Godsey & Gibb Associates
Investment Watch
July 2010

European Debt Crisis, Global Growth Slowdown, Spark Heightened Risk Aversion, U.S. Stock Market Correction; Fed to Stay Lower for Longer, Income Stocks in Focus

Almost a year into the economic recovery and financial market rebound, aftershocks from the global economic recession in Europe and policy tightening in Asia increased the risk of a slowdown in the overall growth outlook for the second half of 2010. For months, policy makers have faced rising fears that sovereign debt risk in peripheral Europe could infect the continent's banking system. European banks collectively hold hundreds of billions of euros of public and private debt from countries such as Greece, Portugal and Spain. Europe's core countries (Germany, the U.K., and France) had a significant exposure to debt in Greece ($135 billion), Portugal ($116 billion) and Spain ($572 billion), at year end 2009, according to the Bank of International Settlements.

Due to deteriorating fiscal balance sheets, credit ratings declined and credit spreads such as the TED spread, which measures the difference between LIBOR and short-term government bills, widened. A handful of southern European nations, including Greece, Portugal and Spain, announced budget cuts and other austerity measures, such as reducing public sector wages and pension benefits, in light of the market's skepticism toward rising debt levels.

The crisis has highlighted the limited ability of individual nations to manage their finances given the region's common currency. The euro fell nearly 15% year-to-date and below $1.20 for the first time since 2006. In an effort to keep the crisis from deepening and spreading to other vulnerable countries, the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) announced a €750 billion ($928 billion) rescue package to provide loans for countries that find capital market financing unavailable.

As a result of Europe's debt struggles, financial market volatility has remained elevated, and as longer-term structural budget tightening takes place, sluggish growth is expected across the Eurozone. While over time the weaker euro benefits manufacturing-oriented economies like Germany and luxury-goods makers in France and Italy, economic growth in nations like Spain and Greece may stagnate as their economies are less globally integrated. For example, exports account for over one-third of German GDP but only 6% of Greek GDP. Consensus economic estimates are for GDP growth in Europe of only 1.0% in 2010.

Europe's turmoil is also expected to slow growth in export-oriented economies like China. According to ISI Group, 20% of total Chinese exports go to the European Union, including about 40% of the total to Europe's big three (Germany, the U.K. and France) and 18% of the total to Portugal, Italy, Ireland, Greece and Spain. While economies across Asia and other emerging regions are experiencing superior growth and leading the global economic rebound, rising inflation trends have led to tighter monetary policies in China, India and Brazil this year. While China's exports are expected to turn down due to lower external demand from Europe, its growth slowdown remains largely government engineered. China's strong fiscal position gives it increased flexibility to respond with additional stimulus if needed.

In a related event, late in Q2, China announced an end to the yuan's current "crawling peg" to the U.S. dollar, setting the stage for a gradual appreciation in its currency. A stronger yuan will help curb inflation in the world's third largest economy in the form of lower import costs.

Flashback Three Years: Mid-Year 2007 vs. Mid-Year 2010

	June 30, 2007	June 30, 2010
Dow Jones Industrial Average	**13,408**	**9,774**
UST 10-Year Note Yield	**5.03%**	**2.94%**
UST 2-Year Note Yield	**4.86%**	**0.60%**
UST 90-Day T-Bill Yield	**4.66%**	**0.13%**
Unemployment Rate	**4.6%**	**9.5%**
Gold ($/ounce)	**$649**	**$1,243**

Sources: Bloomberg and Godsey & Gibb Associates

Changes to ISI's 2010 Real GDP Growth Forecast

	Prior	June Revision
Developed Nations	**2.0%**	**1.4%**
U.S.	4.0%	3.5%
Europe	0.0%	(1.0%)
Japan	0.0%	1.0%
Emerging	**7.0%**	**6.0%**
Global	**3.8%**	**3.0%**

Source: ISI Group estimates

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In the U.S., the upward momentum in leading indicators, which include stock prices, weekly jobless claims, and building permits, appears to be peaking, forecasting a soft spot in economy. While the manufacturing sector continues to expand, the fragile recovery in housing is at risk and the sector will likely be a drag on overall growth in the third quarter. At the end of the day, the overall level of employment is critical. Any drop in the unemployment rate will have important implications for consumer spending, the housing market, and an improvement in bank balance sheets.

After an extraordinary performance over the previous 14 months from the lows of March 2009, broad stock markets corrected 15% from April to June, while yields for the U.S. Treasury 2-year note fell to an all-time low of 0.59%, as investor anxiety related to Europe, the Gulf of Mexico oil spill and slower global growth in the second half of 2010, rose. While it is not unusual for the economy to pause and for financial markets to correct coming out of recessions, statistically, so called "double-dips" (a relapse into recession) are rare, having happened only once, in 1981, in the last 90 years. The 1981 "double-dip" was caused by then Fed Chairman Paul Volcker raising nominal and real rates to 19% and 10%, respectively. Although rare, the risk of a "double-dip" has increased given the possibility of higher taxes, more costly regulation for the financial and energy sectors, and rising levels of state and local government debt. However, policy makers would likely respond to any "double-dip" in growth with additional stimulus. Consensus economic estimates continue to point to modest U.S. GDP growth of 3.1% in 2010, down from 5.6% in the Q4 2009.

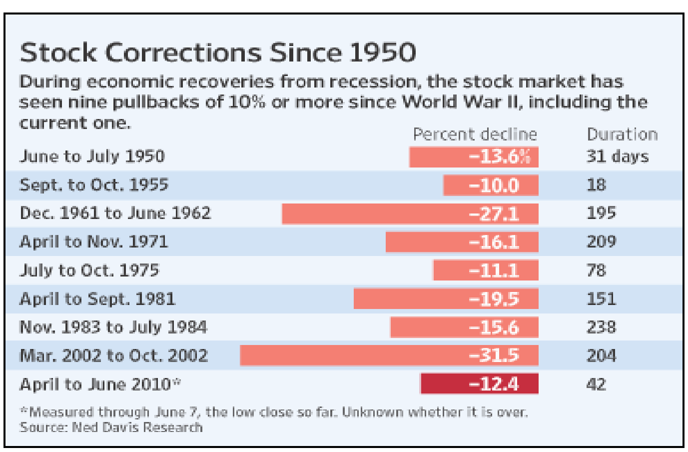
With growth expected to be slow, and a stronger U.S. dollar helping to keep inflation low, multiple indicators suggest the Federal Reserve will keep its fed funds target rate at the current ultra-low level until next year. Using the Federal Reserve's forecasts for unemployment and core PCE inflation, the Taylor Rule, a formula that utilizes the criteria considered by central banks when setting their policy rates devised by Stanford University economics professor John Taylor, currently projects a negative fed funds target rate.

Similarly, a majority (88%) of futures markets participants expect no change (or a cut) in rates by the December FOMC meeting. Moreover, the consensus projection for the fed funds target rate from Bloomberg's survey of 63 economists indicates no change in 2010. Regarding Europe, Chairman Bernanke said the Fed is monitoring the crisis carefully and he believes the region's leaders are taking the right steps.

With the backdrop of a modest economic recovery, the overall equity markets could be range bound until visibility improves. As the U.S. economy transitions from recovery to expansion, the pace of activity will likely slow, but the scope of improvement could broaden. We believe an emphasis on stability over cyclicality is warranted at the sector level and that a focus on dividends from high-quality, large cap, U.S. equities will provide an increasingly important portion of total return in the current environment. As such, we have positioned portfolios with a bias toward income-producing equities with sustainable earnings.

The robust profits recovery over the past year has put corporations in a strong financial position. Corporate free-cash flow and cash balances are at or near all-time highs. These cash flows and cash balances could lead to increasing dividend payments, more share repurchases, higher levels of capital investment and elevated merger activity. In addition, we believe higher yielding equities can provide a buffer of support in volatile markets. While the S&P 500 Index currently has an average yield of 2.0%, many high-quality, large cap U.S. stocks offer above market yields that are also higher than 10-year U.S. Treasury yield. Many of these companies are multi-nationals, with substantial non-U.S. businesses, which provide exposure to faster growing emerging markets.

In fixed-income and balanced portfolios we remain conservative and selective, with a high-quality and short-maturity bias. For municipal exposure, our focus is on high-quality general obligations backed by a taxing authority and essential purpose revenue bonds (e.g. water, sewer, etc.). In the taxable area, our emphasis remains on Ginnie Mae securities and other U.S. government agencies notes.

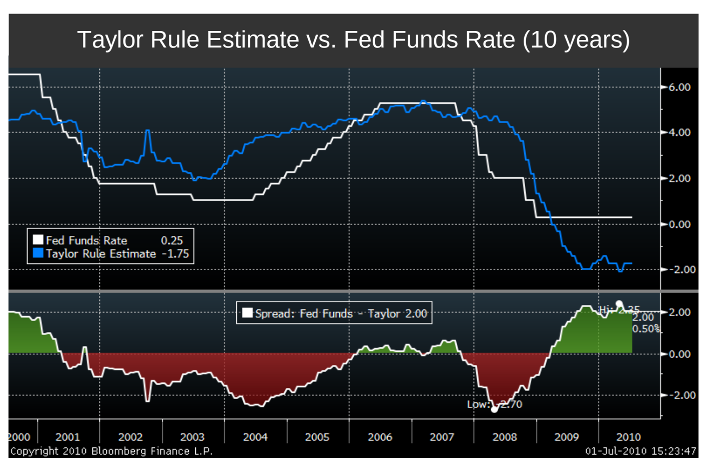

Stock Corrections Since 1950

During economic recoveries from recession, the stock market has seen nine pullbacks of 10% or more since World War II, including the current one.

	Percent decline	Duration
June to July 1950	–13.6%	31 days
Sept. to Oct. 1955	–10.0	18
Dec. 1961 to June 1962	–27.1	195
April to Nov. 1971	–16.1	209
July to Oct. 1975	–11.1	78
April to Sept. 1981	–19.5	151
Nov. 1983 to July 1984	–15.6	238
Mar. 2002 to Oct. 2002	–31.5	204
April to June 2010*	–12.4	42

*Measured through June 7, the low close so far. Unknown whether it is over.
Source: Ned Davis Research

Source: The Wall Street Journal



Source: Bloomberg