

### **LB&C Market Update**

The downgrade of the U.S. credit rating had no impact in the short-term on investors' willingness to buy U.S. Treasury securities. At a time when riskier assets were sold with a vengeance, investors have driven the yield on the 10 year Treasury down to 2.21%. U.S. stock volatility has surged even higher, as stocks fell sharply then recovered some of the decline, as the Federal Reserve Bank confirmed they would not move to increase rates for a two year period of time. The European Central Bank had some success initially in bringing down the interest rates across Italy and Spain, but markets are looking for confirmation that the plan will effectively moderate concerns over these European debt issues and shore up other issues such as the rating on French debt.

Despite very strong earnings results in U.S. companies (second quarter S&P 500 company earnings were up 17% year-over-year on the strength of a 10% rise in revenues), markets are now anticipating a decline in earnings growth. Based on current prices the U.S. equity market is expecting S&P 500 company earnings closer to \$80 than the \$90-95 that seems more likely this year. Valuations on trailing estimates are attractive at 13X (versus a long-term average closer to 15X). While we still do not view a recession as the base case, we do believe this risk has increased and markets will likely remain under pressure if the expectation of a recession escalates. But, if it becomes evident that muted growth should continue and a recession is not likely, equities will provide attractive returns from these levels over longer periods of time. This is confirmed by our internal indicators which now show a high probability of above average equity returns over the next twelve months.

Last year when markets were oversold in the summer, we added to equities in most client portfolios. At that point, we had a higher level of conviction in earnings expectations, economic reports that showed less risk of a significant economic slowdown, and European policy makers who were dealing with sovereign debt concerns in smaller European economies, not in Italy and Spain.

While each client portfolio is unique, our broad plan at this time is to maintain liquidity reserves where they are required. In addition, we will stay with our current positions where company stocks and funds meet our process disciplines while we evaluate the probability of growth continuing and the economic impact of any market disruptions. If a recessionary period unfolds equity markets are likely to trade off of lower normalized earnings values. In this scenario, we would look to have discussions with clients about using this opportunity to rebuild equities weightings with attractively priced stocks. Currently equity markets are reaching extreme oversold levels that have historically led to temporary rebounds. Should a rally occur in the near future, we will evaluate the conditions at the time and may further lower risks in portfolios on a tactical basis. Markets that suffer the degree of correction that we have just experienced rarely turn quickly and go straight back up, but rather establish a trading range for a number of months while investors digest new data points and mitigate risk averseness.

Primary points we are monitoring:

European interest rate spreads as a determination of how aggressively European institutions are supporting the Spanish and Italian debt markets.

Global economic data points which currently point to a slowdown, but not a recession.

The weakening in commodity prices which can remove one of the major issues that led to the current slowdown. Oil prices in the U.S. had corrected from \$115 to \$80 or less. Lower commodity prices should help alleviate the fear of

inflation, lead to less central bank tightening and ultimately pave the way for interest rate reductions across many emerging markets.

We are experiencing a classic form of investor capitulation as our Federal government is being forced to seek a resolution to fiscal irresponsibility at the same time that economic growth and earnings expectations have come into question. We hold out hope (but not conviction) that the downgrade may serve as a wakeup call to government officials in Washington to recognize the need to use this shock to the nations' psyche to unify the country around a common vision and a renewed sense of purpose.