

Client Briefing

DJIA 10135*NASDAQ 2128***S&P 500 1054****August 24, 2010**

Although August is frequently a fairly sleepy month in US financial markets, this time around August is not living up to its usual billing. Rather, thanks to excessive amounts of uncertainty about the current and future prospects of the US economy, the global economy (particularly Europe, China, and Japan), the Middle East (Iran, Afghanistan, Pakistan, Iraq), and the upcoming mid-term elections, this August is anything but boring. Heightened equity market volatility within a somewhat range-bound market and record low yields on US treasuries illustrate the angst and frustration many investors are feeling.

According to the Merriam-Webster Dictionary, something is “uncertain” if it is “not known beyond doubt”. Synonyms for “uncertain” include inconsistent, fickle, unsettled, and mercurial. Unfortunately, these words and phrases rather accurately describe the current state of the US economy, or at least how many people, including the experts, now view the US economy. There are, we believe, several reasons why the uncertainties of late are so pervasive and almost overwhelming. These reasons include:

1. Unrealistic and/or unfulfilled expectations: Just about a year ago, economists and market analysts began to suspect the recession that began in December 2007 had ended. Economic forecasts began to get rosier, corporate earnings picked up, and US equity markets responded by rebounding impressively. Even though the US economy continued to face incredible headwinds in its march on the path toward full economic recovery, consumer confidence rebounded and the generally dour mood that pervaded the country seemed to lift. Along with some better economic data came higher expectations for the not too distant future. Encouraging statements and predictions by some economists and politicians helped buoy the national sentiment even further.

Fast forward a year, to now, and many of these hopes and expectations remain unfulfilled. In many respects, and because consumer confidence and sentiment have turned negative again, it almost feels like the economy

is moving backwards instead of where it continues to move – forwards. The US economy faces persistently high unemployment, tepid job growth in the private sector, a massive overhang of unsold homes, high mortgage default and foreclosure rates, rising deficits, and the prospect of slower economic growth at least for the remainder of this year. This turn of events has left many Americans feeling “once bitten twice shy”.

Disappointed expectations aside, there are many reasons why the US economy is not recovering as quickly as once expected. First, the early stages of the recovery were fueled, in part, by pent-up consumer demand for goods and services, corporate inventory rebuilding, and cost-cutting efforts. Over time and as expected, the impact of these variables waned. Pent-up consumer demand has eased, inventories are now mostly rebuilt, and corporations have done about all the cost-cutting they can do. The positive impact of numerous government stimulus programs further helped boost economic recovery and contributed directly to GDP growth this past year. Now, however, the economy is functioning with far less stimulus support than it did at this time a year ago and economic growth, while still positive, has slowed. This is normal and not surprising. Also, this hopefully temporary slowdown should ease as the economy gradually fills in for the declining stimulus programs and begins to function better on its own.

Second, the housing industry has not pulled its own weight during the economic recovery. Of the eight recessions since 1960, in all but the current one, the housing industry helped lead the US economy out of recession. According to PMI Group, Inc. (a California based mortgage insurer), single-family housing starts and new home sales generally begin to pick up about seven or so months before an economic recovery gets underway. This time around, however, new home sales and housing starts remained sluggish during the first half of 2009 and continue to act as a drag on the economy.

Third, consumer spending – which represents a significant portion of US economic activity – remains con-

strained by ongoing deleveraging efforts, limited access to loans, falling home prices, little, if any wage growth, and high unemployment.

2. Divided expectations: There is great concern about and confusion over the current state of the US economy and its prospects for the remainder of the year and into 2011. Probably the greatest source of uncertainty and frustration is the ongoing lack of any mainstream consensus as to where the US economy might be headed. Some economists believe deflation is coming or even here while others worry that hyper-inflation is on the horizon. Six or so months ago – when the US economy appeared a bit rosier than it is now – many investors and market analysts presumed the recession had ended during the summer or fall of 2009. Indeed, the US economy has put together four straight quarters of GDP growth over the past year – a feat which, under “normal” circumstances would indicate the recession already ended. However, because US economic growth is slowing and the traditional engines of economic recovery remain dismally weak, the current circumstances are not so “normal”. At this point, some economists are beginning to wonder whether the US economy really ever emerged from recession last summer while others are starting to suggest that a relatively rare double-dip recession may be on the radar screen.

Even members of the Federal Reserve Open Market Committee are divided in terms of their views on the current state of the US economy and appropriate monetary policy. Thomas Hoenig, the President of the Kansas City Federal Reserve Bank, cast a dissenting vote at the August 10th meeting and stated he believed “the economy is recovering modestly, as projected.” Several days later, in a speech to the Lincoln, Nebraska Chamber of Commerce, Mr. Hoenig further elaborated on this position saying “I believe that zero rates during a period of modest growth are a dangerous gamble.”

The second quarter corporate earnings season is almost complete and it too contributed to this general sense of economic confusion. Despite lots of fairly negative economic data of late, second quarter 2010 corporate earnings were fairly strong. As of this writing, 75% of the S&P 500 member companies who have reported earnings thus far reported upside earnings surprises. Only 15.6% reported negative earnings surprises. This data compares quite favorably to the past several years when there were fewer positive earnings surprises and more negative earnings surprises. Also, US corporations now have almost \$3 trillion in cash – cash that is

likely now fueling the heightened mergers and acquisition activity of late.

3. The role of government: There are three growing concerns regarding the US government and the economy. First, there seems to be an emerging sense the US government does not actually possess the power it needs to truly heal the US economy. In other words, the government, through its various machinations, may not be able to fix the problems and what the economy truly needs is simply time and the room to operate as a “free market”. Second, there appears to be a developing sense the US government is becoming more disengaged from its citizens. The danger in this scenario is the possibility that Americans lose faith in their government. Third, the US government is growing rapidly and quickly moving towards implementing many additional layers of bureaucracy, regulations, and taxes. This last item injects vast amounts of uncertainty into corporate boardrooms and “mom and pop” operations countrywide. This is likely why hiring remains sluggish and corporations are holding onto their cash.

4. Lack of control – overseas political and economic conditions: Financial markets do not like uncertainty. Uncertainty makes investors nervous, causes individuals and businesses to act conservatively, and ultimately has the power to stifle economic growth. While some amount of uncertainty always exists, too much uncertainty is painful and counter-productive. Right now, US financial markets are grappling not only with domestic economic pain but also with the economic woes of Japan and most of Europe, the uneven growth of China, the potential fallout of a nuclear Iran, the vast flooding of Pakistan, and the war against the Taliban in Afghanistan – all sources of great uncertainty.

Because massive uncertainties continue to rule the day, we still recommend adhering to a conservative and value-oriented approach to equity investing with a focus on dividend-paying equities issued by high-quality companies with experienced management and strong balance sheets. We still think Procter & Gamble (PG), Emerson Electric (EMR), Microsoft (MSFT), Intel (INTC), Home Depot (HD), Johnson & Johnson (JNJ), Automatic Data Processing (ADP), AT&T (T), and Genuine Parts (GPC) offer investors good value and growth potential. Because we expect emerging economies, including India and China, to serve as strong engines fueling global growth over the coming years, we think it makes sense to increase international exposure in portfolios via exchange traded funds.

NOTE: The information herein has been obtained from sources we believe to be reliable but is not guaranteed and does not purport to be a complete statement of all material facts. This report is for information purposes and is not a solicitation of orders to purchase or sell securities. Officers or employees of Burke, Lawton, Brewer & Burke, LLC and their families may own or have a beneficial interest in the securities mentioned and may buy or sell these securities from time to time. Additional information on any securities mentioned above is available upon written request. Past performance is no guarantee of future results and no forecasts can be guaranteed. Also, the information contained herein is subject to change at any time.