<u>Outlook for July, 2012: "The United States of Europe?…"</u>

Regardless of the gyrations in markets and policy foibles, Europe appears to be slowly but surely morphing into a "United States of Europe". Indeed, with policymakers now talking about a Europe wide bank deposit insurance entity, the ability to issue "common" Eurobonds and eventual fiscal as well as political integration, this step seems inevitable. Never mind small technical details like Europe is rife with different languages and cultures and such a move would probably take years if not decades to accomplish – as the Thirteen Original colonies found out in 1776.

Data released over the past month suggests that we are in the midst of a soft patch: June's payroll employment numbers, as issued by the Department of Labor, rose just 80k jobs, with private payrolls +84k and public payrolls -4k. That puts the 2nd quarter monthly average employment growth at 75k, well below the first quarter monthly average of 226k, and marks the worst three month period in two years.

The reports' sector analysis showed professional and business services (+47k), leisure and hospitality (+13K), and manufacturing (+11k) registering gains, while both the information sector (-8k) and government (-4k) reported losses. Revisions in May (69k to 77k) and a decline in April (77k to 68k) produced a net loss of 1k. The data was not all negative as the average workweek and average hourly earnings ticked up in June, albeit at a modest rate.

The politically sensitive unemployment rate was unchanged at 8.2% as was the labor participation rate at 63.8%. The report also noted that 8.2 million people were employed part-time or had their hours cut back due to economic business concerns. Long-term unemployment (defines as those jobless for 6 months or longer) has not budged much in several quarters as it was unchanged in June at 5.4 million people, representing 41.9% of the unemployed. The U-6 measure, a broader measure of unemployment, rose one-tenths for the second consecutive month to 14.9%.

The Bureau of Economic Analysis of the Department of Commerce released their third and final estimate of 1Q GDP at 1.9% annualized, unchanged from their prior estimate, and well below 4Q 2011 GDP of 3.0%. The Institute for Supply Management's manufacturing report reported a fall to 49.7 from 53.5 (a value less than 50.0 indicates contraction within the sector). This was the steepest decline since October 2001 and is the first time the index fell below the 50.0 mark since July 2009. Key attributes of the index (new orders, inventories, exports, and prices) dropped at a steep rate.

On a regional level, the notable indices we follow (Chicago, Empire State and Philly Fed) trended lower for the month with the mid-Atlantic region experiencing the sharpest decline in business activity. From a global perspective, the JP Morgan Global Manufacturing PMI dropped to a three year low of 48.9, signaling that the contraction is not just at home but is being felt around the world (Europe, China, Brazil, etc.). The ISM's Non-Manufacturing Index remained in expansion territory, (52.1 from 53.7) although many of the report's attributes signaled that a slow-down is in progress, with new orders and business activity declining on a month-on-month basis.

In response to this sluggish patch of economic data (or perhaps in anticipation of further weakness), the Federal Reserve at its Federal Open Market Committee meeting in late June, decided to extend the so called "Operation Twist" into the end of 2012 from June 2012 (when the original program was scheduled to end). The Federal Reserve continues to pursue a monetary policy that has been downright oppressive from a saver's perspective – continuing to push longer term rates down in order to spark economic growth.

The problem with the lack of momentum in the US economy is not one of low interest rates: The level of interest rates have not been an impediment to growth for a few years now. It is uncertainty with regard to tax policy and the overhang of regulatory regimes in the financial sector (brought on by Dodd-Frank and other well intentioned legislation) as well as the manufacturing sector. It does not also help when the Administration appears to be pursuing policies that are patently anti-business nor does the heated rhetoric of class warfare.

The US Supreme Court opined in a split 5 to 4 decision that the Affordable Health Care Act (otherwise known by its more popular moniker Obamacare) would stand despite the unconstitutionality of the individual mandate. In essence, the Supreme Court managed to allow the status quo to continue, allowing Congress to essentially "tax" those that refuse to carry health insurance and yet bring under the larger purview of the Federal Government a sector that has not hitherto been known for its efficiency or its ability to deliver quality care to Americans at a reasonable price.

The Fed's moves to boost demand in the US economy have not been in isolation. Central Banks around the world (including those in China, India, Australia, the UK, and the European Central Bank) have taken measures to boost demand either by lowering interest rates or by extending quantitative easing. However, despite the number of moves around the world, the impact of such monetary policy actions has been felt less and less as markets continue to be in "risk-off" mode.

Europe's fiscal crises continue to drag on: Another summit came and went at the end of June (this is the Nineteenth such gathering of heads of government since the crisis began for those of us worried about government waste!) and not much has been resolved. With increasing chatter about promulgating a Europe wide bank deposit guarantee system and the European Stability Mechanism now allowed to contribute directly to bank capital (primarily Spanish banks so far) – it is increasingly clear that Europe will likely continue to "muddle through".

When thirteen original colonies banded together against a colonial power in 1776, each had its own economic fundamentals – some more agrarian than others, some clearly better off than others and some much smaller than others. Despite all their differences, they did have a common cause – a high ideal of "life, liberty and the pursuit of happiness". It wasn't all roses as the fledgling United States had a fiscal crisis on its hands in 1790.

It was up to Alexander Hamilton, the brilliant Secretary of Treasury at that time to solve the fiscal crisis: He proposed that the US would pay off debts incurred by all the colonies (despite objections from Virginia and other wealthy colonies which had managed to pay off most of their own debts) in full. In addition, he imposed tariffs on imports of certain goods and raised taxes on such consumables like whiskey. In a compromise worthy of a chess strategist he also acceded to move the capital of the young nation from New York (his hometown) to the banks of the Potomac River in Virginia.

While there does not appear to be an Alexander Hamilton among the current crop of European leaders it is abundantly clear to us that Germany as well as many of the wealthier nations will have to foot the bill to bail out Greece, Ireland, etc. Fiscal union is, in our considered opinion, a natural outcrop of a monetary one and once a fiscal union starts to occur, the political one cannot be too far behind. We are not suggesting that Europe's problems are behind it: Far from it. We do, however, see light at the end of the tunnel even though it might take years (if not a decade or longer) for all of this to come to fruition.

A word on earnings: Consensus bottoms-up earnings expectations as computed by Standard and Poors imply a gain of 1.3% for 2Q2012 (compared to 2Q2011). With expectations having come down significantly, we are yet again likely to see more companies beat their expectations than miss their expectations. While the ratio of pre-announcements (or warnings) to affirmations is a fairly worrying 3.1 to 1.0 (for those quantitatively minded), we remain of the opinion that this is a time-honored game that managements like to engage in.

Elsewhere, prices of gasoline have declined in the US providing a fillip to the beleaguered American consumer on worries about slowing demand for energy as global prices for both Brent and West Texas Intermediate crude oil have declined recently. In classic economic speak on the other hand (pun intended), prices of corn and sugar (among other agricultural commodities) have seen sharp increases recently bringing yet another specter of food inflation to the fore among market participants.

In summary, we continue to position your portfolios with mild optimism about the medium to longer term. While our worries about politics and policy uncertainty remain in the forefront, we do feel reasonably positive about the longer term prospects for financial markets. Indeed, our abiding faith in a fully diversified portfolio - that has a balanced approach to both risk and return - as the main way to attain favorable investment outcomes over the long haul remains steadfast.

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