



MONTHLY MARKET COMMENTARY

▼ INNOVEST August 2011

The Economy

The U.S.

August was a month that most in the investment industry would like to forget. Weaker than expected economic data, Standard and Poor's credit downgrade of U.S. sovereign debt and increasing nervousness regarding Europe's financial health all contributed to a market correction not seen since the dark days of 2008. From peak to trough during the month, the S&P 500 fell 16.5%. In a massive flight to safety, 10-year U.S. Treasury bonds yielded 1.99% on August 18. We haven't seen Treasury rates that low since the Eisenhower administration—a telling sign that investors are pessimistic about our country's economic prospects.

We still expect the economy to improve in the second half of 2011, though the chances of a “double dip” have escalated in the past month. While certainly anything is possible, we are likely to witness a period of slow growth—not another full blown recession. The White House amended its economic estimates for 2011, putting annual GDP growth at just 1.6%.

There are some silver linings to the recent correction in the markets. Oil was \$110/barrel in April. It now trades just above \$85/barrel, bringing a surprising amount of relief to U.S. consumers. Large companies in the U.S. continue to be as profitable as ever. The forward price/earnings ratio of the S&P 500 is now around 11, well below historical averages. From a valuation perspective, both in absolute and relative terms, the stock market represents a buying opportunity. With the Fed now guaranteeing to keep short-term interest rates low through 2013, accommodative monetary conditions are here to stay.

“Men have forgotten this truth,” said the fox. “But you must not forget it. You become responsible, forever, for what you have tamed.”

- Antoine de Saint-Exupéry, *The Little Prince*

Government fiscal and monetary policy over the last two decades is, at least in part, responsible for how our economy looks today. With respect to our government's financial tinkering, we have tamed our economy. Former Fed Chairman Alan Greenspan's low interest rate targets artificially expanded the U.S. economy. Current Fed Chairman Ben Bernanke has done his best to spur the economy with low interest rates and two rounds of quantitative easing. Now facing another potential soft patch in the economy, our collective responsibility for the economy emerges yet again.

We look now to our country's leaders to create an environment where the U.S. economy can regain its strength. The primary issue is confidence. Consumers need to feel more confident in order to spend. Consumer spending represents 70% of U.S. GDP. Businesses need to feel more confident about their future prospects in order to hire and invest. Fortune 500 companies now have record levels of cash on their collective balance sheets (\$1.8 trillion). Why are they hoarding cash in an essentially 0% interest rate environment? Businesses are not confident enough in the future prospects of the U.S. economy.

The World

For European elites, the month of August is typically a time for holiday and relaxation. August 2011 was anything but a vacation. The European Monetary Union continued to juggle several difficult issues, all of which relate back to a single monetary union without a unified vision of political sovereignty.

Italy's public finances have created a potential problem for Europe much bigger than anything seen in Greece. Prime Minister Berlusconi unveiled on August 12 an Italian deficit reduction proposal, one which was comically weak in addressing its burgeoning deficit. Two things prevented Italy from much more dire circumstances in August: the European Central Bank buying €30 billion of Italian debt and a subsequent €45.5 billion deficit-reduction plan that was forced on the country by the ECB.

Germany's Angela Merkel and France's Nicolas Sarkozy met in August to propose new measures to address the European financial crisis—the results were anything but encouraging. The leaders paid lip service to stronger reforms and greater fiscal discipline, though the only concrete proposal was a new transaction tax on securities. This new tax will only serve to make matters worse. As Will Rogers once noted: “Never slap a man who's chewing tobacco.” In this case, the collective European Monetary Union is chewing—and now feeling woozier. Merkel and Sarkozy failed to re-establish any semblance of confidence, as credit and equity markets gave the proposal a big “thumbs down” and continued to sell off.

European manufacturing data took a turn for the worse in August, even in the previously robust German economy. Euro-zone manufacturing output contracted in August for the first time since 2009. Of the eight countries in the manufacturing survey, five contracted: France, Italy, Ireland, Greece and Spain. Germany was barely in positive territory in the survey.

The upside to all of this turmoil in Europe? The Eurostoxx 50 Index currently trades at about 0.9 times book value. Investors are all too aware of the problems in Europe. As a result, stocks are cheap, and pessimism abounds. Admittedly, European markets could correct even further, though long-term investors should feel comfortable investing in high quality European companies at this juncture.

With economies in the developed world losing steam, the emerging markets continue to serve as the world's growth engine. Currently, emerging markets represent roughly 49% of global GDP. Goldman Sachs' economist Jim O'Neill's so-called BRIC countries (Brazil, Russia, India, and China) have been a huge driver for growth over the past decade. Brazil and China have both encountered new inflation concerns this year, though both countries have so far continued on a path of sustainable growth.

At the end of the second quarter, U.S. exports were up 15% over a trailing 12 month period. A cheaper dollar and a relatively faster growing world economy contributed to the increased demand. If emerging markets stay on track for the next year, expect to see an increasing share of U.S. corporate earnings generated overseas.

The Market

August was a difficult month for investment returns. The S&P 500 finished the month 5.43% lower. The U.S. market rallied in the last week of August; otherwise the losses would have been even larger. U.S. stock valuations have become even more attractive given the profitability of U.S. firms.

Global equity markets tumbled—in some cases much harder than in the U.S. The MSCI EAFE index lost 9.03% for the month. Of developed world markets in August, two were up and forty three were down. The German index fell 18%, while Italy fell 14.4%. Topping it off, Greek equity markets lost nearly 25% of their value in August.

Perhaps unsurprisingly, high quality fixed income instruments rallied given the bearish news out of world economies. The Barclays Aggregate Index



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posted a 1.27% gain. In spite of S&P's downgrade of U.S. sovereign debt, U.S. Treasuries rallied for the month as well. High yield bonds did not fare so well. For the month, the Barclays corporate high yield index was down 4%.

The Dow Jones UBS commodity index was up 1% in August on the back of huge gains in precious metals. The price of gold keeps climbing. Prices for gold seem frothy and bubble-like at these levels, though it would be difficult to bet against gold in this environment. John Maynard Keynes noted decades ago: "Markets can remain irrational longer than you can remain solvent." As projections for world economic growth wane, expect to see energy prices continue to remain subdued.

Outlook

We still expect to see economic improvement in the second half of the year, though growth may be more modest than initially projected. President Obama's jobs creation plan will be debated by our representatives in Washington. We can only hope any resulting legislation will be substantive and confidence-inducing. Based upon our government's track record over the past 18 months, we aren't holding our breath. Infrastructure spending will be a focus for the Obama administration, though so far "shovel ready" jobs have been a fallacy.

The outlook for housing remains a central part of an overall recovery. New home sales data suggest that we still haven't reach rock bottom in

the housing market. A further 5-10% correction nationally would likely create more market clearing prices. A bottom in housing should lead to increased housing starts, creating desperately needed jobs in the housing industry.

Government spending as a percentage of our economy will fall in the coming year. While in the short term this is a negative, in the longer term this is a positive development. The overwhelming majority of Americans agree that the U.S. must return to a sustainable fiscal path. Some degree of fiscal austerity can build confidence, though a balanced approach must be taken.

September and October have typically been the most volatile months in the financial markets. A general lack of confidence in the markets could contribute to continued volatility. As long-term investors, we emphasize patience. As markets sell off and become cheaper, it may make sense to rebalance portfolios by adding to those positions at attractive valuations.

By no means are we experiencing 2008 all over again. A common measure of perceived risk in the financial markets is called the TED spread, which is the difference between the interest on interbank loans and short-term U.S. Treasury bills. In times of fear, the TED spread rises. Banks demand more interest from one another to be compensated for higher risk. The historical average for the TED spread has been just above 30 basis points. Today the spread sits at 30 basis points. Credit markets are not fearful. In the words of the World War II British government: "Keep calm and carry on."

Bond Rates	9/2/2011	12/31/2010
U.S. Federal Funds Target Rate	0.25%	0.25%
U.S. Two-Year Treasury Yield	0.21%	0.60%
U.S. Ten-Year Treasury Yield	2.00%	3.30%
U.S. Ten-Year Muni Yield	2.83%	3.75%
High Yield	8.43%	7.51%

Exchange Rates	9/2/2011	12/31/2010
\$ per €	1.42	1.34
\$ per £	1.62	1.57
¥ per \$	76.77	81.11

Latest Returns						
EQUITIES						
Index	Aug-11	3 months	YTD	1 Year	3 Years	5 Years
S&P 500	-5.43%	-8.90%	-1.77%	18.50%	0.54%	0.78%
S&P 400 Midcap	-7.11%	-12.22%	-2.72%	22.89%	4.00%	4.65%
S&P 600 Small Cap	-7.67%	-12.25%	-3.90%	24.44%	2.07%	2.65%
MSCI EAFE	-9.03%	-11.60%	-6.02%	10.01%	-2.96%	-1.48%
MSCI Emerging Markets	-8.94%	-10.74%	-8.55%	9.07%	5.05%	8.40%
FIXED INCOME						
Index	Aug-11	3 months	YTD	1 Year	3 Years	5 Years
BC Aggregate Bond	1.46%	2.77%	5.90%	4.65%	7.24%	6.57%
BC Muni Bond 1-10 Yr	1.44%	2.39%	5.55%	3.07%	5.55%	5.24%
BC High Yield	-4.00%	-3.83%	1.95%	8.39%	11.95%	8.10%
BC Global Aggregate Bond	1.27%	3.44%	7.89%	8.96%	7.87%	7.42%
CSFB Bank Loan Index	-4.16%	-4.32%	-1.15%	3.43%	4.88%	3.22%
OTHER						
Index	Aug-11	3 months	YTD	1 Year	3 Years	5 Years
DJ UBS Commodity	1.00%	-1.25%	32.20%	64.20%	4.36%	6.35%
DJ Wilshire US REIT	-5.48%	-6.98%	6.76%	19.80%	1.65%	-0.49%
S&P Developed World Property	-6.10%	-7.59%	0.37%	16.54%	1.47%	-1.02%
LPX 50 TR	-12.56%	-18.51%	-8.47%	19.02%	-8.68%	-7.34%
HFRI Fund of Funds Index	-2.07%	-2.91%	-1.92%	4.02%	-0.96%	1.09%
3 Month T-Bills	0.02%	0.02%	0.10%	0.15%	0.32%	1.83%

* Returns provided by outside vendor. Innovest not responsible for accuracy of numbers presented.

Innovest Portfolio Solutions LLC

4643 South Ulster Street, Suite 1040 ~ Denver, CO 80237 303) 694-1900 ~ (303) 694-4707 fax ~ www.innovestinc.com