Global Growth Falters on Deeping European Recession, Rising Concerns in Asia and Looming U.S. Fiscal Cliff Uncertainty, Putting 2% U.S. GDP Growth at Risk; Corporate Earnings Visibility Decreases Skewing Risk Reward to the Downside

After posting double-digit gains for two consecutive quarters, stocks corrected nearly 10% from April to early June and bond yields fell to all-time record lows, as for the third consecutive year European sovereign debt problems are inflicting slower global economic growth and increased financial market volatility. Economically cyclical equity sectors such as industrials, materials and financials bore the brunt of the correction, while the more defensive bond proxies with attractive dividend yields such as telecommunications and utilities, outperformed. Investors who utilized dividend paying stocks in 2011 were rewarded and in an increasingly macro driven financial market, where uncertainty and political paralysis are working against the growth outlook, we continue to believe that investing in large-cap, high-quality, dividend yielding equities provides the greatest potential risk-adjusted returns.

Europe's recession intensified in the second quarter, with Greek and French voters expressing their disapproval of austerity at the polls, and Spain and Malta joining the growing list of nations receiving financial assistance. We increasingly view the Eurozone crisis as having morphed from a short-term situation into more of a persistent, long-term consideration for investors, as there are no quick solutions to the continent's leverage problems and structural economic headwinds.

In early July, the European Central Bank cut its target rate by 25 basis points to 0.75% and brought its deposit rate to zero, in an attempt to spark bank lending by removing any benefit to banks from keeping excess reserves idle in the overnight market. The Bank of England also eased policy by resuming the quantitative easing program it stopped two months ago with a £50 billion addition.

China, the world's second-largest economy, is under pressure given the recession in Europe and the sluggish recovery in the U.S. After expanding at an 8.1% in the first quarter its economy slowed to a 7.6% pace in the second quarter, the lowest level in three years. The Chinese government is stepping up moves to stimulate growth by easing monetary policy for the first time since December 2008. In July, the Chinese central bank moved more aggressively to promote growth by cutting both its lending and deposit rates, the second such interest rate reduction in a month.

The synchronized global economic slowdown and a burdensome government debt load are negatively affecting the U.S. economy. The ISM Manufacturing Index fell to 49.7 in May, from 53.5, its first reading below the 50-breakeven line since June 2009, as all three major components of manufacturing: inventories, exports and capital spending, are slowing. Although the reading was below 50, it is not consistent with outright recession. The ISM Manufacturing Index would have to drop below 43 to signal recession.

U.S. nonfarm payrolls registered a third consecutive month of sub-100K growth with a reading of 80K in June as business confidence waned in the wake of Eurozone turbulence and fiscal policy uncertainty. Employment growth averaged 75,000 in the second quarter, down from a monthly average of 226,000 in the first quarter. The unemployment rate remained unchanged in June at 8.2%, marking the 41st consecutive month above the 8% level (a post-World War II record).

The sluggish manufacturing sector and labor markets remain a stumbling block for the U.S. economy. Severe weather in late June and early July across the Mid-Atlantic, as well as forest fires in the Mountain West, could put additional pressure on upcoming economic releases due to power outages that led to supply chain and labor disruptions.

The so-called U.S. fiscal cliff is approaching at year end, keeping corporations reluctant to hire and expand. Without action, more than $600 billion, or 4% of U.S. GDP, in higher taxes and reductions in defense and other government programs will take place. In addition, with a potential shift in control in the U.S. government, financial markets are likely to remain volatile based on expectations related to the presidential and

Congressional elections this fall. Uncertainty related to the historically high debt-to-GDP ratio will also likely diminish the near-term growth outlook. Although delaying some of the pending changes would be beneficial in the near-term, such action would lead to a deterioration of the long-term fiscal situation and likely put the U.S. at risk for future downgrades. The U.S. recorded a debt-to-GDP ratio of 103% in 2011, above the 1940 to 2011 average of 60%. Multiple academic studies, including Reinhart & Rogoff (2009) have concluded that debt-to-GDP levels above 90% slow the trajectory of a nation's economic growth.

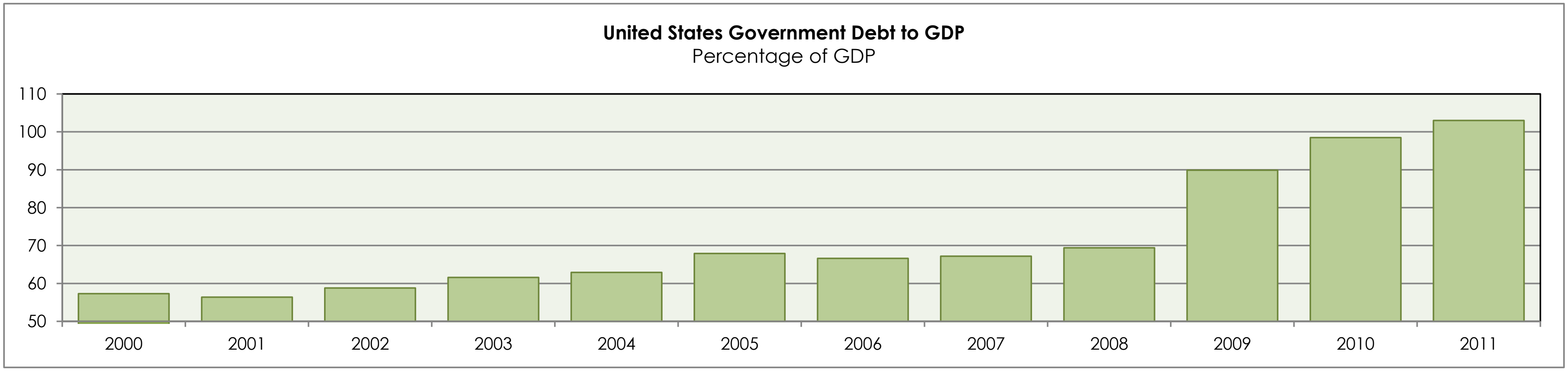
Lower sales to Europe and slowing growth in China and the U.S. are negatively impacting corporate visibility, suggesting second quarter earnings are at risk. According to S&P, analysts expect earnings for the second quarter of 2012 to fall by about 2%, the first decline since 2009, although revenue is expected to rise 2.5%. More than 85 members of the S&P 500 lowered expectations over the last several weeks by issuing profit warnings, citing Europe's worsening environment (Europe accounts for about 15% of S&P 500 sales), an emerging slowdown in China and a general lack of global demand. Profits are of course an important driver of the business cycle and unfortunately the deterioration in the economic and financial market fundamentals do not support a bullish near-term earnings outlook.

The recent drop in energy prices is one positive that is leading to increased disposable income. Gasoline prices fell about 20% after touching $4.00 a gallon in April to end the quarter at $3.33 a gallon, according to AAA. Gasoline stockpiles are growing and demand remains weak, indicating consumers are likely to continue to enjoy lower prices at the pump.

Moreover, the U.S. housing sector is contributing to growth again and may have hit bottom. The S&P/Case-Shiller 20-City Home Price Index rose for three consecutive months (February – April 2012), helped by record low mortgage rates. In May, existing homes sales rose 10% year-over-year and housing starts were up 26% year-over-year. While housing activity is far from robust, the upturn in the data marks a potential milestone nearly seven years after the housing bubble burst.

The U.S. central bank continues to do what it can to support the economies. On June 20, the Federal Reserve (the Fed) expanded its plan to replace short-maturity Treasuries in its portfolio with longer-term debt, known as Operation Twist, by $267 billion and extended it until year-end 2012. Given the softening economic data in the U.S, as well as lower inflation figures, the Fed could announce additional stimulus measures, such as a third program of bond purchases (known as QE3) at the upcoming FOMC meeting August 1st, the Jackson Hole conference in late August or the FOMC meeting on September 13th. However, as the post-crisis recovery lingers on, additional central bank policy moves appear to experience diminishing returns, with a reduced impact on the macro economy and financial markets.

In conclusion, with a decelerating economic environment and volatile financial market backdrop, we continue to focus on controlling risk as an essential aspect of our investment process. As we analyze the global economic and investment landscape, we continue to allocate assets conservatively with an emphasis on high-quality, non-cyclical companies with sustainable competitive advantages and healthy levels of cash flows for stability and income generation.



Sources: www.tradingeconomics.com and U.S. Bureau of Public Debt