



# MONTHLY MARKET COMMENTARY

▼ INNOVEST June 2011



**Martin Walsh**  
Vice President

Bond Rates	7/1/2011	12/31/2010
U.S. Federal Funds Target Rate	0.25%	0.25%
U.S. Two-Year Treasury Yield	0.49%	0.60%
U.S. Ten-Year Treasury Yield	3.20%	3.30%
U.S. Ten-Year Muni Yield	3.41%	3.75%
High Yield	7.29%	7.51%

  

Exchange Rates	7/1/2011	12/31/2010
\$ per €	1.45	1.34
\$ per £	1.60	1.57
¥ per \$	80.89	81.11

Latest Returns						
EQUITIES						
Index	Jun-11	3 months	YTD	1 Year	3 Years	5 Years
S&P 500	-1.67%	0.10%	6.02%	30.69%	3.34%	2.94%
S&P 400 Midcap	-2.04%	-0.73%	8.56%	39.38%	7.82%	6.60%
S&P 600 Small Cap	-1.81%	-0.16%	7.53%	37.03%	8.16%	4.61%
MSCI EAFE	-1.25%	1.56%	4.98%	30.36%	-1.77%	1.48%
MSCI Emerging Markets	-1.54%	-1.15%	0.88%	27.80%	4.22%	11.42%
FIXED INCOME						
Index	Jun-11	3 months	YTD	1 Year	3 Years	5 Years
BC Aggregate Bond	-0.29%	2.30%	2.74%	3.94%	6.47%	6.53%
BC Muni Bond 1-10 Yr	0.15%	2.54%	3.23%	3.69%	5.55%	5.22%
BC High Yield	-0.97%	1.06%	4.98%	15.64%	12.68%	9.30%
BC Global Aggregate Bond	0.08%	3.10%	4.38%	10.52%	6.15%	7.17%
CSFB Bank Loan Index	-0.33%	0.33%	2.98%	9.68%	5.95%	4.32%
OTHER						
Index	Jun-11	3 months	YTD	1 Year	3 Years	5 Years
DJ UBS Commodity	-5.04%	-3.54%	27.13%	64.29%	-3.69%	5.41%
DJ Wilshire US REIT	-3.35%	3.97%	10.94%	34.96%	4.72%	1.67%
S&P Developed World Property	-2.38%	2.95%	6.03%	34.07%	2.70%	1.45%
LPX 50 TR	-3.05%	-0.33%	8.89%	49.74%	-4.18%	-3.18%
HFRI Fund of Funds Index	-1.50%	-1.49%	-0.64%	6.32%	-1.92%	1.47%
3 Month T-Bills	0.01%	0.04%	0.09%	0.16%	0.42%	2.00%

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

## The Economy

### The U.S.

Mixed signals from the U.S. economy continued into June, leading many to be frustrated by the glacial pace of economic growth. James Carville, Bill Clinton's 1992 campaign manager, once famously stated: "It's the economy, stupid." Indeed, in 2011 it is still about the economy. The tepid rate of recovery in the U.S. captures the collective mood of our country as we head into the summer months: political and economic ennui. Consumer confidence in June, according to the latest University of Michigan survey, dropped to 71.5—lower than expected. A Washington Post-ABC News poll in June indicated that American disapproval of the economic policies of the President and Congress is at an all-time high.

The slow growth recovery is not a surprise. The recession we experienced in 2008 and 2009 was fundamentally a financial one. The IMF writes that over the past half century there have been 122 recessions worldwide, including 15 that were associated with a financial crisis. Recessions associated with financial crises are typically longer and more painful than average. Notably, these recessions are also followed by weaker economic recoveries.

The bubble in real estate prices through 2007 was fueled by a boom in financial leverage and credit. At its peak in the third quarter of 2007, U.S. households had borrowed an equivalent of 127% of their annual incomes, according to the Wall Street Journal. The deleveraging of American families' balance sheets has slowed the bounce back that is typical after a recession. American households are now saving more than they earn and have reduced their leverage, which is a good thing for the long run, but a headwind in 2011.

Despite the widespread discontent with the economy, the prospects for a better second half to 2011 are strong. Manufacturing data has surprised to the upside in recent weeks in several areas across the U.S. Corporate profits remain at lofty levels and record piles of cash sit on corporate balance sheets. Eventually high corporate profits and greater economic clarity will result in the hiring of more workers in the private sector. When hiring

picks up and U.S. consumers feel more secure, economic growth will naturally follow.

The effects of the Japanese earthquake/tsunami were perhaps greater than initially thought. Many U.S. companies faced supply chain disruptions throughout the spring that markedly reduced output. In turn, this surprising drop in manufacturing over the past few months has been a central contributing factor to pervasive bearish sentiment.

As we wound down our latest round of quantitative easing (QE2) on June 30th, greater stability is returning to the macroeconomic outlook. While QE2 was mildly helpful in spurring the economy and keeping interest rates low, it comes as a welcome sign that the program is being put to rest. The effectiveness of the QE program is still up for debate by pundits across Wall Street. We believe the program to be a mild success, with credit due to Fed Chairman Bernanke. Just last year at this time, the specter of deflation was still very much a possibility. Doomsday articles compared the U.S. of today with Japan of the early '90s. Today, deflation is off the table as a concern. While quantitative easing's effect on money supply was fairly negligible, at the very least it was a step in the right direction. We hope the Fed and the Obama administration possess the necessary judgment to change course should core inflation become a real concern.

The U.S. economy could very well surprise to the upside in the second half of the year. Preliminary data indicate an upswing in consumer spending. Corporate profitability predicts an uptick in hiring. Low short-term real interest rates will remain with us for the foreseeable future. Estimated 2011 annual GDP growth is still around 3%, according to the Fed and most economists, indicating a much better six months are ahead. Patience and faith in the underlying fabric of the U.S. economy will get us through the tough times that still exist. Rudyard Kipling reminds us in If:

*If you can keep your head when all about you  
Are losing theirs and blaming it on you;  
If you can trust yourself when all men doubt you,  
But make allowance for their doubting too;*

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*If you can wait and not be tired by waiting,  
Or, being lied about, don't deal in lies,  
Or, being hated, don't give way to hating,  
And yet don't look too good, nor talk too wise...*

## The World

There was no shortage of headlines, economic or otherwise, in June. The Economist magazine has likely had difficulty deciding which crisis should go on the front page of their weekly publication. Europe will likely face financial problems for many months. The political momentum of the "Arab Spring" has given way to quagmire in parts of the Middle East. Libya remains war torn. Syria is on the edge of revolution. While the headlines were at times troubling, the global economy continues to grow and recover from the recession.

The Greek financial crisis continues, as problematic as ever. Austerity measures by the Greek government, along with asset sales, are the latest step in securing more emergency funding to prevent defaulting on their own sovereign debt. Riots continue in Athens as Greek citizens face a significant reduction in living standards due to a combination of higher taxes, higher unemployment and fewer social services. In similar situations in the past, countries like Greece which faced such economic hardship have typically allowed their currency to depreciate by 35-50%. Because of their membership in the EU, Greece has no such flexibility. The prospect of Greece eventually leaving the European Monetary Union appears increasingly likely.

Positive news has been coming out of Japan, which is also good news for developed markets and for neighboring Asian economies like China and Korea. According to J.P. Morgan, manufacturing surveys in Japan have recovered 93% of the economic output decline seen in March. Supply chain disruptions are mostly in the rear-view mirror. Also encouraging for the world's third largest economy was that Japan's industrial production rose 5.7% in May.

Inflation is a concern for the global economic recovery. While core inflation remains benign in the U.S., the global story looks quite different. Particularly in developing countries, a sudden rise in food prices could have serious consequences. Egypt's revolution earlier this year was partially a result of food inflation that made it difficult for the lower classes to subsist. Food prices account for only 15% of the consumer price index in the United States. In China, food accounts for 33% of CPI, and 48% of India's CPI is food related. A pull back in food related commodities would be very welcome, something we are already beginning to see signs of in corn and wheat.

## The Market

June was a volatile month for the U.S. stock market. The S&P 500 finished June down by approximately 1.67%. This downturn in the markets was in spite of five consecutive up days to finish the month. The S&P 500 remains up 6% year to date. Over the last 52 weeks, the S&P 500 is up over 30%. Bearish investor sentiment reached its highest levels in June since 2008. We would actually view this bearishness as a mildly positive signal, as retail investors frequently get it wrong. As the Warren Buffett saying goes: "Be fearful when others are greedy and be greedy when others are fearful."

Global equity markets were down for the month of June as well. The MSCI EAFE index lost 1.25%. European equities will likely not establish upward momentum until the debt crisis in the PIGS (Portugal, Ireland, Greece and Spain) has been resolved. Emerging markets posted a 1.54% loss for the month. Though emerging markets were down in June, they finished the month on the longest upward swing in three months. Morgan Stanley issued a report suggesting that China would delay the tightening of financial conditions, paving the way for higher growth.

Fixed income was down slightly in June, with the Barclays Aggregate

Index posting a negative 0.29% return for the month. While capital flowed into U.S. treasuries during the first part of June as a reflection of fear in Europe, the U.S. has its own problems with fiscal and monetary policy. The global fixed income market is a beauty contest without any beauties. Like a bad bar scene, investors are going for "least ugly" as their decision making calculus.

Other asset classes had mixed performances in June. Commodities were down again in June, correcting 5%. Much of the correction was energy related. The U.S. announced on June 22 that it would deliver 60 million barrels from the U.S. strategic reserve, sending crude prices down 4.5% for the day. The move by the Obama administration was a short term attempt to bring down oil prices—and summer gas prices. The DJ U.S. REIT Index was down 3.35%, correcting after a long run up in demand for institutional real estate assets.

## Outlook

Risk assets have clearly benefitted from the Fed's unprecedented stimulus over the last eighteen months. Equities are up significantly and credit spreads have continued to narrow. Commodities are up nearly across the board. Looking in the rear view mirror, investors have seen an increase in wealth across almost all asset classes.

Yet current economic data do not provide a clear vision for what the future holds. Interest rates are low and will continue to be low, but this alone will not goose U.S. residential housing market demand. Corporate profits are high, but this has not yet resulted in a major reduction in the unemployment rate. The global demand driven by growth in the emerging markets is more in doubt today than a few months ago, as China, India and Brazil fight inflation and economic overheating.

Investment returns for the second half of 2011 will likely reflect the realities of slow growth for the U.S. and European economies. From a top down view, it is difficult to find the catalysts that will create meaningful GDP growth above 3%. On a valuation basis, stocks still look relatively attractive. The S&P 500 is trading at 13 times forward earnings. Historically, the S&P has traded at approximately 16 times earnings. High single-digit returns for equities in 2011 seem reasonable.

Apparently not content to make news only by violating the terms of her parole, actress Lindsay Lohan tweeted her thoughts last week on U.S. fiscal and monetary policy. "Have you guys seen food and gas prices lately? U.S. \$ will soon be worthless if the Fed keeps printing money!" Ms. Lohan does indeed have a point. However, she might be dismayed to find out that she is closer to the Tea Party than she is to the Democrats.

Finally, look for gas prices to be a major factor this summer with respect to growth in the second half of the year. Every 1 cent increase in gas prices reduces U.S. disposable income by approximately \$600 million per year. It is the higher marginal propensity to spend of the American middle class that will boost consumer spending for the economy. \$3 gas is much better than \$4 gas.

The third year is usually the best year in a four year Presidential election cycle. Incumbent presidents generally like to be re-elected, providing the necessary conditions to provide for a warm and fuzzy feeling about the economy. Since the Great Depression, the average return in the third year of an election cycle is 22.6%. While this year we are likely not headed for a 22% gain, a more modest gain would still be welcome.

We hope July is filled with more optimistic headlines, economically and politically.