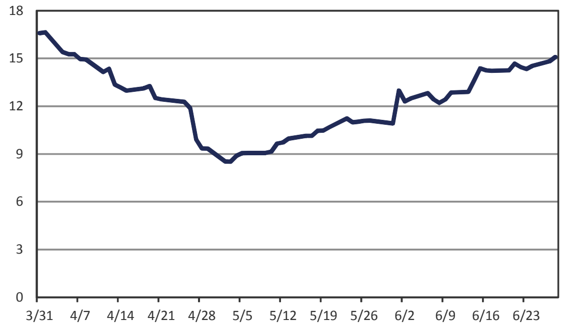
Economic and Market Outlook

Third Quarter, 2011

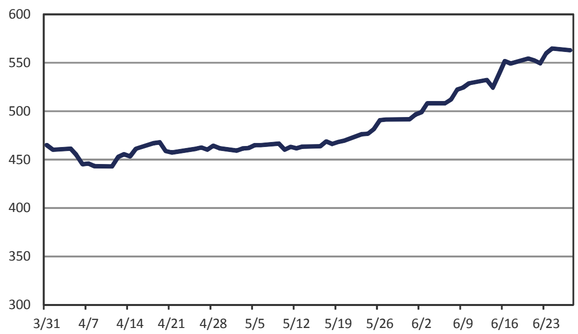
There is no doubt that the economy entered a soft patch sometime toward the end of the first quarter. The sputtering pace of the economic advance has stretched throughout the second quarter. As we enter the summer months the financial markets remain mired in the soft economic news. Volatility has increased sharply coincident with the loss of momentum, and risk based assets declined. (Figure 1) After a promising start to the year, stocks as well as high yield bonds retreated in the quarter. (Figure 2) High grade corporate bonds and especially US Treasures benefited from the flight to quality. (Figure 3)

Figure 1: S&P 30 Day Volatility



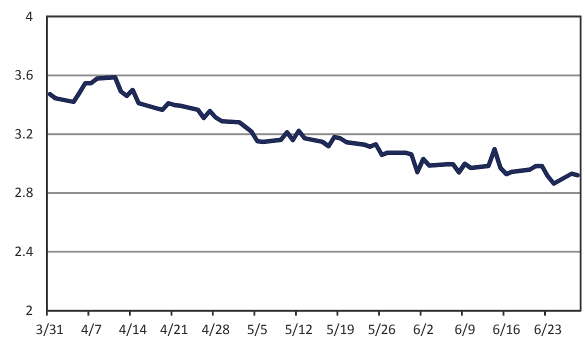
Source: Bloomberg.

Figure 2: Barclays High Yield Index



Source: Barclays Capital.

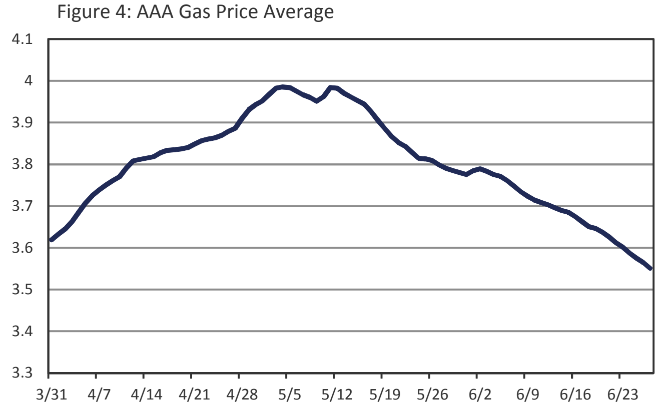
Figure 3: 10 Year U.S. Treasury Yield



Source: Bloomberg.

A confluence of factors contributed to the downbeat economic trend in the quarter. Most important among them was the rapid increase in the price of commodities especially gasoline, and the effects of the natural disaster in Japan on production and consumption. What has been described as the deadliest spring since the early 1950's also wore on consumer optimism. A record number of tornadoes and floods caused a temporary shut down of refineries and devastated crops in some areas. Adding to the onslaught of fears, NATO action against Libya commenced in late March, sending oil prices sharply higher. The national average retail price of gas shot up from $3.50 per gallon in early March to the peak of $3.98 on May 15. (Figure 4) Among other effects retail sales in the important Easter shopping period were muted, due in large measure to consumer worries about gasoline and food prices. Industrial and agricultural commodities prices acted in similar fashion.

Figure 4: AAA Gas Price Average



Source: Bloomberg.

The second quarter caught the full brunt of the perfect storm of earthquake, tsunami, and nuclear meltdown which crippled Japan on March 11. These tragic events tipped the world's third largest economy into an immediate and severe recession. The Japanese economy shrank 3.5% in the first quarter as all production and commerce ceased, and the courageous populace turned to the job of rescuing their country. The negative hit to production in the United States was immediate. Motor vehicle production fell 6.5% in April and 1.4% in May, a decline of 16% at an annualized rate relative to the first quarter. The number of workers filing for first time unemployment benefits surged in April because of lay offs at Japanese and American automobile manufacturers. A broad swath of other companies and industries domestically and in other industrialized nations were constrained by the curtailment of components from Japan.

Economists estimate that the disruptions subtracted about 1% from second quarter gross domestic product. There are signs, however, that the worst of the contraction is over. The Bank of Japan recently upgraded its assessment of their economy, and Toyota announced that automobile production will reach 90% of normal by the end of June and 100% by August. In the second half our economy will get a tailwind as production gradually returns to normal and lines of supply are restored.

Despite the overhang of disappointing economic news and ongoing angst about the budget impasse in Washington, there were some positive signs in the quarter. Durables goods orders increased in May and April orders were revised upward, taking some of the sting out of the poor New York and Philadelphia manufacturing surveys. Production ex-automobiles remains in positive territory and the Index of Leading Economic Indicators appears to be reaccelerating. Net exports of goods and services are in a strong expansionary phase as a result of the recent decline of the dollar. While a depreciating currency is certainly not an optimal long term policy it provides a clear boost to GDP in the current environment.

We believe a return to solid but moderate growth in the second half of 2011 is in prospect. The drag that higher gasoline prices had on consumer spending will abate as the price declines. Even before the announcement of the release of oil from the strategic oil reserve, oil and gasoline prices were receding. Industrial commodity prices too are sharply off their highs. Economic growth mainly in emerging economies is resuming, and will accelerate as disruptions to the global supply chains ease. An improvement in the labor market and in consumer incomes will come as the "soft patch" ends, and growth firms. While we remain committed to the view that interest rates will rise at some point, developments in the second quarter move the prospect of higher rates farther out. In our judgment rising corporate earnings and dividends and unusual low valuations will propel stock prices higher.

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Alfred A. Lagan, CFA, Chairman
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June 27, 2011