

## Summary

The economy grew at an anemic 1.3% annual rate in the second quarter, primarily as a result of cautious consumer spending due to the combined effect of weakness in the labor market and higher food and energy costs. In addition, first-quarter growth was revised sharply lower to a gain of only 0.4% led by a large revision in the inventory investment component.

There is a concern that slower growth is leading the economy into another recession. We do not see that risk as likely at this point for three reasons. First, over the past 50 years, every recession has been preceded by an inverted yield curve. Today, the yield curve is very steep with short-term interest rates well below longer-term interest rates. Next, the Institute for Supply Management (ISM) indexes for both manufacturing and non-manufacturing remain above 50, the level that separates growth from contraction. True, the indexes do not show much growth, but that's expected since economic growth has slowed. Lastly, although consumers have reacted to news out of Washington, concerns in Europe and the continued weakness in the job market with cautious and reduced spending, their expectations about the future appear to be a bit better.

As we have said for some time, economic growth will be slower than in a typical recovery due to the weak labor market's sizable impact on consumer spending and, therefore, the economy. However, low interest rates and low inflation should be positives longer term and should keep the economy from slipping into a recession again.

### POSITIVES

- ❑ Continued low interest rates and low inflation readings
- ❑ The ISM manufacturing and non-manufacturing indexes remain above 50
- ❑ Growth in nonfarm payrolls; unemployment rate declined slightly in July

### NEGATIVES

- ❑ Cautious consumers spending less
- ❑ Additional problems in Europe impacting exports
- ❑ Weather conditions continue to impact commodity prices

### UNKNOWNNS

- ❑ Debt limit issues resolved for now; questions remain about longer-term solution

## Summary

The roller coaster ride which was the month of July first saw equity markets decline as the ramifications of a possible U.S. Treasury default sank in, then rally as compromise seemed at hand, only to reverse sharply with Congress in stalemate going into the final weekend.

The S&P 500 Index eventually closed off 2% for the month, with only the technology and energy sectors managing positive returns of 1.6% and 0.7%, respectively. Industrials and telecommunications bore the brunt of traders' wrath, plunging 7.0% and 5.7%.

In August, equity markets have slipped further as more disconcerting news emerged that economic growth in the first half of the year was much worse than expected. No sooner had the market begun to factor in a slower-growth forecast for the remainder of the year than the European debt crisis reasserted itself.

While the outlook for economic growth in the U.S. seems less certain today than just a month ago, recent action in equity markets has already significantly discounted lowered earnings expectations for the second half of the year. Moreover, the fact that the Federal Reserve is not actively moving to curb demand through interest rate hikes leads us to view the current market action as a correction in what has been a strong equity market for two years, and not the beginning of a more serious price decline.

### POSITIVES

- ❑ Corporate earnings outlook still positive
- ❑ Steep yield curve bodes well for equities
- ❑ Equity valuations not expensive

### NEGATIVES

- ❑ European debt issues spill over into U.S. equity markets
- ❑ Economy still not creating sufficient jobs
- ❑ Increasing regulatory burdens for business (esp. finance and health care)

### UNKNOWNNS

- ❑ Can European central bankers effectively address the debt issue?

## Summary

Even with the threat of a downgrade to the credit rating of the U.S. government, Treasury yields declined significantly in July. This seemingly counterintuitive move was driven by continued turmoil in the European debt markets, the deteriorating outlook for most of the world's economies and by investors fleeing riskier asset classes, such as stocks. Led by the industrial sector, corporate credit outperformed government debt. Financial company credits lagged on fears of sovereign debt exposure, increased capital requirements and counterparty contagion. As measured by the Barclays Capital Government/Credit Index, the market returned 1.95% for the month, bringing the year-to-date total return to 4.61%.

Now that the U.S. long-term debt rating has officially been downgraded by Standard & Poor's for the first time in history, one might expect that rates would move higher as investors require more yield to compensate for the higher credit risk. Not only is this not happening, rates have instead fallen sharply again. Remember, the downgrade does not reflect a fear about the ability of the U.S. to pay debts in the near term, but rather the projected outcome of an increasingly dysfunctional government that is unwilling to come together to solve the significant long-term deficit trajectory. Indeed, S&P has indicated that further rating downgrades may be in the offing in November if greater actions are not taken.

In the end, we suspect that the credit rating cut will not cause interest rates to rise in the near term as some investors are forced to sell lower-rated credits and buy AA+ rated U.S. debt to keep their average portfolio quality at an appropriate level. Additionally, the European debt crisis is far from being resolved, the equity markets are weak and many major economies may be entering a double-dip recession. Longer term (i.e. five to ten years out), rates may become structurally higher unless Washington becomes a better steward of the nation's finances.

### POSITIVES

- ❑ Increasing potential for a double-dip recession
- ❑ Inflation at the core level is moderate and energy prices are declining
- ❑ Uncertainty in European debt markets

### NEGATIVES

- ❑ Dysfunctional governmental efforts to stem further deficits
- ❑ U.S. credit rating downgraded; further downgrades possible
- ❑ Rates at or near historical lows

### UNKNOWNNS

- ❑ Ultimate resolution of European debt crisis
- ❑ Investors continued flight from riskier asset classes
- ❑ Continued attractiveness of U.S. Treasury auctions to international investors