



## 2011 - 2ND QUARTER REVIEW AND PREVIEW

### Battling a Debt Hangover



#### BOB'S CORNER

##### Quick Review of the Past

As we finish the second quarter of 2011 and look back on our view of the market over the past 18 months, we were pretty spot on. When the markets bottomed in March of 2009, after a 57.1% drop from the top, we were shopping for bargains. We added to our already existing exposures (J.P. Morgan High Yield and Blackrock Equity Dividend) plus a couple of new great value plays (Alger Capital Appreciation and the emerging markets). We believed there would be a significant bounce and there was. From March 2009 to September 2009 the Russell 3000 was up 59%. Since December 2009, the market is up an additional 24%, but we believe the "New Normal" of slower economic expansion lies ahead. We have also warned of an increase in volatility and we have certainly been correct on that account, as we have seen an increasing number of days of greater than 1% gain or loss.

So, when we look forward and try to determine where the good values are, things really have not changed all that much over the last six months. The three uncertainties are still whether or not the economy can grow without stimulus, will corporate America start to hire and will we see the housing supply start to diminish. If we address those concerns honestly we can say there is good value in the market, but how good depends on how fast those issues are addressed. Be prepared for an extended period of volatility and slower growth!

#### MARKET OVERVIEW

##### Overview

Since the financial crisis exploded in the fall of 2008, we've seen governments in the U.S., China and Europe invest trillions of dollars to support their banking systems and re-start their economies. The result was as intended. Economic growth resumed worldwide as most stock markets have recovered most of the ground lost from the depths of the recession. In addition, corporate profits are at near record levels.

Yet the economy remains sluggish and the stock markets continue to be choppy in the first half of 2011. One of the key reasons why the economic recovery hasn't continued at normal levels is that a new challenge has developed – "How do we deal with all of the government debt incurred leading up to and following the financial crisis?"

The biggest headlines have come from Greece, where its relatively tiny economy remains mired in a recession while the government is forced to implement austerity measures. Greece is dealing with debt levels equal to twice the size of its economy. Other European countries face similar challenges that have yet to come to a head, such as Portugal, Ireland and Spain. All three are battling weak economies, high unemployment and crippling levels of government debt.

Debt issues are also taking center stage in the U.S as well. Much of the discussion centers on lifting the government's debt ceiling by the early August deadline. Not directly connected, but likely more crucial, is the need to address the long-term deficit and structural debt problems. This will include addressing the growing burdens of entitlement programs such as Social Security, Medicare and Medicaid and reforming corporate taxes and subsidy programs.

A key issue is how damaging could this debt hangover be to our future economic growth. We believe we will see slower growth rates in the years to come in Japan, Europe and the U.S. In the current environment, the consensus forecast is that growth in the U.S. in 2011 will be at 2.5%, about half of the 4.6% rate of growth the nation has averaged in periods of expansion since World War II.

#### ECONOMY

##### THE 2ND QUARTER

It appears that the U.S. economy's rate of growth slowed in the 2nd quarter. Final GDP growth in the 1st quarter was just 1.9% with 2nd quarter growth expected to be in a similar range. The ISM Manufacturing and Service Sector Indexes continued to show the economy expanding, but at a much slower rate than earlier in the year.

A large contributor to the slowdown was the cost of energy. Oil prices rose 30% from midyear 2010, eating into consumer's wallets and leading to a period of flat consumer spending. The earthquake and tsunami in Japan in March caused several supply and production disruptions for automakers and technology companies while regional economies were disrupted by floods, wildfires and tornadoes.

Yet business and consumer spending rose and job creation continued at a modest pace. Unemployment ticked up to 9.1% in May with economists estimating that the rate won't decline significantly until the economy can regularly create about 200,000 jobs per month, well above the average of recent times.

Inflation, as measured by the Consumer Price Index (CPI), rose 3.4% over the 12-month period ending in May due largely to the spike in energy prices. By June, oil prices began to fall modestly. Core inflation (items outside of the more volatile food and energy sectors) remains tame at a 1.5% annualized



rate. This is well within a comfort level for the Federal Reserve, which continues to hold the line on short-term rates at close to 0%. The housing market continues to battle falling prices as demand does not yet match the excessive housing inventory.

### **LOOKING AHEAD**

Consumers and investors still feel that we haven't escaped the recession. The recent slowdown in growth contributed to a sharp decline in consumer confidence surveys in June. Yet some numbers still indicate that the economy will rebound.

Energy prices fell in June, and the decision to release strategic petroleum reserves into the market should help moderate prices in the near term. Disruptions from Japan's natural disaster may also have passed as that nation's industrial production rose 5.7% in May.

We look for GDP growth in the 2% to 3% (annualized) range for the remainder of 2011. The U.S. economy is benefiting from strong export growth and moderating energy prices and could also give consumer spending a boost. Business investment might see a spurt to take advantage of tax incentives that expire at year's end. Continued low interest rates also should help boost consumer and business spending.

## **BOND MARKET**

### **THE 2ND QUARTER**

Bond markets benefited from a slowing economy and fears related to the global debt crisis. This was contrary to what many experts anticipated when the quarter began. Little value was seen in Treasury bonds at that time. But the perception that risks were on the rise changed their thinking and money flowed toward what are perceived to be safe havens. As a result, the yield on the 10-year U.S. Treasury note declined from 3.45% to as low as 2.87% during the second quarter.

Bond performance was strong across the board. The Barclays Aggregate Bond Index was up 2.29%. Treasury Inflation Protected Securities (TIPS) led the way with a return of 3.66% as rising inflation drew more investor interest. Government bonds gained 2.22%. Investment Grade Corporate bonds, Mortgage and Agency bonds, Municipal bonds and Global Government bonds all returned from 2.2% to 3.9% for the quarter.

Returns were mixed in the credit-related sectors. High-yield bonds gained just 1.04% during the period as corporate debt issuance increased. Emerging market bonds gained 4.03% as investors accepted higher risk for a yield premium.

### **LOOKING AHEAD**

We don't expect the surprising turnaround in interest rates to last. While the Federal Reserve will likely maintain short-term interest rates at low levels for, as it suggested, "an extended period of time," interest rates are prone to rise if economic news improves. While the Fed's active program to purchase Treasury securities has ended, it will still be reinvesting a significant sum in those securities for the near term.

Corporate, High Yield and Emerging Market bonds offer attractive yield spreads compared to Treasuries. While default rates in these sectors remain low, some volatility can be expected. Municipal bonds continue to provide attractive tax-equivalent yields to investors in higher tax brackets and there are signs that local tax revenues are improving. Other good opportunities can be found among Global Government bonds in markets outside of Europe and Japan.

Credit and capital markets still face the risk of the impact of the sovereign debt crisis in Europe. This issue will continue to play out through the rest of the year, but expect some short-term solutions to be in place by year's end.

## **DOMESTIC STOCK MARKET**

### **THE 2ND QUARTER**

Risk aversion was evident in equity markets through much of the 2nd quarter. Markets continued their positive direction through April, but took a sudden turn in May and steadily declined through mid-June before rallying again in the closing days of the quarter.

Investors focused on defensive industry sectors during the quarter. Health Care stocks gained 7.26%, supported by higher profits and fresh drug discoveries. Utility stocks rose 5.37% as investors sought out higher dividend payouts. Consumer Staple stocks also performed well, returning 5.55%.

Financial stocks lagged the market, losing -5.32% during the 2nd quarter as this sector continued to deal with a variety of problems leftover from the financial crisis. Energy stocks fell -4.74%, dropping significantly when oil prices began to decline in June. Slower sales growth led to a loss of -1.57% in Technology stocks.

Risk aversion was evident in the performance based on market capitalization. Mid-Cap stocks held up better than other segments of the market, as they eked out a 0.42% gain. Large-Cap Stocks rose 0.12% while the riskier Small-Cap stock sector lost -1.61%. From a style perspective, both growth and value stocks rose marginally at 0.64% and 0.68% respectively.



### Performance Update

Market Index	2nd Qtr	YTD	1 Year	2 Years	3 Years	5 Years
DJ Ind Average	0.09	6.37	32.37	23.70	4.04	3.59
S&P 500	0.10	6.02	30.69	22.29	3.34	2.94
Russell 2000	-1.61	6.21	37.41	29.20	7.77	4.08
S&P Mid-Cap 400	-0.73	8.56	39.38	31.96	7.82	6.60
<b>Russell 3000</b>	<b>-0.03</b>	<b>6.35</b>	<b>32.27</b>	<b>23.76</b>	<b>4.00</b>	<b>3.35</b>
MSCI EAFE	1.56	4.98	30.36	17.51	-1.77	1.48
MSCI Em Mrkt	-1.15	0.88	27.79	25.45	4.22	12.16
NASDAQ	-0.04	5.00	32.73	24.07	7.56	5.01
Barclays High Yield	1.05	4.97	15.63	21.07	12.68	9.30
Barclays US Agg Bond	2.29	2.72	3.90	6.66	6.46	6.52
Barclays Global Agg	3.10	4.35	10.51	7.72	6.04	7.10
Barclays US Gov	2.22	2.14	2.26	4.34	5.09	6.09
Barclays US Credit	2.50	3.41	6.20	10.36	8.23	7.01

While concerns about the state of the economy clearly affected investor perceptions, underlying factors remained strong. Corporate profits continue to outpace analyst projections and U.S. companies are sitting on an estimated \$1 trillion in cash. Merger and acquisition activity and new Initial Public Offerings are on the rise, also providing support to equity markets.

#### LOOKING AHEAD

Stocks appear to offer more opportunity. Corporate earnings should remain strong and valuations are attractive. Continued low inflation and interest rates should be beneficial. As previously stated, the key issue is how do we address the problems, and if we can keep the economy on track (new jobs).

Cyclical growth sectors such as Technology, Materials, Energy and Industrial stocks are positioned to benefit from increased export activity, and that should give Growth stocks an advantage over Value stocks. Dividend-paying stocks are well positioned as investors seek income-oriented investments in an era of ongoing low interest rates.

#### INTERNATIONAL MARKETS

##### THE 2ND QUARTER

Foreign markets lagged the U.S. again for the third consecutive quarter. Most major regions experienced modest gains as each region was forced to deal with its own challenges which dampened returns.

The European markets rallied toward the end of the quarter and ended up 2.44% with optimism of a Greek budget agreement. Germany and France remained strong with returns of 6.27% and 4.50% respectively. Japanese stocks scratched out a 0.18% gain as the economy continued to struggle to recover from March's natural disaster and nuclear meltdown.

Economic growth remains strong in emerging markets, in the 4% to 9% range. But some are struggling with dramatic jumps in food and energy prices. Central banks in Brazil, India and China have raised interest rates and increased bank reserve requirements in an effort to fight the inflation threat. As a result, Emerging Market stocks declined -1.15%.

#### LOOKING AHEAD

Europe's debt problems continue to create challenges. With few good choices available, it is hoped that a medium-term solution will be in place for Greece in the 3rd quarter. Ultimately, the European Union will need to provide support mechanisms and funding to help other weak nations overcome their budget challenges.

Japan will eventually experience a "rebuilding surge" in its economy to help get it back on track. However, this could be a long-term process.

Emerging market countries have managed to slow inflation rates for now but that issue will continue to be significant for them. Lower oil prices should help. We believe emerging markets still offer the best relative value to growth with fantastic long-term potential. Be prepared for continued volatility, however.

#### SUMMARY

As we indicated early in the year, "policy risk" – the potential of policymakers to make critical errors in addressing today's significant issues, has emerged as the most notable risk to ongoing economic recovery. We will be closely watching developments related to Europe's debt problems, budget battles in Washington and China's management of an economy that faces a severe inflation threat.

While "macro" events are moving quickly, underlying fundamentals indicate that this is a good time to be a long-term investor in equities. Earnings are growing, dividend payouts are rising, and inflation and interest rates remain near historical lows. What's more, valuation levels are well below historical averages. There is a window of opportunity to buy stocks at attractive prices, expect the markets to remain volatile even though there is solid, long-term upside potential. Remember, when fear is prevalent, it is a good time to buy for the long-term!



### Is There Value in the Market?

The first half of 2011 has been a series of ups and downs in the bond and equity markets, and the second half will assuredly have a few more surprises. As value managers, our investment philosophy focuses on pockets of value throughout the bond, stock, and alternatives markets. As the market ebbs and flows, certain asset classes, sectors and regions will look more or less attractive on a relative and historical basis. We continue to monitor our current asset allocation and sector positioning as new information becomes available. Below are a few thoughts on each investment class.

#### Fixed Income

Even though the U.S. treasury market has been very strong the past three months, we remain steadfast in our belief that there are more attractive opportunities in the fixed income universe. The fiscal soundness of many corporations is actually better than the United States government with the additional yield making the high yield market particularly of good value. For that reason we continue to be overweight in credit-related securities and underweight in U.S. government debt.

Today vs. Long-Term Avg	20+ Year Avg	Current
High Yield Bond Spreads	5.9%	5.7%
High Yield Bond Defaults	4.3%	0.8%

Sources: US Treasury, J.P. Morgan, J.P. Morgan Asset Management. Spreads are bond yields minus the 10-yr US Treasuries. Default rates are defined as the par value % of the total market trading at or below 50% of par value and include any Chapter 11 filing, prepackaged filing or missed interest payments.

#### U.S. Stocks

When you look at the U.S. stock market it currently shows that we are trading at levels that are below the historical 5, 10 and 15-year Price/Earnings ratios. Most companies have been able to improve their bottom lines over the past few quarters by becoming more efficient after the downturn in 2008. Less fat in corporate America has created a good value for equities. Many of these companies have also been increasing their dividend payouts as their cash balances have built up.

S&P 500 INDEX					
Valuation Measure	Current	3-Yr Avg	5-Yr Avg	10-Yr Avg	15-Yr Avg
Price to Earnings Ratio	12.4	12.9	13.5	15.2	17.1
Price to Book Ratio	2.3	2.1	2.4	2.6	3.1
PEG (P/E to Growth)	0.9	0.9	1.1	1.2	1.2
Dividend Yield	2.1%	2.3%	2.2%	2.0%	1.9%

Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Metrics used include: Price to forward earnings, price to current book, P/E to current growth rate, and price to last 12 months' dividends normalized using means & average variability over last 10 years

#### Foreign Stocks

Internationally we are seeing even better P/E ratios relative to historic norms. We believe there are still plenty of opportunities in the emerging markets as companies continue to prosper from the burgeoning middle class in these regions. These are the companies that exhibit outstanding revenue growth while they also continue to increase their relative market share.

Region	Current		10-Year Average
	Fwd P/E	Growth	Fwd P/E
World	11.6	12.4	14.2
Emerging Mkts	10.4	16.9	10.9

Source: MSCI, FactSet, J.P. Morgan Asset Management. Metrics used include: Price to forward earnings and EPS growth rate.

**Remember, when everyone is leaving the market based on fear, we want to be adding exposure where we still see good value!**

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