



Monthly Economic Update

September 9, 2010

The Month in Brief

After strong gains in July, stocks reversed sharply in August, continuing the tug-of-war pattern that has characterized equity returns through most of the year. When the smoke cleared at month's end, global equities markets (MSCI World Index) had declined 3.7%, led by a loss of 4.7% in the U.S. market (Russell 3000 Index). Fixed income returns around the world were generally positive, as worried investors ignored low yields and sought the safety of bonds.

Also last month, the data showed that the economy has been crawling along and fears have grown that the recovery is running out of steam. The impact of the 2009 federal stimulus continues to fade, the Fed has appeared to "run out of bullets", and businesses and consumers seem to be marking time as they watch and wait for clarity on tax policy and the election results in November. Overall, investors avoided stocks and poured money into fixed income funds and precious metals.

Domestic Economic Health

As the dog days of August gave way to September, emerging indicators show an economy that appears healthier than proclaimed by many market pundits only a couple of weeks ago. The first sign of hope came in the form of consumer confidence, as consumer spending rose 0.4% in July after a flat June. That was the biggest increase since March, and welcome after three months without a net gain. Personal incomes were up 0.2%, and the personal savings rate declined to 5.9% from the previous 6.2% rate. The University of Michigan/Reuters consumer sentiment index improved to 68.9 in August from 67.8 in July, and the Conference Board's August poll made the same move, rising to 53.5 from July's 51.0.

The retail and manufacturing sectors are also beginning to rebound from the summer slowdown. Analysts polled by Briefing.com expected the Institute for Supply Management's August manufacturing index to fall to 52.9 from the July mark of 55.5, but were surprised when it registered at 56.3. Additionally, the Commerce Department reported retail sales in July increased for the first time in three months with a small, but still positive, gain of 0.4%.

Also, recent inflation statistics are starting to deflect some of the "deflationary spiral" fears. In July, the Consumer Price Index rose 0.3% after declining the three previous months; the Bureau of Labor Statistics measured year-over-year inflation at 1.2%. Also, the Producer Price Index advanced 0.2% in July for a 4.2% year-over-year gain.

Other indicators were somewhat less reassuring. Unemployment ticked up to 9.6% in August, although analysts had been expecting an increase from the previous reading of 9.5% as new people continue to enter the work force. On a positive note, the private sector gained 67,000 jobs

for the month. Durable goods orders rose only 0.3% in July, not the 2.7% economists surveyed were forecasting. However, it was the first gain in the category in three months. Finally, the ISM service sector index declined from July's reading of 54.3 to 51.5 in August.

At the Fed's annual Jackson Hole retreat, chairman Bernanke advised that the central bank would intervene in the economy if necessary, admitting that "although private final demand, output, and employment have indeed been growing for more than a year, the pace of that growth recently appears somewhat less vigorous than we expected." He noted that Fed policymakers did not think the recovery was fading, but there appears to be growing disagreement among Fed Governors regarding the degree of the longer term inflationary implications of the current monetary policy stimulus. The majority of economists still see deflation as the bigger problem at this point.

Global Economic Health

In late August, we learned that the European Union's collective economy expanded in the second quarter at a rate unseen since 2006. The Eurozone PMI was 55.1 in August, still showing growth but down from 56.7 in July. Though the pace of manufacturing growth in Germany, England, Italy and Spain slowed in August, the PMI index has been above 50 for the last 11 months of data. Economists polled by Bloomberg felt the European Central Bank would keep interest rates at around 1% for an extended period.

News from the developing world was encouraging as well, as both the government PMI and the most respected private-sector PMI in China advanced in August and registered growth readings above 50. India's manufacturing sector grew again in August, and Russia's manufacturing sector expanded by the most since April 2008.

Financial Markets and Commodities

As previously mentioned, August was a dismal month for stocks. In the U.S., the large-cap S&P 500 Index Fund fell 4.5% for the month, and the Russell mid- and small-cap benchmarks dropped 4.4% and 7.4%, respectively. Foreign stocks were also down for the month, with developed country markets (MSCI EAFE) down 3.1% and emerging markets (MSCI EM) losing 1.9%. Year-to-date through August, domestic equities are down about 4.5% to 5%, while losses in foreign markets averaged close to 8% for developed markets and 2% for emerging markets.

Domestic fixed-income provided some positive news for investors in August as the Barclays Aggregate Bond Index gained 1.5% for the month, and the Barclays 7 Yr Muni Bond Index rose 2.3%. The fixed-income returns abroad were also positive as the Citigroup World Government Bond Index returned 2.0% and the JPMorgan GBI-Emerging Market Global Diversified Index gained 0.7%. Led by U.S. Treasuries, fixed income markets have enjoyed a strong eight months, with the Barclays Aggregate gaining 7.8% and municipal bonds gaining 7.7% on average.

Gold futures enjoyed a strong August after a pullback in July, advancing 5.6% for its best month since April. Through August, gold prices had gained 12.9% year-to-date versus a net loss in world equity markets. August was a tough month for energy, as oil futures fell 8.9% and natural gas futures sank 22.5%, and both are down significantly for the year. Finally, the U.S. Dollar Index gained 1.9% for the month against a basket of world currencies, again indicating heightening investor concerns over soft economic data.

Housing & Interest Rates

The National Association of Realtors did report a bit of good news in July, as the median sale price of an existing home was \$182,600, or 0.7% higher than it had been in July 2009. But that was about all the good news for the real estate sector in August. Analysts expected home sales would drop without encouragement from the federal government, but were stunned when existing home sales fell 27.2% on the month and were 25.5% under year-ago levels. Also, new home purchases slipped 12.4% in July to the slowest pace since the start of recordkeeping in 1963.

Meanwhile, mortgage interest rates continued their descent. Freddie Mac's August 26th Primary Mortgage Market Survey showed rates on the 30-year FRM averaging under 4.5% (4.36% nationally) and rates on 15-year FRMs averaging below 4% (3.86% nationally). In the September 2nd survey, rates declined even further dropping to 4.32% on 30 year and 3.83% on 15 year mortgages.

Market Outlook

Going into election season, equities appear to be stuck in a "trading range" of 1010 to 1140 on the S&P 500 Index (presently at about 1100). Over the short to intermediate term, meaningful flows back into the equities markets by long-term investors will require increased clarity on the status of expiring tax cuts and the general direction of economic policy. In short, equities markets are likely to vacillate until November election results are in. Meanwhile, the credit markets are indicating few economic concerns, as credit spreads have been stable throughout the slowdown period this summer. In summary, we see no compelling reason to move away from the policy asset mix for most clients at this point.

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