



## Current Conditions

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Several prominent issues have cast the financial markets into turmoil recently. It is appropriate to examine them to try to ascertain their affects on our economy going forward.

On Saturday, August 6<sup>th</sup> Standard & Poor's removed for the first time the triple A rating U.S. debt has held for over 70 years. This action was well telegraphed and long expected, but nevertheless threw the government into a state of confusion and panic. The Treasury Department immediately announced that it found a \$2 trillion error in S&P's math, prompting long time economic guru Larry Summers to remark "S&P's track record has been terrible and its arithmetic is worse". A Senate Committee announced it would hold hearings, not on the nation's debt, but on S&P. The weak response reverberated through the financial markets. While some continue to make light of it, S&P's action casts the spotlight on the massive rise in the government deficit since the recession started in Q1 2007 and the shadow it casts over our financial future. It is recognized by virtually everyone that something must be done to control the debt, either through tax increases, spending reductions, or cuts to entitlements. While the solution has not been arrived at yet the issue will ultimately be addressed, probably by some combination of all three.

More immediately, regional manufacturing surveys (New York and Philadelphia) have shown sharp declines in current business conditions and severe deterioration in their six month outlook also. This hurts, because regional manufacturing surveys have been firm all year. Business confidence has taken a serious hit as a result. The hoped-for recovery in housing has not yet materialized. Most other economic benchmarks corroborate a slowing economy, and guarantee that monetary policy will remain very accommodative.

The Eurozone sovereign crisis is another major psychological negative. The crisis is real, enormous, and seemingly intractable. However while the headlines make frightening reading, governments will continue to arrive at short term solutions until a more permanent financial response is found. There seems to be a growing acceptance by Germany and France that more financial integration to preclude serial crises is necessary. Ultimately, this will include the creation of euro bonds carrying the full faith and credit of the central bank in some form.

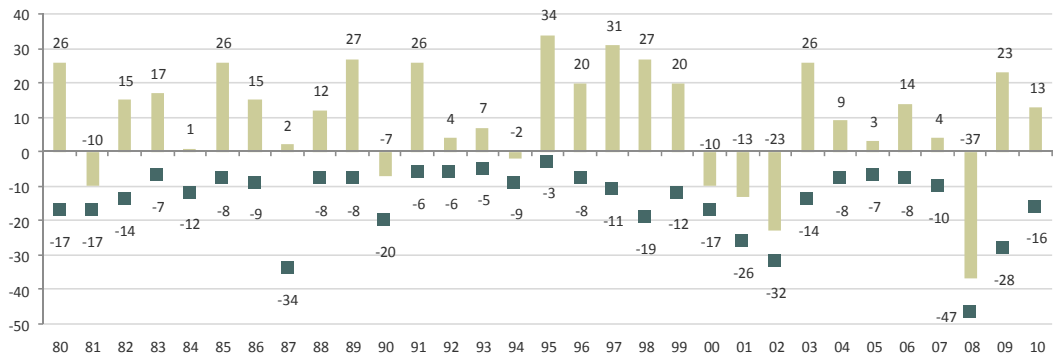
The negative surveys and soft economic reports are not necessarily conclusive, and there are mixed signals. The Index of Leading Economic Indicators recently reported is strongly positive. Japanese production has returned to pre earthquake levels. Restoration of the supply chain in Japan along with inventory replenishment will improve industrial production and help investor confidence. Various metrics of retail sales remain strong through mid-August and the four week average of initial unemployment claims is still in a downtrend. Withholding tax receipts are growing indicating a higher level of income. Finally, commodity prices have declined as has

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gasoline. As a result, the recent rise in consumer inflation is likely to taper off in coming months. Neither the negatives nor the positives are conclusive at this point, but negative psychology is clearly dominant.

When faced with a frightening situation and a feeling of powerlessness the natural inclination is to vote with your feet and leave the scene. Confidence of both business and consumers has been badly shaken. Investors have voted with their feet by selling the most liquid of risk based assets, common stocks. In our judgment this will prove to be a mistake in time. The chart below shows historical calendar year returns and intra-year market declines. Despite an average intra-year drop of 14.3%, the market ended up finishing in positive territory 24 out of 31 years. Last year, the S&P 500 Index returned 13%, despite declining 16% from April 15 to July 5.

Intra-year Declines vs. Calendar Year Returns (%)



Source: J.P. Morgan, Guide to Markets, June 30, 2011

By all financial metrics the stock market is extraordinarily cheap while bonds are expensive. Unless a serious and prolonged recession is around the corner corporate earnings and finances are and will remain strong. We remain firm in our conviction that high quality companies with excellent managements, finances and solid market positions will be excellent long term investments. In a world where deleveraging is an on-going theme there is more safety in this category of investment than in the bond market.

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