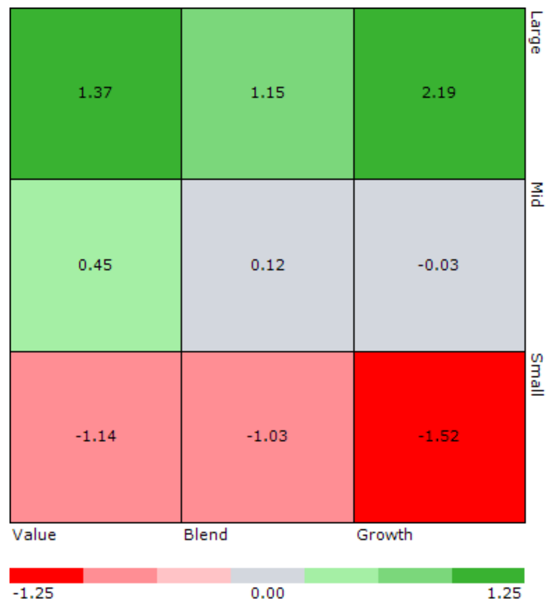
Pettinga Insights and Outlook

August 2012 | Vol. No. 1 | Investment Updates

Monthly Market Barometer

1 Month, ending July 31, 2012. The U.S. Market returned 1.12% (YTD 10.57%).

The Morningstar Market Barometer provides a visualization of the performance of various stock market indexes. The color scale (red for losses and green for gains) allows you to assess which areas of the market performed strongly and which areas showed weakness for the time period analyzed. The nine-square grid represents stocks classified by size (vertical axis) and style (horizontal axis). There are three investment styles for each size category: small, mid and large. Two of the three style categories are "value" and "growth" while the central column represents the core style (neither value nor growth characteristics dominate). Large-caps account for the top 70% of the capitalization; mid-caps represent the next 20%; and small-caps represent the balance.



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Our Firm

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Monthly Market Commentary

Much of July consisted of market participants eagerly awaiting announcements from the U.S. Federal Reserve and the European Central Bank (ECB). The main expectation was for some form of concrete action to revitalize lackluster economies in the wake of the global slowdown. Markets soared after ECB chief Mario Draghi made strong statements, including how the ECB was "ready to do whatever it takes to preserve the euro," but unfortunately fell sharply again when the ECB failed to actually provide any strong policy support to troubled Eurozone economies. Earnings season showed corporate earnings mostly came in better than expected, though revenue was mostly light as the European crisis continued to affect many companies.

GDP: Second quarter real GDP growth came in at an anemic, but not surprising 1.5%, down from a revised 2.0% in the first quarter. A slowdown in consumer spending and a rise in imports were the main causes of this deceleration. While many have questioned whether the U.S. might already be in a recession, the latest GDP results do not currently reveal that. At the same time, it is difficult to argue that the U.S. economy is booming.

Employment: Investors breathed a huge sigh of relief as 172,000 jobs were added in July, up from a revised 73,000 jobs in June. Most of the job growth came from business services, restaurants, health care, and manufacturing while government hiring shrank by 9,000. Unfortunately, the construction industry continued to contract from poor construction hiring in the commercial sector. The unemployment rate inched upwards slightly to 8.3%.

Housing: Housing data continued to show improvements, as July builder sentiment made its largest single-month increase in a decade. June housing starts set a new recovery high after rising 29% year-over-year, and June existing home inventories remained about 20% below year-ago levels. While low inventories have started to weigh on existing home sales, which fell 5.4% from May to June, lower inventory levels also caused a dramatic rise in median prices. Morningstar economists believe that while it is unfortunate housing is improving at such a slow pace, it still has a lot of room to expand and may drive the economy even higher as exports and manufacturing begin to slow.

Manufacturing: The purchasing manager reports in July indicated paltry gains for both U.S. and China manufacturing, while the Eurozone continued to show broad-based weakness with a 37-month low reading as European companies continued to cut employment and inventories in the face of further expected declines. More importantly, slowdowns in France and Germany suggest that further weakness lies ahead.

Auto: Auto sales were a big help for the economy in both the December 2011 quarter and the March 2012 quarter, but were essentially flat from March to June. With July's vehicle sales of 14 million units, the auto industry continued to hold steady and will most likely not be a big help in the second half of 2012. Although sales did not accelerate, more sales were made to consumers instead of corporate fleets or rental car companies. It is worthwhile to note that consumer sales tend to occur at higher prices and are considered more indicative of economic strength.

Inflation: June's CPI report showed that medical services and apparel prices increased, while overall energy and airline prices fell. Droughts in the Midwest continued, which could mean even higher corn and soybean prices that may further drive up the prices of items (such as pork and chicken) higher up the food chain. Unfortunately, this may hurt consumers, who were just beginning to get ahead of inflation.

2012 Mid-Year Economic Outlook

While the U.S. economy continues to slowly recover from the 2008–2009 recession, there still remain many dark clouds, making it difficult to look ahead and navigate the investment landscape. The European debt crisis, slowdown in emerging markets, and U.S. debt problems are some of the causes for this challenging environment.

U.S. Economic Forecast

1. The outlook for the remainder of 2012 suggests a slow start before acceleration.

2. Real (inflation-adjusted) U.S. GDP growth is estimated at 2.0% to 2.5%.

3. Inflation is expected to slow in the range of 2% to 2.5% due to falling commodity prices.

4. Employment growth is expected to accelerate to 195,000 per month.

5. The unemployment rate is forecasted to drop to 8% or lower.

Potential Economic Drivers

1. Consumer spending

2. Housing and construction

3. Lower inflation

4. Automotive sales

Risks to Economic Growth

1. Inflation: drought could cause food inflation, driving prices skywards.

2. Consumer spending could outpace incomes.

3. European sovereign debt continues to play a key role in global financial markets.

4. Increased emphasis on the slowing manufacturing economy outside the United States.

5. Geopolitical issues: Financial markets have mainly been focused on the European debt crisis, the U.S. fiscal cliff, and the deceleration of the Chinese economy. However, investors also need to watch for other geopolitical risks, such as Iran and Syria.

Economic Data Suggests

1. Caution toward emerging markets, which are dependent on both Europe and each other.

2. Bonds look risky, as low rates will not stay forever.

3. Taking a closer look at U.S. wide-moat stocks, which are companies that have strong pricing power.

4. Taking a closer look at small-cap stocks, as they tend to have less non-U.S. exposure.

All of the above statements are based on Morningstar economists' estimates. Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. Bonds have varying levels of sensitivity to changes in interest rates. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes. Stocks are not guaranteed and have been more volatile than the other asset classes. Furthermore, small stocks are more volatile than large stocks and are subject to significant price fluctuations, business risks, and are thinly traded. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards. Emerging-market investments are riskier than developed market investments.

Geopolitics Dominate Traditional Economics

This newsletter summarize what has occurred in the markets thus far in 2012, and offers insight into what may happen during the balance of this year. An overlay affecting the world markets in 2012 are the serious geopolitical and economic issues we face today.

The most significant issues currently include: the U.S. "fiscal cliff" at the end of 2012 where taxes will rise dramatically on individual taxpayers, and automatic government spending cuts come into effect; the E.U. financial crisis, which has subsided from the front pages but is destined to return later this year; and, the nuclear crisis between Israel and Iran. Any one of these issues may derail our economy and the markets. This poses a challenge as we manage client portfolios, and seek to preserve wealth.

As a firm, we are committed to long-term portfolio management techniques based on sound asset allocation methodology. Even traditional portfolio management practices are challenged in the face of these political and economic issues. For example, in 2011 the United States government was at risk of running out of cash unless Congress and the White House could agree to raise the debt ceiling. The stock market was reeling in fear an agreement might not be reached. Ultimately, an agreement was secured at the eleventh hour, and the stock market rebounded nicely. This uncertainty unnerves investors, and the market went for a wild ride in response.

Building a portfolio with the current economic and political risks in mind may lead to a more conservative allocation than would be the case in circumstances where the political and economic climate was more stable. In any event, we limit the changes we make to portfolios in response to short term challenges because markets respond quickly, and sometimes dramatically, when issues are resolved.

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