GODSEY & GIBB
WEALTH MANAGEMENT

INVESTMENT WATCH

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U.S., European Debt Concerns, and Macroeconomic Data Weigh on Stocks But As Drags from Severe Weather and Oil Fade, Earnings Gains Are Expected

Rising levels of sovereign debt in both the U.S. and Europe, and softer macroeconomic data in the wake of natural disasters, and a nuclear meltdown in Japan, along with a surge in crude oil prices, raised investor uncertainty and kept financial markets range bound in the second quarter. After rising to multi-year highs in April, stocks corrected for most of May and June, before rallying sharply to end the quarter. In our view, the choppiness in the economic data remains consistent with a modest economic expansion and is typical of recoveries following a financial crisis. While we are cognizant of multiple risks in the macroeconomic and financial landscape, we believe that economic activity will accelerate in the second half of the year as the transitory impacts from Japan's disasters, an oil price spike and severe weather in the U.S. fade, leading to gains in corporate earnings.

The U.S. debt-ceiling debate is front and center in Washington and contributing to investor anxiety. With an annual budget deficit near $1.6 trillion, an accumulated debt level of over $14 trillion, and unfunded liabilities from entitlements in excess of $50 trillion, all three major rating agencies, Standard & Poor's, Moody's, and Fitch, have threatened to downgrade the U.S. government's credit rating if Congress fails to increase the nation's borrowing limit by early August. Negotiations between the administration and Congressional leaders are ongoing regarding a deficit reduction package which is expected to include spending cuts, tax reforms and potentially some entitlement plan savings. Approximately $2.5 trillion of offsets over 10 years will be necessary if the debt limit is to be raised enough to last through the next year's election. We believe the debt ceiling will be raised and a default will be prevented, reducing financial market uncertainty, either by a compromise of spending cuts and tax reforms, or alternatively via the recently proposed "last choice option" that in effect empowers the president to raise the government's borrowing limit in three stages without its prior approval of offsetting cuts in spending.

The European sovereign debt crisis is also contributing to financial market volatility. A year after a rescue package was announced in an attempt to stop the spread of its debt crisis, the economy in Greece remains in recession and shut out of financial markets. In late June the Greek government approved sweeping austerity measures and in early July the European Union approved a $12.6 billion aid package, with the IMF agreeing to provide an additional $4.8 billion. Both groups pledged to prepare a new aid package for Greece that could include a "voluntary" role for creditors in a so-called "reprofiling" – an extension of the maturity of Greek debt, to help avoid a near-term default. The European Central Bank and French finance officials favor a plan in which private banks holding Greek sovereign debt would keep the bonds in their portfolio until maturity and subsequently roll them over by purchasing new, longer-term issues from the Greek government. Germany and other European governments back a plan whereby Greek debt holders would effectively take losses in a debt exchange that would result in delayed repayment. European banks hold a total of $52.3 billion in Greek sovereign debt according to the Bank for International Settlements, with German and French banks owning the biggest shares. Systematic risk from Greece is definitely an issue and the crisis is forcing Germany to integrate more closely with the rest of Europe. The longer the crisis drags on, the greater the risk that contagion will spread to other troubled economies like Ireland, Portugal, Italy and Spain. Over the last year, European authorities have done just enough to prevent the crisis from escalating; however we believe a more comprehensive approach is needed. The operational details of such a plan are being discussed and we will be actively monitoring the progress of European policymakers.

Back in the U.S., persistently high unemployment and weakness in housing continue to be economic drags. The unemployment rate rose for the third straight month in June, to the highest level this year at 9.2%, as slow economic growth and a high-level of policy uncertainty continued to weigh on the jobs market. U.S. house prices as measured by the S&P/Case-Shiller indices increased in April on a month-over-month basis but remain below year ago levels. The ten-city index rose by 0.8%, while the 20-city composite increased by 0.7%, however prices remain 3.1% and 4.0% lower, respectively, than a year ago. Lower mortgage rates have failed to increase demand as an oversupply of unsold homes has led to a mismatch in housing supply and demand, which continues to weigh on price levels and overall housing activity.

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Japan's economic recovery is under way after it contracted by 3.5% in the first quarter of this year following the March 11 earthquake, tsunami, and subsequent nuclear crisis, which sent the economy into recession. Industrial output rose by 5.7% in May in Japan and economists predict that Japan's economy will gain momentum later this year as companies boost output and the government begins reconstruction projects. According to the Bank of Japan and individual companies, the supply constraints from the disasters earlier this year in the automobile and electronics industries are easing earlier than expected and output levels are expected to return to those reached prior to the March disasters during the third quarter.

In the U.S., tornadoes and flooding across the Southeast and Midwest states had a significant impact on economic activity this spring, with Alabama and Missouri among the hardest hit. More than 1,000 tornadoes struck the U.S. from late April to late May according to the Storm Prediction Center, severely impacting homes, businesses and industrial properties. Gasoline prices soared to near $4 per gallon in many parts of the country in mid-May, as many Gulf coast refineries were threatened by flooding along the Mississippi River.

However, in the reverse of the normal trend where prices tend to rise entering the summer, the average U.S. price of a gallon of unleaded gasoline fell to $3.55 at quarter end, down from close to $4.00 in May, according to AAA.

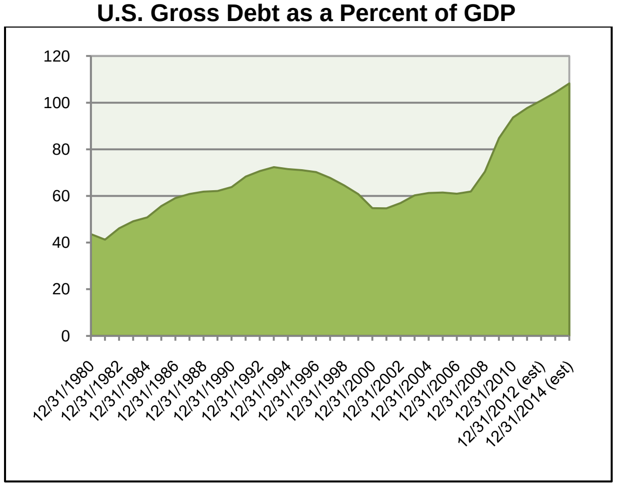
While OPEC failed to reach consensus to raise production at its June 8 meeting, Saudi Arabia broke ranks and pledged to supply additional crude in light of the 1.5 million barrels of Libyan production that is currently offline. The decline in commodity prices will have a quick and significant impact on headline consumer prices in developed and emerging economies, which would be welcome news for policy makers, market participants and consumers.

The factors that dampened growth rates are dissipating and leading indicators in the U.S. are rising. Eight of the ten components of the Conference Board's Leading Index made positive contributions in May, and the annualized six-month rate of change remains consistent with above-trend growth; however drags from high unemployment and a weak housing market will continue to make the expansion choppy. Business spending and investment, and exports, at a record 13% of U.S. GDP, will help to offset weakness in housing and consumer spending, and provide for a more favorable earnings environment.

While the U.S. economy is not sprinting forward, it is not contracting. Since the recession officially ended in June 2009, GDP growth has averaged 2.4%, slightly below the 20-year average of 2.6%. And even with the Federal Reserve's $600 billion bond purchase program ('QE2') officially ending on June 30, the Fed will continue to buy Treasuries with proceeds from the maturing debt it currently owns, which could total $300 billion over the next 12 months.

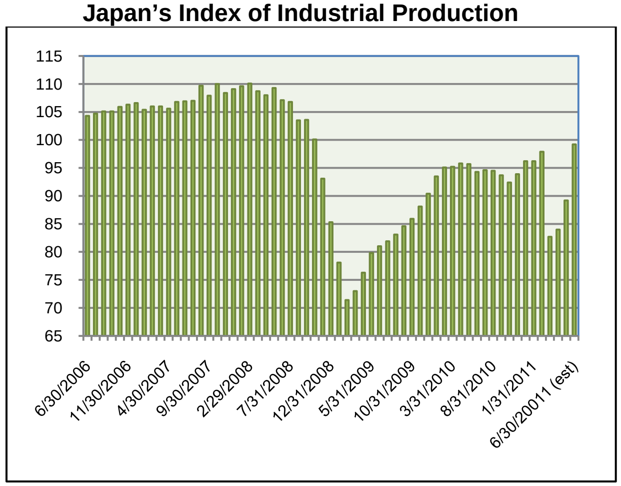
We expect overall activity to pick up speed at a modest rate in the second half of 2011 as the impacts from the March earthquake in Japan, a surge in commodity prices and severe weather in the U.S. fade, though the pace will stay uneven and moderate. Given this outlook, we have positioned portfolios with "one foot on the gas pedal and one on the brake", with growth oriented equities on the one hand and more defensive income oriented equities on the other. We continue to believe the current economic and market environments favor globally diversified large cap companies with higher quality, sustainable growth characteristics, and the ability to return value consistently, including through dividend increases. We continue to favor short maturity, high-quality bonds in fixed-income for capital preservation, low interest rate risk and attractive relative levels of income-generation.

U.S. Gross Debt as a Percent of GDP



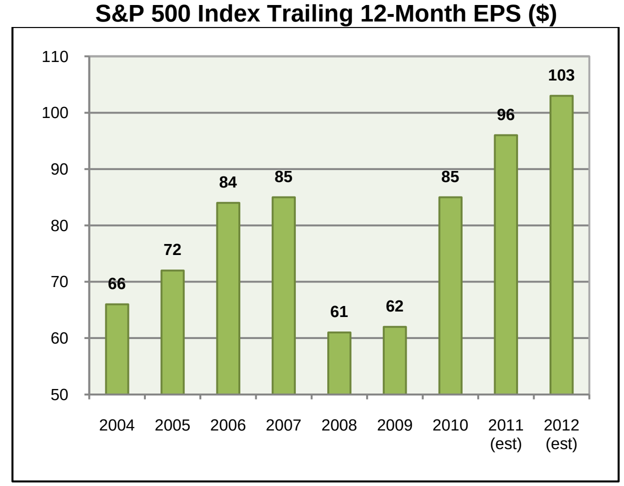
Source: The International Monetary Fund

Japan's Index of Industrial Production



Source: Ministry of Economy, Trade and Industry

S&P 500 Index Trailing 12-Month EPS ($)



Source: Bloomberg