Outlook and Market Review – Second Quarter 2011

The economy continues to muddle along with low growth and high unemployment in what hardly feels like the start of the third year of a recovery. According to the advanced announcement by the Bureau of Economic Analysis, second quarter GDP grew at an anemic 1.3% rate (which is already being revised downward as new data come in). Worse yet, first quarter growth was revised down from 1.9% to only 0.4%. Revisions show that the recession in 2008 and 2009 was worse than originally reported. Peak to trough, real GDP fell 5.1% rather than the 4% decline reported in prior announcements. With the revisions, U.S. GDP still remains shy of its pre-recession level. On a year-ago basis, real GDP rose 1.6% in the second quarter, well below the 3% to 4% rate needed to expand jobs. Unemployment remains high with a 9.1 unemployment rate and a falling labor force participation rate. Payroll employment fell by almost 9 million during the downturn while the economy has added back fewer than 2 million jobs, even with massive fiscal and monetary stimulus. Most analysts expected 2011 to be the transition year where GDP growth would exceed 3%. Now, economic conditions in 2011 raises doubt about the sustainability of the recovery with a one in three chance of falling back into a recession.

Financial markets were relatively stable earlier this year with the CBOE Volatility Index (VIX) trading in a narrow range (14.6 - 18.4) prior to June. Global and macroeconomic events starting in June shocked the markets causing the VIX to trade near 25. The tsunami in Japan created a temporary disruption in the global supply chain, largely concentrated in the automobile industry. Concerns over sovereign debt grew worse as the U.S. demonstrated an inability to come to grips with an unsustainable and growing debt burden while the Eurozone debt crisis became more severe. With signs of a weaker than expected U.S. economy, the weight of these events created a roller coaster ride for equities. Neither concerns over a weak economy nor uncertainty over sovereign debt conditions will go away soon, setting a stage for a continued tug of war between risk and reward in financial markets.

Going forward, sentiment and expectations must improve if the economy is to continue on the path of modest expansion. For the remainder of the year, GDP growth should rebound slightly to about 2%. Inflation continues to rise, but at a rate that will not cause alarm for the Fed or derail the Fed's plan to keep rates low throughout the year. The flight to safety is keeping interest rates low and the Fed will try to quash any upward movement that would make a recovery more difficult. A real improvement in the fiscal deficit and corresponding reduction in the rate of growth in government debt is unlikely, causing more drag on the economy (see the discussion in the First Quarter Outlook).

Markets Reflect Eroding Confidence – When will we get a Viable New Direction?

Consumers and investors have good reason to be pessimistic. Within a relatively short period of time they have learned that the economy has been worse than reported, experts believe in a one in three chance of a forthcoming recession, firms with good earnings have lowered forecasts, sovereign debt problems are spreading and may be past a point of no return, policymakers refuse to face up to the long run consequences of massive sovereign debt burden, and the prospects of lowering unemployment are becoming dimmer as cyclical and frictional unemployment is now becoming chronic structural unemployment. To make matters worse, leaders claim that economic "headwinds" are to blame for the dismal economic performance in 2011, implying that nothing could be done.

A view that is gaining credence posits that traditional fiscal stimulus and monetary expansion programs without focus simply add to the debt burden. Spending and tax reductions without a clear target that improves long term employment or asset creation does not help the fundamental problems behind an "asset price driven" downturn. The irony is that business balance sheets are as strong as they have ever been, since many firms have repaid debt and locked in low interest rates. The interest coverage ratio for nonfinancial corporations (the ratio of interest payments to cash flow) has never been lower, and the quick ratio (the ratio of liquid assets to short-term liabilities) is as low as it has been since the 1950s. A new direction focused on mobilizing the ample corporate cash positions to invest and hire is unlikely anytime soon given the unfriendly business environment created by regulation overkill and an emphasis on redistributing rather than creating wealth. Corporations have cash on the sidelines waiting for a more predictable, competitive, and streamlined business environment. It is not likely that real progress will be made in this direction for some time.

Stock prices are based on expectations, making the market a leading indicator. Prices move as new information changes expectations. There is a tug of war between investor desires for higher returns on one hand, and a preference for safety on the other hand. A loss of faith in the economy can quickly become self-fulfilling. Stocks represent a significant part of consumer wealth that supports consumption decisions. Well over $3 trillion in wealth has evaporated since equity prices peaked in late April. Every $1 decline in stock wealth is estimated to reduce consumer spending by at least 3 cents. With the stock market loss to date spending will take a $100 billion hit over the coming year. Stock prices also signal to firms when it's time to expand and also provide the means to raise capital to invest. Rising stock prices prompt managers to take risks and seek growth opportunities, by issuing more equity to fund investment, hire, or acquire other businesses. Falling stock prices reverse this process. A true recovery in the economy requires a strong rebound in stock prices. Both of these events require improved levels of confidence and consumer sentiment.

The downward spiral of confidence also affects the economy through credit conditions. Consumers are less likely to buy durable goods when wealth is lower and lenders are less likely to take on risks of lending when the borrower has lower wealth. The decline in asset prices (housing, stocks, etc.) has a real impact on spending and GDP with a subsequent downward revision in expectations and fall in asset values. The central bank has helped keep liquidity in the system but lenders continue to be cautions and borrowers have retrenched. The Fed can't push excess reserves into loans and investment if banks lack confidence in borrower credit. It would not serve a recovery to return to toxic loan generation.

The crisis in confidence is taking center stage across all asset markets. The downgrade of U.S. debt by S&P is confirmed by the market. For example, credit default swap spreads on one-year Treasury bonds ballooned from 25 basis points at the start of the year to 80 basis points in recent days. For example, the cost of insuring $10 million of Treasury debt against default has surged from $25,000 to $80,000. Rather than lead to higher rates on U.S. Treasuries due to the downgrade, rates fell as investors fled to safety (driving Treasury prices up and yields down). Investors are faced with near zero returns with safety or the prospects of returning to stocks that may move up or down significantly in short periods of time. Without a boost of confidence the markets are likely to continue with excess volatility and a corresponding drag on the economy.

Many of the recommendations of the President's National Commission on Fiscal Responsibility and Reform, a bipartisan group formed back in February 2010, offer a balanced long run approach to the economy. It is not clear why these recommendations were not embraced by the President with a clear and strong voice of optimism that we are on track to solve our long run debt debacle. Now, nearly one and a half years later, it is not likely that the new "bipartisan" committee selected from the partisan Senate and House will offer a better plan. Time is passing and confidence is eroding in both economic conditions and the ability of leadership to manage economic affairs.

Summary of Recent Economic Data

Gross Domestic Product – *After revisions, the first half of the year will be well below 1% Real GDP Growth. We didn't miss a technical definition of a recession by much.*

- GDP growth in the second quarter of 2011 was a disappointing 1.28% following a revised .36% growth rate in the first quarter of the year. Consumer spending in the second quarter was flat and government spending created a drag. Inventory growth was small, which may help create a better environment for inventory investment in the third quarter. Table 1 below summarizes the annualized percentage change in GDP by quarter since the third quarter of 2009.

Table 1. Annualized Percentage Change in GDP and GDP Components

	2011 Q2	2011 Q1	2010 Q4	2010 Q3	2010 Q2	2010 Q1	2009 Q4	2009 Q3
Real GDP	1.28	0.36	2.35	2.51	3.79	3.93	3.80	1.69
Consumption	0.07	1.47	2.48	1.85	2.05	1.92	0.33	1.66
Fixed investment	0.69	0.15	0.88	0.28	2.12	0.15	**- 0.42**	0.13
Fixed residential investment	0.08	**- 0.06**	0.06	**- 0.76**	0.50	**- 0.41**	**- 0.10**	0.42
Fixed nonresidential investment	0.61	0.20	0.82	1.04	1.62	0.56	**- 0.33**	**- 0.29**
Inventories	0.18	0.32	**- 1.79**	0.86	0.79	3.10	3.93	0.21
Net exports	0.58	**- 0.34**	1.37	**- 0.68**	**- 1.94**	**- 0.97**	0.15	**- 0.59**
Government	**- 0.23**	**- 1.23**	**- 0.58**	0.20	0.77	**- 0.26**	**- 0.18**	0.28

Source: Bureau of Economic Analysis

- Second quarter growth of 1.28% was far below an expected forecast of 1.8% growth. On a year-ago basis, real GDP rose 1.6% in the second quarter.

- Real GDP grew just 0.4% in the first quarter of 2011, revised down substantially from the 1.9% reported last month. Real GDP has now increased for eight straight quarters, but the rate of growth is well below normal rates of growth in a recovery.

- Final sales of domestic product (GDP minus the change in inventories) grew at an annualized rate of 1.1% in the second quarter, after being flat in the first quarter.

- Personal consumption expenditures barely increased in the second quarter, after increasing 2.1% in the first quarter. Second quarter consumer spending added less than 0.1 percentage point to growth. The big drag was motor vehicles and parts, which subtracted 0.7 percentage point from growth after the Japanese disaster disrupted auto production.

- Fixed nonresidential investment expanded at a healthy 5.9% annualized rate in the second quarter, adding 0.7 of a percentage point to growth. Investment in residential structures rebounded slightly from a dismal second quarter adding 0.1 % to growth.

- Inventories added 0.2 % to growth in the second quarter as firms added to their stocks with weak demand.

- Overall, net exports added 0.6 % to GDP growth.

- Government spending fell 1.1% annualized in the second quarter as the drag from state and local governments more than offset the gain on the federal side.

Productivity and Unit Labor Costs – *Increased productivity from cutting labor has just about run its course as productivity begins to fall.*

- Nonfarm business productivity (output/hours worked) fell 0.3% (Seasonally Adjusted Annual Return - SAAR) in the second quarter. Unit labor costs rose 2.2% in the quarter compared to a 0.6% decline in the first quarter, revised down from a 1.8% increase. Over the past year, nonfarm business productivity increased 0.8% and unit labor costs were up 1.3%.

- Revisions to GDP data resulted in weaker productivity measures over the past few years and a lower than reported unit labor costs. Slowing productivity and low unit labor costs should lead firms to hire as demand increases.

- Manufacturing productivity fell 2% (SAAR) in the second quarter while durables manufacturing productivity fell 3.5%. Nondurable productivity rose 1.4%. Manufacturing unit labor costs rose 4.4% in the second quarter.

- Table 2 below provides quarterly data for productivity, compensation, and unit labor costs since the third quarter of 2009.

Table 2. Productivity and Unit Labor Costs (Annualized Percentage Change)

	2011 Q2	2011 Q1	2010 Q4	2010 Q3	2010 Q2	2010 Q1	2009 Q4	2009 Q3
Nonfarm businesses								
Output per hour	-0.3	-0.6	2.2	2.1	1.2	4.6	5.5	6.5
Compensation per hour	1.9	4.2	0.6	1.9	2.6	1.4	1.2	2.3
Unit labor costs	2.2	4.8	**-1.6**	**-0.2**	1.4	**-3.1**	**-4.1**	**-3.9**
Manufacturing								
Output per hour	-2.0	4.2	4.9	2.1	5.2	4.7	6.9	12.4
Compensation per hour	2.3	3.1	2.3	1.7	3.8	-2.7	3.1	1.4
Unit labor costs	4.4	**-1.1**	**-2.5**	**-0.5**	**-1.3**	**-7.1**	**-3.6**	**-9.8**

Source: Bureau of Labor Statistics

- Unit labor costs are down almost 3% from their peak in late 2008, so labor is relatively inexpensive. Low unit labor costs have led to higher profits that firms are retaining to meet capital needs and prepare for a better business environment for investment. The ability to retain earnings is especially important given the tight credit conditions.

Unemployment – *The numbers are deceptive. Declining labor force participation masks the depth of unemployment overall and stark regional differences in unemployment are getting worse. The inability to sell homes prevents mobility from high to low unemployment regions. Frictional and cyclical unemployment is turning into structural unemployment, making it even harder to put Americans back to work.*

- The unemployment rate declined to 9.1% from 9.2% in June but the decline was driven by a nearly 200,000 drop in the labor force. The participation rate reached a new low of 63.9%. The labor force contraction brought down the number of unemployed by 156,000 as people stopped looking for work. Table 3 below provides monthly data for the unemployment rate and the labor force participation rate.

Table 3. Unemployment and Labor Force Participation

	July 2011	**June 2011**	**May 2011**	**Apr. 2011**	**Mar. 2011**	**Feb. 2011**	**Jan. 2011**	**Dec. 2010**
Unemployment rate, %	9.1	9.2	9.1	9.0	8.8	8.9	9.0	9.4
Labor force participation rate, %	63.9	64.1	64.2	64.2	64.2	64.2	64.2	64.3

Source: Bureau of Labor Statistics

- Slowing productivity and the declining unit labor costs should eventually lead to an improved labor market. If aggregate demand picks up the unemployment rate should eventually move below the current 9.1% rate in 2012. Nevertheless, the unemployment rate is not likely to drop below 8% until 2013 at the earliest.

- Payrolls increased by 117,000 in July following a dismal June where the 18,000 increase was revised upward to 46,000. Nevertheless, payroll employment is inadequate for a healthy expansion.

- Private sector payrolls increased by 154,000 in July while government payrolls declined by 37,000. For the year, government payrolls are down by 142,000 while state and local governments are laying-off workers to cut costs in order to balance budgets.

- The average length of the workweek was unchanged at 34.3 hours in July and average hourly earnings were up 0.4%, following no gain in June.

- Gross job losses have eased since reaching a peak in the first quarter of 2009. Job cuts have slowed since the depth of the recession and workers are staying in their current jobs, leading to low turnover.

- The payroll income proxy, combining hours and earnings, rose 0.5% in July reversing June's 0.2% decline. As the proxy improves there is support for increased spending.

- Jobless claims below 400,000 per week generally suggest an improving labor market. The four-week moving average of claims fell to 405,000, lowest since mid-April.

- The average duration of unemployment hit a record high of 40.4 weeks in July. Long-term unemployment leads to a reduction in marketable skills, making it much harder to find employment. Many economists now suggest that structural unemployment as well as cyclical unemployment have combined to push the full employment rate closer to 6%.

Inflation - *Inflation picked up unexpectedly in June but the acceleration is likely to be temporary. Inflation is on the rise but is not yet at a level to prompt concern by the Fed. Producer prices continue to rise more rapidly than consumer prices, suggesting latent pressures on prices that will surface when overall demand rebounds. Expectations for future inflation remain low as global economic fundamentals are too weak to support inflation at the consumer level. This does not preclude higher prices for commodities, food, and energy.*

- Consumer prices measured using the personal consumption expenditure price index rose 2.5% annualized in the second quarter following a 1.8% increase in the first quarter. The core PCE deflator, which excludes food and energy prices, was up 1.3% annualized in the second quarter from a 1.1% inflation rate in the previous quarter. The core PCE is the Federal Reserve's preferred inflation measure from a policy perspective.

- The top-line CPI for urban consumers, CPI-U, rose 0.5% in July from its June level. The year-ago change from July 2010 was unchanged from the previous month at 3.6%, before the seasonal adjustment.

- The core CPI rose 0.2% in July from its June level, moderating from five-year high readings in the two previous months. The year-ago change increased to 1.8%, after being stuck near a historic low in 2010 and into 2011.

- Sluggish demand and a reversal in energy prices should lower reported inflation in coming months. Businesses are more likely to hold prices steady or cut them, rather than jeopardize sales. Table 4 below shows the monthly CPI pattern since December of 2010.

Table 4. Monthly CPI Percentage Change from December 2010 to July 2011

	Jul. 2011	Jun. 2011	May 2011	Apr. 2011	Mar. 2011	Feb. 2011	Jan. 2011	Dec. 2010
CPI, % Change								
CPI	0.5	-0.2	0.2	0.4	0.5	0.5	0.4	0.4
Core CPI (minus food and energy)	0.2	0.3	0.3	0.2	0.1	0.2	0.2	0.1
CPI % Change, year ago								
CPI	3.6	3.4	3.4	3.1	2.7	2.2	1.7	1.4
Core CPI (minus food and energy)	1.8	1.6	1.5	1.3	1.2	1.1	0.9	0.6

Source: Bureau of labor Statistics

- Like other measures of inflation, the Implicit Price Deflator used to adjust nominal GDP has risen on over the last two years. Table 5 below provides data on the quarterly increases in the deflator.

Table 5. Quarterly GDP Implicit Price Deflator (Annualized Percentage Change)

	2011 Q2	2011 Q1	2010 Q4	2010 Q3	2010 Q2	2010 Q1	2009 Q4	2009 Q3
Implicit price deflator	2.39	2.73	1.77	1.32	1.59	1.52	1.04	0.23

Source: Bureau of Economic Analysis

- Inflation at the consumer level is more moderate than the inflation pressures at the producer level.

- Prices for finished goods fell 0.4% in June after rising for the last 12 months. The decline is largely a result of a deceleration in fuel prices. On the other hand finished food prices increased. Excluding food and energy, core prices for finished goods rose 0.3% in June.

- Prices for core intermediate and crude goods were higher as commodity prices excluding fuel firmed. Table 6 below summarizes monthly producer price data.

Table 6. Producer Price Index – Monthly Percentage Change from one Year Ago

	Jun 2011	May 2011	Apr 2011	Mar 2011	Feb 2011	Jan 2011	Dec 2010	Nov 2010
Finished goods	7.0	7.0	6.6	5.7	5.6	3.7	3.8	3.3
Core Goods								
Finished	2.3	2.1	2.1	2.0	1.9	1.6	1.4	1.2
Intermediate	7.2	6.3	5.6	5.6	5.8	5.4	4.7	4.6
Crude	25.1	19.0	18.2	19.2	28.0	25.5	27.9	30.3

Source: Bureau of Labor Statistics

Manufacturing and Capacity Utilization – *Manufacturing will get a boost from autos in the second half of 2011, but overall capacity utilization remains low.*

- Manufacturing output barely grew in the second quarter of 2011. But, industrial production began the third quarter with a surge, led by auto assemblies and utilities usage. Overall output rose by 0.9% in July, including a 0.6% increase in manufacturing production. Motor vehicle output rose 5.2% because several automakers that typically close their plants for retooling did not because of low inventories. Outside of autos, manufacturing production was fairly soft at 0.3%, as the combination of weak final sales and rising inventories over the last few months is limiting growth.

- Capacity utilization remains well below a level where pressure on prices occurs due to bottlenecks in production. Low capacity utilization suggests a low demand for new investment in plant and equipment.

- Table 7 below summarizes production data for 2011.

Table 7. Industrial Production for 2011- Monthly Percentage Change

	Jul 2011	Jun 2011	May 2011	Apr 2011	Mar 2011	Feb 2011	Jan 2011
Total (% change)	0.9	0.4	0.2	-0.3	0.7	-0.4	0.2
Manufacturing (% change)	0.6	0.2	0.2	- 0.4	0.6	0.1	0.7
Durable goods (% change)	1.0	0.3	0.7	-0.8	0.8	0.8	1.7
Nondurable goods (% change)	0.3	0.1	-0.3	0.0	0.7	-0.4	-0.2
Business equipment (% change)	0.6	0.2	1.4	-0.1	-0.3	0.6	1.9
Mining (% change)	1.1	1.2	0.6	0.5	1.7	-1.4	-0.6
Utilities (% change)	2.8	0.8	-0.4	-0.9	-0.3	-2.3	-1.7
Capacity utilization (%)	77.5	76.9	76.7	76.6	77.0	76.5	76.9

Source: Federal Reserve

- New orders for durable manufactured goods fell 2.1% in June, more than offsetting last month’s 1.9% increase. Excluding transportation, new orders rose 0.1%. Total shipments rose 0.5%, while inventories were up 0.4%.

Retail Sales – *Sales look better than they are as consumers are buying necessities and paying higher prices for food and gas.*

- Retail sales rose 0.5% in July but much of that increase was linked to sales of gasoline. Core sales grew 0.3% in July, down from the upwardly revised 0.5% June figure. Second quarter sales are disappointing following a 1% gain in core sales during the first quarter.

Household Income, Consumption, and Saving - *Consumers’ income and wealth provide little room for growth.*

- Revisions to U.S. personal income data reveal smaller financial cushions for households than expected. Analysis are revising downward the outlook for real consumption in the second half of the year from 3% to 2.5%

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- Consumer spending fell 0.2% in June, the first decline since September 2009. Consumption declined for both durable and nondurable goods. Personal income grew only 0.1% in June, the slowest increase since November of 2010.

- The savings rate is up to 5.4%, which is the highest level since September 2010. Wage income failed to rise for the first time since November of 2010.

- A summary of monthly personal income, consumption, and saving data appear in the table 8 below.

Table 8. Monthly Data on Personal Income, Consumption, and Saving

	Jun 2011	May 2011	Apr 2011	Mar 2011	Feb 2011	Jan 2011	Dec 2010	Nov 2010
Monthly % Change								
Personal Income	0.1	0.2	0.4	0.4	0.5	1.1	0.5	0.1
Consumption	**-0.2**	0.1	0.2	0.6	0.8	0.4	0.4	0.4
Durable	**-0.4**	**-1.3**	**-0.3**	**-0.1**	2.0	1.1	0.4	0.0
Nondurable	**-0.6**	**-0.3**	0.9	1.1	1.4	1.3	0.7	0.7
Services	0.0	0.4	0.0	0.5	0.3	0.0	0.2	0.4
% Change from 1 Year Ago								
Personal income	5.0	5.0	5.4	5.8	5.8	5.5	5.1	5.3
Consumption	4.4	4.6	4.8	4.7	4.7	4.4	4.2	4.4
Savings rate, %	5.4	5.0	4.9	4.7	4.9	5.2	5.2	5.1

Source: Bureau of Economic Analysis

- Consumer credit has increased for nine consecutive months after falling in the prior twenty-one months. Total credit balances reached $2.45 trillion in June, which is $56 billion higher than the trough reached in September but $150 billion below the peak reached in mid-2008.

- Income growth came nearly entirely from asset and transfer income. Wage income was unchanged, its weakest performance in seven months. Rental and proprietors' income fell. Tax payments rose faster than personal income for the 17th straight month.

Investment and Inventory – *Inventory adjustment remains in line with sales, preventing added cyclical volatility.*

- Total business inventories increased 0.3% in June, falling short of the revised 0.9% gain in May. Previously released manufacturing and wholesale trade inventories data showed month-over-month growth of 0.2% and 0.6%, respectively.

- Inventories are 11.1% higher on a year-ago basis with wholesale inventories above last year's levels by 15.8%. Manufacturer inventories are 12.8% higher on a year-ago basis. The important point is that the inventory-to-sales ratios have remained unchanged. The total I/S ratio was unchanged at 1.28, the manufacturer I/S ratio was unchanged at 1.34, the wholesaler I/S ratio was unchanged at 1.16, and the retail I/S ratio was unchanged at 1.34. Slower inventory accumulation, which better aligns with cuts to manufacturing production in the second quarter, improves the economy's prospects in the second half.

Construction Spending – *Nonresidential construction shows gains but private residential and public construction decline.*

- Construction spending increased slightly from May to June, coming in 0.2% higher than the revised May level of spending, with a 4.7% year-over-year decline from June 2010.

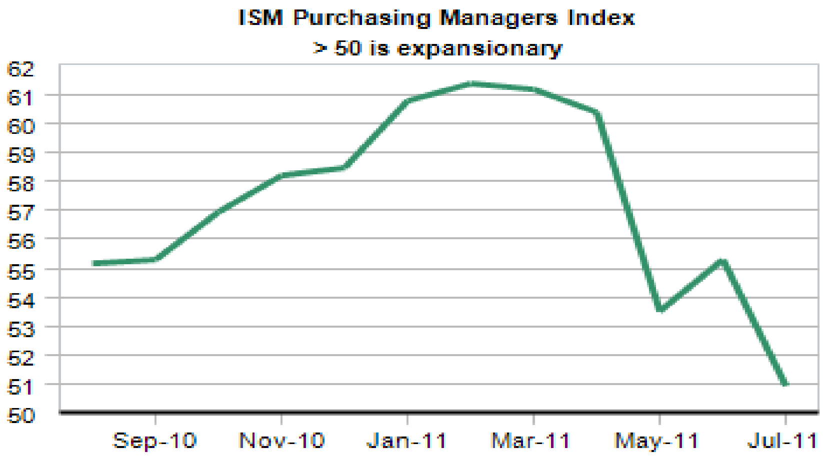
- The best improvement in construction came from private nonresidential construction, which increased 1.8% from May to June. The gain from private nonresidential construction more than offsetting the 0.3% decline in private residential construction spending and the 0.7% decline in public construction spending.

ISM Manufacturing Index – *The tide is turning against manufacturing*.

- Manufacturing got off to a slow start this quarter as the ISM manufacturing index fell from 55.3 to 50.9 for July. The larger than anticipated decline leaves the index barely above its expansionary threshold of 50 and noticeably below its second quarter average of 56.4.

- The index suggests that the third quarter had a sluggish start. Figure 1 below illustrates the decline in the ISM index in 2011.

Figure 1. Purchasing Managers Index – September 2010 to July 2011



<u>**Sentiment and Confidence**</u> **-** *Expectations are dismal.*

- Consumer sentiment took a dive early in July. The <u>University of Michigan Consumer sentiment index</u> dropped 7.7 points from June to July, led by a fall in the expectations component. The index has fallen nearly 20 points in three months. While broad-based, expectations led the decline. Inflation expectations held steady.

- Table 9 below shows the data from the University of Michigan survey for 2011.

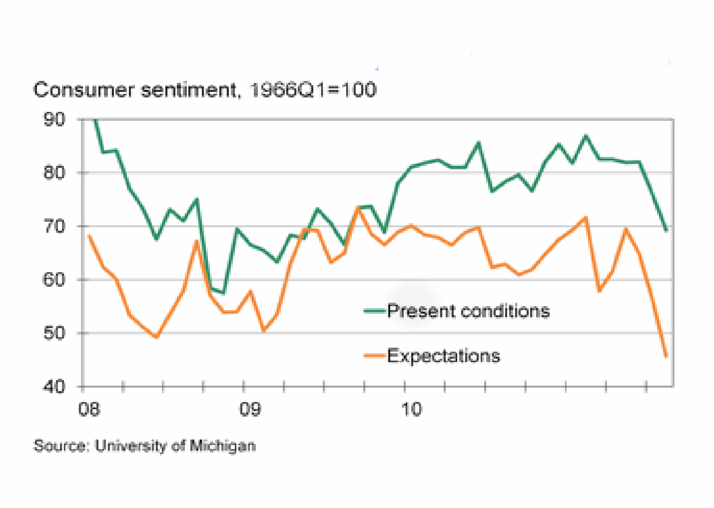
Table 9. University of Michigan Consumer Sentiment Survey (1966 1st Quarter =100)

	Aug 2011	Jul 2011	Jun 2011	May 2011	Apr 2011	Mar 2011	Feb 2011	Jan 2011
Overall Index	54.9	63.7	71.5	74.3	69.8	67.5	77.5	74.2
Percentage Change	-8.8	-7.8	-2.8	4.5	2.3	-10.0	3.3	-0.3
Inflation Expectations (%)								
1-yr	3.4	3.4	3.8	4.1	4.6	4.6	3.4	3.4
5-yr	2.9	2.9	3.0	2.9	2.9	3.2	2.9	2.9

Source: University of Michigan

- The gap between the expectations and present conditions components of the University of Michigan sentiment survey is widening, as shown in the graph below. Sentiment for the future course of the economy is weakening, as shown in Figure 2. Below.

Figure 2. University of Michigan Consumer Sentiment



- The Conference Board index of leading indicators rose 0.5% in July. The rise, however, is largely due to an increase in the money supply. Excluding the money supply contribution, the index fell 0.2%. The key drags on the leading index were the timing of deliveries, consumer expectations, building permits, and the average workweek.

<u>Housing</u> – *Foreclosures and short sales keep housing prices low. The market is still searching for the bottom.*

- After advancing for six months from a record low in early 2009 the National Association of Housing Bureau (NAHB) index has now remained flat for almost two years. The housing market has not entered a recovery and may still have significant problems ahead.

- New-home sales are still at record lows while existing-home sales are at levels not seen since the 1990s. The low level of sales continues even though mortgage interest rates are at cyclical lows. It is clear that a housing recovery is not linked to lower interest rates without a much stronger labor market, higher equity values, and a rebound in confidence. This represents a catch 22 situation where an improved housing market is critical to a recovery in the economy and a recovery in the market is critical for an improved housing market.

- The U.S. homeownership rate fell again in the second quarter and is likely to continue through 2013. Foreclosures and short sales continue to keep downward pressure on housing prices. Quarterly data show the homeownership rate was 65.9% in the second quarter, down from 69.2% in 2004. This translates to roughly 3 million fewer homeowners.

- The housing downturn has resulted in a shift toward renting. Over the last year there have been 1.4 million more rentals and 600,000 fewer owner-occupied homes.

- There is no clear evidence of a trend in housing prices. The S&P/Case-Shiller 20-city index remains flat month to month when adjusted for seasonal factors, while the Federal Housing Finance Agency purchase-only index is up 0.8%. The median existing house price is down 1% for April.

- The outlook for housing prices depends heavily on the share of sales of distressed homes (known as REO sales). As this share increases, the proportion of discounted home sales increases causing house prices to fall. This relationship was particularly evident in the first quarter of this year

- Housing is starting to look cheap according to one key metric, the house price-to-rent ratio. A key question for the outlook is how far prices will fall into undervaluation territory before the market starts to recover.

- Distress sales have picked up recently, causing house prices to extend last year's decline, while apartment rents have firmed because of lacking new construction and better job growth. The combination has made buying appear cheaper than renting—based on the S&P/Case-Shiller house price index and rental prices from the Bureau of Labor Statistics.

- The table below shows the monthly data for existing home sales from December 2010 through July 2011. Existing home prices have posted a steady decline from one-year-ago levels (see Table 10 below).

Table 10. Existing Home Sales – December 2010 through July 2011

	Jul 2011	Jun 2011	May 2011	Apr 2011	Mar 2011	Feb 2011	Jan 2011	Dec 2010
Millions of units, SAAR	4.67	4.84	4.81	5.00	5.09	4.92	5.40	5.22
% Change	**-3.5**	0.6	**-3.8**	**-1.8**	3.5	**-8.9**	3.4	12.5
Months supply on market	9.4	9.2	9.1	9.0	8.3	8.5	7.5	8.2
Median Home price, % change yr. ago	**-4.4**	**-4.0**	**-3.0**	**-6.5**	**-5.8**	**-5.2**	**-4.2**	**-1.0**

Source: National Association of Realtors

International Trade – *The trade deficit is wider than expected, calling for downward revisions in second quarter GDP announcements. The prospects for trade-led growth are dimming.*

- The U.S. trade deficit widened more than expected in June as imports fell 2.3% while imports dropped a third as much. Inflation-adjusted figures showed a similar widening.

The trade deficit is larger than the government assumed in its first estimate of second-quarter GDP, suggesting second quarter GDP may be revised downward.

- In aggregate the global equity markets were flat in the second quarter with, ironically, Europe the best performing area and Asia, ex-Japan, the worst. Clearly much of the noise about Europe already has been reflected in share prices, although this certainly does not exclude the risk of political failings making the situation much worse in the future.

- Concerns over rising inflation in China are abating. It appears that growth continues to be rapid and that the increases in the banks' reserve ratio requirements in conjunction with restrictions on the users of capital (such as property purchasers) has reduced inflationary pressures. Accounting issues at a number of widely held companies in China also present questions for investors.

- Expropriation issues have stalled investing in Russia.

- Sovereign debt in the Eurozone remains a major source of uncertainty for investors. Investors monitor potential failures of leadership to align fundamentals and the willingness and ability of member countries to support troubled countries. Italian yields had risen to such an extent that it was paying twice as much for its euro-denominated debt as the Germans. The Germans are showing a resistance to automatically bailing out troubled neighbors, calling into question the existence of the common Euro. Still, the Italian move to a balanced budget policy represents a potential move that could serve as a model for convergence. The weaker Euro is likely to improve overall exports and help the region's growth.

- Brazil has become an investment favorite in recent years due to the commodity boom, strengthening currency, growth in domestic consumption and good outlook based on substantial infrastructure projects and stable political management are all very reassuring.