 15.14% in July, after losing 28.33% in the prior two months. Spot Silver closed at $40.11 per troy ounce.

Gold futures rallied strongly in July, gaining 8.54%, up 14.76% for the year and closing at an all-time high of 1,631.20 per troy ounce. The current economic uncertainty and fears of a downgrade of U.S. AAA sovereign rating led investors to buy the precious metal as a store of value.



Wheat and Corn gained 9.48% and 7.78% respectively as adverse heat in U.S. was expected to damage crops, lowering their yields. Sugar continued its prior month's rally on supply concerns from Brazil and gaining 13% in July.

Cotton prices fell 14% in July and have declined over 50% from their peak set in early March because of poor demand and higher output from China. Cotton prices had seen a price surge late last year and early 2011 on robust demand and a poor harvest.