



Economic Commentary and Capital Market Update

September 2011

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Overview: The economy is sputtering. At the same time, confidence has fallen over policymakers' ability to revive it. The U.S. debt ceiling debate showcased to the world that Washington has saturated its appetite for fiscal stimulus; any case for additional fiscal accommodation will be a tough sell politically. In an environment of private sector weakness, the U.S. government can no longer be counted on to pick up the slack. With a diminished capacity for a strong public policy response and lagging private sector, overall growth will continue to struggle. However, a double-dip recession remains an unlikely scenario.

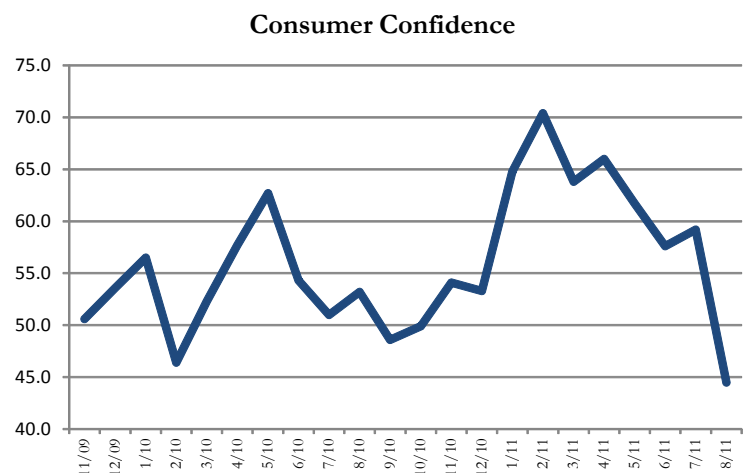
Market panic in recent weeks overshadows the fact that some positives do remain. Importantly, signs of pent-up demand are evident. Corporate profits are sky-high and businesses are sitting on piles of cash. Consumers, too, have scope to increase spending. That oil prices have dropped more than 20% from their late April highs will help. In addition, the intent to purchase autos is at a record high, and has been so for months.

The force of pent-up demand is a potent one as it could provide the economy with some much needed thrust in the months ahead. A lack of confidence is the main challenge facing the markets today. Provided that consumer and business confidence isn't permanently undermined by the events of recent weeks, the U.S. economy should continue to bump along. However, it will be difficult to build strong economic momentum as long as deep-rooted structural problems persist, particularly in the struggling housing and labor markets.

GDP: The first estimate of Q2 2011 GDP shows that the U.S. economy grew much slower than previously believed. For the quarter, GDP grew at an annualized 1.3% rate, much lower than our expectations. Most concerning is that consumer spending growth has slowed to essentially zero; consumer spending was up only 0.1% on an annualized basis. Government spending also declined in the period. Modest positives include business investment and net exports.

There were also significant downward revisions to previous GDP figures. For Q1, GDP was revised down sharply to an annualized 0.4% from 1.9%. The decline was primarily attributable to a steep adjustment in inventory levels. Interestingly, profits as a share of GDP have reached 12.9%, its highest level since the fourth quarter of 1950. This indicates that once confidence in the economy is restored, businesses have the firepower to resume much higher investment and hiring.

Consumer Confidence: Consumer confidence plunged 14.7 points in August to 44.5, the largest drop since October 2008 (see chart). Uncertainty surrounding the debt-ceiling agreement, the S&P downgrade, and a shaky stock market pulled consumer confidence down. This offers a first glimpse into the minds of consumers who watched helplessly as late summer turmoil sent financial markets into a tailspin. The financial and political uncertainties of the last month could have negative implications for the real economy if it causes consumers and businesses to adopt a "wait and see" attitude with regards to new spending and investment.



Consumer Spending & Income: Consumer spending jumped 0.8% in July and core consumer spending (excluding food and energy) rose 0.2%. Personal income rose 0.3% in July while disposable income, after controlling for inflation and taxes, fell 0.1%. While consumer spending posted its biggest monthly gain in 19 months, inflation-adjusted disposable income fell for the first time in nearly a year. July's spending momentum is unlikely to hold into August given the decline in income, a loss of confidence and tumultuous financial markets. Still, the relative strength of this month's report reinforces our belief that the economy was moving along quite nicely before the debt ceiling debate and the subsequent financial market fallout jolted consumer and business confidence.

Durable Goods: New orders for durable goods increased by 4.0% in July. This follows a 1.3% contraction in June. Order of durable goods, excluding the transportation equipment component, were up 0.7% on the month, an improvement on June's upwardly revised 0.6% expansion. On the other hand, core orders (i.e., non-defense capital goods excluding aircraft) lost 1.4% on the month. The weakness in core capital goods is another confirmation that the U.S. economy will struggle to regain momentum during the second half of the year after a very weak first half. Given the rising uncertainty regarding the economic growth outlook, businesses both in the U.S. and abroad are holding back on their investment decisions. Accordingly, we expect business investment to grow at a slower pace during the second half of the year.

Industrial Production: Industrial Production expanded 0.9% in July, the third straight month of expansion, and the indicator's best showing this year. Manufacturing and capacity utilization indices also inched up. Industrial production is still 7% off its pre-recession peak. If the index were to continue growing at its average pace set over the last 3 months, it would take over a year to regain these highs.

Inflation: The Consumer Price Index surged 0.5% in July largely from a substantial increase in gasoline prices. The CPI remained up 3.6% relative to one year ago. Excluding volatile food and energy prices, the core price index advanced 0.2% and is up 1.8% relative to a year ago. The rise in gas prices during July has partially reversed in August and September. This should help reduce the pressure on prices in the months ahead. Core prices, meanwhile, have been growing slightly faster than the Fed's comfort zone for four months running, and are set to exceed the 2% threshold early this fall.

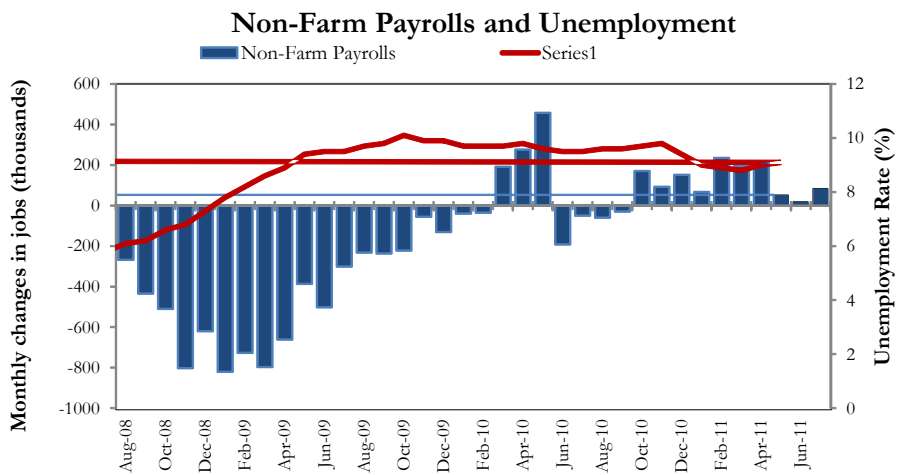
We expect monthly core price growth to slow during the second half of the year as the recent gains in autos (driven by supply chain disruptions) and apparel prices (driven by the lagged impact of record cotton prices) recede. Headline inflation figures should also drop in coming months as steadily lower prices for oil and food work their way through the economy. The weak economy and high unemployment rate will prevent companies from raising prices and workers from demanding higher pay.

Housing: Housing starts fell 1.5% to a 604,000 unit pace in July with single-family starts accounting for the decline. Multi-family starts showed significant gain. Despite many of the challenges in the housing market, housing starts are looking a little better. On a year-ago basis, starts are up 2.0% with apartment construction supporting much of the gain. The seasonally adjusted S&P Case-Shiller (C-S) Composite Index of home prices declined by a modest 0.06% in June. On a year-over-year basis, the C-S composite 20-city index fell 4.5%. This report, combined with other home price measures suggests that housing prices stabilized somewhat as the U.S. economy headed into the summer months of July and August. However, July's existing home sales data left the impression that

economic uncertainty and financial volatility were weighing on sales, and this most likely extended into August. As such, we may see renewed weakness in C-S prices in the coming months.

The key to stronger housing construction lays in clearing the existing stock of foreclosed homes. To date, foreclosure policy initiatives have not been very effective, as shown by the high level of re-defaults among mortgage modifications. At the current rate of liquidation, we estimate it will take several years to clear the market. We don't expect housing starts as well as home prices to pick up in a big way until employment conditions and consumer confidence improve and the glut of existing housing inventory starts to clear.

Labor: Nonfarm payrolls were extremely disappointing in August, with zero jobs gained in the month. Private payrolls gained a paltry 17,000 jobs, mainly in the service sector. Goods-producing jobs fell by 3,000. The private sector was impacted by the Verizon strike, which put 45,000 people temporarily out of work. Even excluding the Verizon strike, private sector job growth was still uncomfortably weak. The government sector continues to shed jobs at a rapid clip, declining by 17,000 in the month, many at the local level. Despite the poor jobs picture, the unemployment rate remained unchanged at 9.1%. This is largely due to more workers leaving the workforce.



Clearly, employers remain cautious about hiring and increasing their fixed costs in the midst of only modest economic growth and the potential negative impact of policy rancor and disagreement in Washington. Until there is greater clarity, businesses will be cautious and selective in their hiring keeping a lid on economic growth.

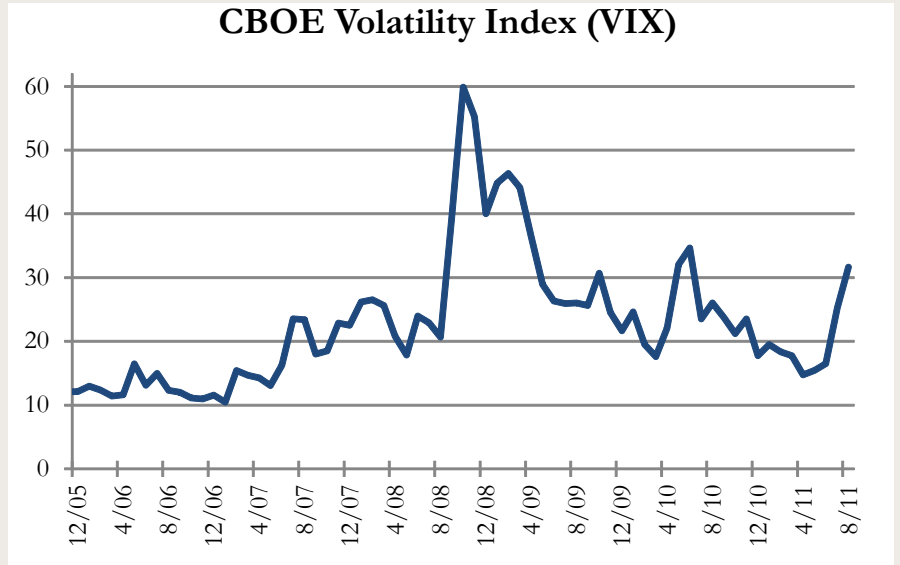
Trade Deficit: The U.S. trade deficit narrowed dramatically to \$44.8 billion in July from a revised \$51.6 billion in June. The drop was driven primarily by a surge in exports of goods and services. Export growth was widespread across categories with especially strong performances in industrial and capital goods. On the other hand, imports dropped due to a decline oil prices. The sharp rebound in exports bodes well for continued economic growth in the third quarter of this year. In real terms, the trade deficit narrowed by \$5.0 billion in July. If the real trade deficits in August and September remain unchanged at July's level, then net exports should add about 0.5 percentage points to overall GDP growth in the third quarter.

A significant amount of uncertainty hangs over the global outlook. Provided there are no major shocks from the sovereign debt crisis in Europe, global growth is expected to continue, but is unlikely to be robust. Support to U.S. growth from net-trade is likely to be relatively modest over the next year.

Outlook: Market volatility, and it has escalated dramatically of late (see VIX chart below) continues to be driven over concerns about the possibility of recession in the United States and in Europe.

Real GDP in the United States grew by around 1% in the first half of the year, a rate just above stalling and one that contributes to worries about the state of the economy. Although we acknowledge the downside risks, we continue to believe that another U.S. recession is not in the cards.

One somewhat bright spot is that gross domestic income (GDI) in the United States grew faster than GDP over the first six months of 2011. GDI is an equally valid measure of the state of the overall economy, and this difference suggests the possibility that GDP data may yet be revised higher. In addition, if the US economy were about to fall into recession, we would likely be seeing weakness in unemployment claims, capital expenditures and corporate profits, none of which is occurring. As a result, we do not believe a recession will be forthcoming anytime soon.



However, we continue to forecast positive – albeit unspectacular – growth for the remainder of 2011. GDP in the major world economies have been growing at below-trend levels for the past several quarters, and growth rates are likely to remain sluggish. The world has not fully recovered from the effects of the credit crisis and tighter financial conditions in many parts have been holding back growth. The downside has also been exacerbated by doubts over the possibility of fiscal policy and/or monetary stimulus to break the circle between weakness in the global economies and markets.

The U.S. debt ceiling impasse and the escalation of the European sovereign debt crisis has exacerbated the perceived lack of political leadership, further curtailing business and consumer sentiment. The new election cycle in the U.S. is almost certain to constrain policy initiatives. This will continue to impact aggregate demand, thus hurting the manufacturing sector. Unless the service sector picks up the slack, which we do not expect, we can read current market behavior as adjusting in a very volatile way to the expectation of lower growth.

At this point, we are not anticipating that additional easing measures (beyond keeping rates extremely low) will be forthcoming from the Federal Reserve Bank unless renewed deflation risks emerge. Although President Obama has indicated that he would like to see a new stimulus and jobs plan to help the troubled economy, we do not believe that any such program is likely given the current political backdrop. Meanwhile, members of the staff of the so-called “super committee” charged with identifying deficit reduction options have been indicating that they may be coming to some sort of understanding. This may be an overly optimistic view, but we do hope that the super committee would arrive at a deal by their October 23 deadline.

Index Performance as of August 31, 2011	1 Month	QTD	YTD	1 Year	5 Year
Russell					
3000 Growth Index	-5.55	-6.73	-0.22	24.25	3.73
3000 Index	-6.00	-8.15	-2.32	19.30	1.14
3000 Value Index	-6.45	-9.55	-4.36	14.55	-1.54
1000 Growth Index	-5.28	-6.23	0.18	23.96	3.75
1000 Index	-5.76	-7.80	-1.93	19.06	1.11
1000 Value Index	-6.24	-9.35	-3.99	14.37	-1.62
Mid-Cap Growth Index	-6.82	-10.31	-1.71	25.61	4.28
Mid-Cap Index	-6.88	-10.25	-3.00	21.28	2.99
Mid-Cap Value Index	-6.93	-10.19	-4.18	17.51	1.36
2000 Growth Index	-8.57	-12.15	-4.60	27.54	3.59
2000 Index	-8.70	-12.00	-6.54	22.19	1.53
2000 Value Index	-8.83	-11.85	-8.52	16.86	-0.62
S&P 500					
Consumer Discretionary	-5.43	-7.36	-1.77	18.50	0.78
Consumer Staples	-5.26	-6.59	1.19	26.62	4.35
Energy	0.58	-0.90	6.94	20.12	6.98
Energy	-9.69	-9.05	1.30	34.38	5.62
Financials	-9.56	-12.83	-15.50	0.02	-14.75
Health Care	-2.07	-5.86	7.26	21.20	2.36
Industrials	-6.48	-13.01	-6.02	17.05	1.33
Information Technology	-5.98	-4.47	-2.51	20.52	4.87
Materials	-6.67	-9.75	-6.48	19.93	4.74
Telecommunication Services	-1.36	-6.97	-0.40	15.62	2.59
Utilities	2.30	1.36	10.53	15.01	3.49
Other U.S. Equity					
Dow Jones Industrial Avg	-3.96	-5.93	2.14	19.03	3.17
MSCI USA	-5.53	-7.37	-1.64	19.12	1.05
Wilshire 5000 (Full Cap)	-5.95	-8.03	-2.60	19.00	1.56
International Equity - Broad Market					
MSCI EAFE	-9.02	-10.45	-5.66	10.50	-1.01
MSCI Emerging Markets	-8.90	-9.24	-8.31	9.40	8.72
MSCI Frontier Markets	-5.12	-7.48	-12.47	1.60	NA
MSCI AC World	-7.26	-8.74	-4.19	14.28	1.14
MSCI AC World ex USA	-8.55	-9.77	-6.06	10.80	1.24
MSCI AC Asia ex Japan	-9.85	-8.74	-7.55	9.84	8.98
International Equity - Country Region					
MSCI Brazil	-6.46	-10.48	-11.82	0.99	15.81
MSCI BRIC	-9.49	-11.10	-11.26	1.65	8.56
MSCI China	-9.32	-10.06	-9.09	-0.12	12.29
MSCI Europe	-10.01	-13.03	-4.69	10.61	-1.12
MSCI India	-12.35	-14.36	-21.62	-6.84	8.10
MSCI Japan	-8.13	-4.87	-9.32	6.39	-4.78
MSCI EM Latin America	-5.35	-8.57	-10.00	5.50	13.78
MSCI Russia	-13.41	-11.65	-2.76	19.94	-3.20
Fixed Income					
BC Aggregate Bond	1.46	3.07	5.88	4.62	6.56
Merrill Lynch 3-month T-Bill	0.02	0.02	0.10	0.15	1.83
BC Government	2.54	4.25	6.48	4.04	6.42
BC Credit Bond	0.36	2.77	6.28	4.98	6.91
BC High Yield Corporate Bond	-4.00	-2.89	1.94	8.39	8.10
BC Muni Bond	1.71	2.75	7.29	2.66	4.94
BC TIPS	0.81	4.76	10.85	10.79	7.19
BofA ML Global Broad Market Ex USD	1.24	3.62	9.30	11.93	7.86
BofA ML Global Broad Market	1.36	3.38	7.80	8.64	7.30
BofA ML Emerging Market Credit	-2.77	-0.89	6.81	11.41	9.70
Alternative Investments					
NAREIT Equity REIT Index	-5.60	-4.61	5.52	18.42	0.22
DJ-UBS US Commodity Index	1.00	3.99	1.31	25.83	0.84
HFRI Equity Hedge	-4.11	-4.19	-3.41	8.18	3.46
HFRI Equity Market Neutral	-0.94	-0.78	1.52	5.73	2.30