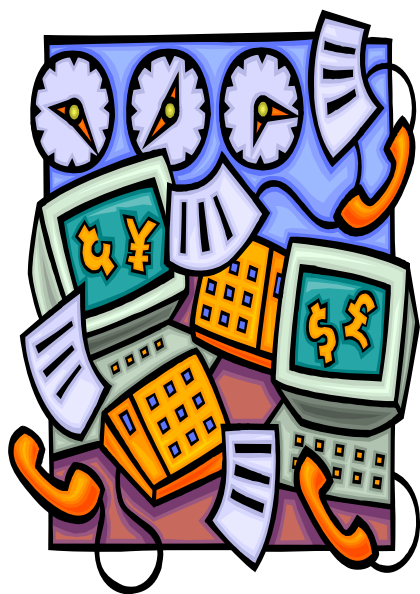


QUARTERLY REPORT

VOLUME 9, ISSUE 2 AUGUST 2011

UP AND DOWN, UP AND DOWN!

The second fiscal quarter demonstrated wide volatility as investors shifted allegiances between “risk-on” and “risk-off” positions. Fund flows between riskier equities and “relatively safer” fixed-income bonds nearly became circular as the world struggled with heavy economic, financial, political and social concerns. The ongoing structural weakness of the individual southern partner countries in the Euro remains a threat to both the Euro and the European Economic Community, as “contagion” to larger European economies such as Spain or Italy cannot be ruled out. The resiliency of the Japanese economy, as well as the Japanese people, in the face of the horrific tsunami and nuclear disaster, is laudable. Nevertheless, significant damage to transportation, infrastructure and manufacturing in Japan is affecting worldwide supply chains.



In developing countries we are seeing rising interest rates as central banks seek to rein in inflation and prevent overheating in their economies. China has raised interest rates three times this year in an effort to take some wind out of the housing market. Brazil and India are also raising interest rates in an effort to fight inflation in food prices. Of course, here in the US, we are repeatedly advised that core inflation or CPI is negligible and benign. According to Harvard Professor Niall Ferguson, inflation methodology “has been “improved” 24 times since 1978. If the old methods were still used, the CPI rate would actually be 10 percent!” What isn’t generally understood is that the Federal Reserve’s zero interest rate, QE1 and QE2 policies have inflated the stock market as well as worldwide commodities. With the ending of QE2, we are hopeful that the Fed will pursue a less inflationary policy. Alas, there are encouraging signs: worldwide economic growth is projected to grow at an annual rate of 4.5% for the remainder of the year; and, corporate profits, which drive stock market returns, are setting new all-time highs. We will fill in the detail on the second quarter and then add commentary about the debt ceiling debate, the S&P downgrade and recent developments.

Cordially,
Kathy Wimmer, CFA, CIC
President

KEY FACTS FOR 2011

- *Annual gift exclusion*
\$13,000
- *Estate, gift and generation-skipping tax exemption*
\$5 million
- *Highest marginal estate tax rate* 35%
- *IRA contribution limits*
\$5,000, plus another \$1,000 for those over fifty
- *SIMPLE IRA and 401(k) contribution limits*
\$11,500, plus another \$2,500 for those over fifty
- *401(k) contribution limits*
\$16,500, plus another \$5,500 for those over fifty
- *SEP IRA contribution limits*
25% of compensation, max of \$49,000
- *Top Federal tax rate is 35% on income over \$379,150*

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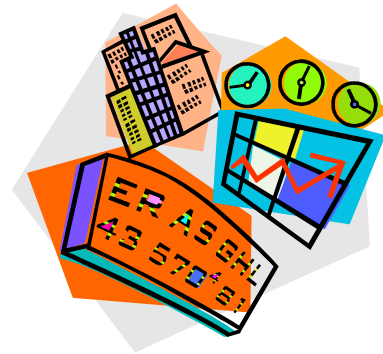
SECOND QUARTER 2011

The second quarter came and went, essentially leaving stock market investors where they started the quarter. Of course, the market didn't simply glide from one position to another. In fact, the second quarter saw many peaks and valleys, graphically illustrating the volatility arising from on-again, off-again concerns over European debt burdens. It seemed that on one day the German bankers were willing to let Greece sink into debt default, then the next day offer additional new financing. Greece, facing outstanding debt that exceeds its annual GDP by 160 percent, cannot possibly meet all of its debt obligations so its lenders have no choice but to offer concessions that will forgive much of the debt and roll-over the remaining indebtedness at lower interest rates with longer maturities. With the German banks finally agreeing to more lenient terms for the Greeks, the US stock market rose some 4% in the final week of the quarter. In fact, the two weeks following the Greek debt settlement showed the greatest stock market performance in two years!

While nearly 75% of US corporations have reported earnings for the second quarter as we go to press, it appears likely that US corporate earnings will reach all-time highs in the quarter. We attribute the positive earnings news to a moderate recovery in the economy and tight expense controls at the corporate level. Also, there is little promise for wage inflation when unemployment remains stubbornly high. In the latest Federal Reserve flow of funds report, corporate America demonstrated its strong liquidity with some \$1.91 trillion in corporate cash balances being reported. The high levels of cash are partly attributed to cash being held abroad from foreign operations which would otherwise be taxed upon repatriation to the United States.

Also, corporate treasurers remember when corporate debt markets seized up in 2008 and access to the corporate commercial paper market was impossible until the Federal Reserve stepped in. Federal Reserve Governor Edward Warsh further attributes large corporate cash holdings to "business caution due to geopolitical uncertainty, concerns about the sustainability of the recovery, and a more process-intensive regulatory and legal environment."

Investors continue to favor the bond market as inflows into bond mutual



funds far outstripped investments into equity mutual funds during the second quarter. Bond yields, like stock market returns, offered significant volatility as investors see-sawed between equities and bonds depending upon an ever-changing perception of risk. The 10 year Treasury yield rose from 3.47% at the end of the first quarter to a peak of 3.59% in April only to fall substantially to 3.18% at the end of the second quarter. It is striking to note that the Federal Reserve ended its second quantitative easing program (QE2) on June 30, 2011 and US interest rates did not rise. QE2 was a stimulus plan whereby the Federal Reserve periodically bought US Treasury issuances in an effort to drive down long-term interest rates. The conventional wisdom was that the cessation of the Fed's program would lead to higher long-term interest rates as demand for treasuries

would fall in the absence of the Fed's treasury purchases. We suspect sluggish economic growth in the US led to the drop in long-term bond yields as investors continued to put aside any serious concerns with future inflation.

Economic growth in the US in the second quarter was well below potential and sputtered to a rather unimpressive advance. According to the BEA, "real gross domestic product -- the output of goods and services produced by labor and property located in the United States -- increased at an annual rate of 1.3 percent in the second quarter of 2011, (that is, from the first quarter to the second quarter), according to the "advance" estimate released by the Bureau of Economic Analysis." In a rather dispiriting economic release, the BEA further revised downward the GDP growth rate for the first quarter to 0.4 percent. Of course, *any* growth in GDP is welcomed after the declines seen during the Great Recession.

According to the Institute of Supply Management (ISM), "The Purchasing Managers Index (PMI) registered 55.3 percent, an increase of 1.8 percentage points from May, indicating expansion in the manufacturing sector for the 23rd consecutive month. New orders and production were both modestly up from last month, and employment showed continued strength with an increase of 1.7 percentage points to 59.9 percent. Although manufacturing has seen headwinds from shortages arising from the Japanese tsunami and general concerns over rising commodity prices, manufacturers remain cautiously optimistic.

Core inflation, as measured by the consumer price index (CPI), rose 1.6% over the past twelve months ended 6-30-11 on a seasonally adjusted

SECOND QUARTER 2011 (CONTINUED FROM PAGE 2)

basis according to the Bureau of Labor Statistics. This was the highest rate in a year and a half. The core inflation figure excludes volatile inputs such as food and energy. Economists prefer using the core inflation rate as it excludes volatile food and energy prices while consumers prefer the empirical nature of the headline inflation rate which was 3.60% for the same period and better reflects the actual costs to consumers.

Housing showed signs of life as indicated by the most recent release (July 26, 2011) of the Case-Schiller Home Price Index. Both the ten and twenty city indices saw the second consecutive increase in monthly home prices. Only Detroit, Las Vegas and Tampa saw monthly price declines. Of course, seasonal adjustments are normally expected with summertime home sales regularly higher than springtime. Further reflecting a

modest improvement in housing is the Commerce Department's June housing start figures which were up 14.6% on a seasonally adjusted annualized basis. This is the highest level since January of 2011. These data points do not indicate a double-dip recession waiting in the wings!



LOOKING FORWARD

(SEPARATING FEAR AND PANIC FROM REALITY)

*"Facts are simple and facts are straight
Facts are lazy and facts are late
Facts all come with points of view
Facts don't do what I want them to!"*

*Byrne, Eno, Harrison, Weymouth and
Frantz*

The American Public, having suffered through the debt ceiling crisis and media-fed frenzy over the US credit rating downgrade by S&P (a rating agency which itself has a tarnished image after its designation of subprime junk mortgage bonds as AAA in the 2000s), can be forgiven for having a sense of dread over economic prospects. Some pundits are predicting a double-dip recession for the United States and blaming intractable differences in Congress for a declining economy. It appears that the psychological underpinnings of fear, gloom and panic are in place to create a self-fulfilling decline in the equity market. As we go to print, the equity markets have gone topsy-turvy throughout the global marketplace in the immediate aftermath of the debt ceiling debate and S&P downgrade of the United States' sovereign debt. Contrary to the talking heads on television, we do not attribute the volatile drop in the stock market to a lack of

confidence in the federal government's ability to meet its obligations. We do recognize that investors are likely spooked by hysterical reporting in the media but we aren't buying the current themes of inevitable decline and economic malaise for the United States.

An objective test of the direct effect of the US credit rating downgrade by S&P would be the actual cost of borrowing. After all, market mavens have insisted that the cost of borrowing for the US, mortgage-holders, etc. would rise as a result of the downgrading. Well, well! The actual cost of borrowing for the United States **dropped** on the first trading day after the US downgrade. The yield on the 2-year note was down 4 bps to 0.24%, the yield on the 10-year note was 19 bps lower to 2.37% and the 30-year bond rate declined 15 bps to 3.70%. So, instead of the US downgrade driving borrowing costs up, the market decidedly lowered US borrowing costs reflecting investors' faith in the US Treasury while belying concerns over equity risks.

We attribute the stock market's recent volatility and decline to the following

in order of magnitude:

Europe's financial woes appear to be spreading from small countries, e.g., Greece, Ireland and Portugal to large countries, e.g., Italy and Spain. The European Central Bank (ECB) can readily manage its smaller members' debt issues but is ill-equipped to manage any potential run from the debt of its larger members. Moreover, it appears that Europe's banks are vulnerable to potential losses stemming from loans to dodgy sovereign countries. In recent weeks, US money funds have stopped investing in European banks' short-term debt which has forced the banks to seek liquidity through any means possible, including the wholesale liquidation of global stocks.

Global growth has clearly hit a "soft patch" and US growth has moderated in the face of high global commodity prices and weak US consumer demand. The US is undergoing a process of "deleveraging": the personal savings rate climbed to 5.4 percent in June, compared with 5.0 percent in May. In contrast, the personal savings rate declined to the 1.0-2.8 percent range in the three year period, or bungee, leading



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We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

LOOKING FORWARD (CONTINUED FROM PAGE 3)

up to the 2008 financial crisis. Only through savings or payment default can the US dig itself out of an overleveraged state!

Food and fuel price inflation has damped US consumer demand for discretionary purchases, leading to lower overall economic growth. Additionally, unemployment and loss of unemployment benefits (as individuals fall out of the workforce) are obvious impediments to healthy consumer demand. However, the latest US unemployment rate improved with a decline to 9.1%, which is down from the 10.1 percent peak in 2009.

The central banks of developing countries are raising interest rates in an effort to cool "overheating" economies and reign in inflation. Worries that China, India and Brazil will see slowing economic growth is frightening low growth developed countries into thinking that worldwide economic growth will sputter to a stop. In fact, the IMF projects a healthy 4.5% worldwide growth rate in GDP.

In summary, we do not believe that recent volatility in the stock market necessarily portends a double-dip recession. Nobel laureate Paul Samuelson famously noted that "the stock market has predicted nine out of the last five recessions."



The negative, or inverted, yield curve may be a more accurate predictor of recessions than the stock market. The negative yield curve is an interest rate environment in which long-term debt

instruments have a lower yield than short-term debt instruments of the same credit quality. Inverted yield curves have preceded many US recessions and are rare compared to the other types of yield curves, the normal yield curve and the flat yield curve.

On August 9, 2011, The Federal Reserve announced that it expects to keep short-term rates near zero through mid-2013. This Fed announcement was historic: it is the first time that the US Federal Reserve has ever included a specific date in an FOMC interest rate policy statement. The Fed statement that pledged two more years of near-zero interest rates was warmly received by the US stock markets, which experienced their largest single day gains in two years. Given the Fed's near-zero interest rate pledge and the high improbability of US long-term rates falling below zero before 2013, we do not expect to see an inverted yield curve or a double-dip recession!

Disclosure: "Be careful about reading health books, you may die of a misprint." Mark Twain Keep that in mind as you read these articles. We obtain data from sources we believe are reliable but they should not be relied upon for making life-changing decisions.