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July 2011 Market Update

Presented by Investment Partners, LTD

Quarter-end rally erases many recent losses

The quarter saw renewed volatility for equity investors, as markets reacted to political and economic news from around the globe. Markets sold off going into June, on renewed fears of a Greek debt default and evidence that the U.S. recovery had slowed. They rallied, however, on both technical and fundamental factors in the last four trading days of the quarter. This left the S&P 500 Index positive for the quarter, with a gain of 0.10 percent, despite a modest 1.67-percent loss in June. The Dow Jones Industrial Average gained 1.42 percent for the quarter and lost 1.10 percent in June. Despite the market selloff, both indices ended the quarter comfortably higher for the year, with the S&P 500 up 6.02 percent and the Dow up 8.59 percent.

Global markets also had mixed results, in part because of geopolitics. The MSCI EAFE Index was down 1.25 percent in June, but is up 4.98 percent for the year. Emerging markets, as measured by the MSCI Emerging Markets Index, have disappointed investors, losing 1.86 percent in June and 0.45 percent since January 1.

Interest rate volatility rises

Fixed income investments performed well during the quarter, but volatility rocked interest rates at the end of June. For most of the quarter, a fairly steady downward trend in 10-year Treasury yields prevailed, from an early April high of 3.57 percent, to a low in late June of 2.87 percent—a substantial move. But yields snapped higher in the last four days of the month, closing the quarter at 3.15 percent, still historically low but up from earlier in June.

Fixed income investors were hurt in June, as the Barclays Capital Aggregate Bond Index lost 0.29 percent. For the quarter, the index was still up 2.29 percent because of the overall move lower in longer-term rates. Risk-taking investors saw mixed results from the Barclays Capital U.S. Corporate High Yield Bond Index, which lost 1.64 percent in June, in part due to the downturn in equity markets earlier in the month.

The drop in rates surprised some market strategists, who had believed that the end of quantitative easing (i.e., QE2) would increase the supply of Treasuries, pushing prices lower and yields higher. Instead, yields moved lower in anticipation of the end of the program. Despite its termi-

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nation of QE2, the Federal Reserve has indicated a desire to keep rates low for “an extended period,” reaffirming its commitment to bolster economic growth.

Economy—in a holding pattern

In the first quarter, manufacturing took the lead while housing lagged. But in the second quarter, manufacturing slowed and housing didn’t look quite as bad, leaving the economy in slow-growth limbo.

The Case-Shiller 20-City Home Price Index rose 0.66 percent in April, the first such increase since the new homebuyer tax credit in spring 2010. On a seasonally adjusted basis, it fell just 0.09 percent. Despite these signs of stabilization, housing remains very depressed, with new home sales near their lowest levels since recordkeeping began in 1963. Nevertheless, steadier prices could eventually begin to support the market and signal a bottom.

ISM Manufacturing fell from 61.2 in March to 53.5 in May but rose to 55.3 in June. Any number above 50 indicates expansion. Several regional manufacturing indices also suffered setbacks, with some indicating outright contraction; however, a few caveats can make the picture look less bleak. First, the earthquake in Japan temporarily disrupted manufacturing activity. Second, manufacturing growth tends to rebound during a recovery and slow as recovery matures. Finally, durable goods orders have continued to trend upward since March 2009.

Job market indicators haven’t been as encouraging. The unemployment rate increased from 8.80 percent in March to 9.10 percent in May, and average weekly jobless claims jumped from 404,230 in the first quarter to 428,583 in the second. In response, consumer confidence lost steam, falling from 63.8 in March to 58.5 in June.

First-quarter gross domestic product (GDP) grew 1.90 percent. Though not inspiring overall, growth did come from important areas such as personal expenditures and business investment in inventories. On the other hand, weaker government spending detracted. Lower consumer and manufacturer confidence could hamper second-quarter GDP, but, even with these headwinds, the consensus among Bloomberg analysts is that GDP will grow 2.30 percent.

Greece and its debt

Greece has been a central concern for global markets, although it makes up only a small percentage of global GDP. The country has a staggering amount of debt and can’t meet interest payments. Rather than allow a default, the European Union (EU) has agreed to a second bailout, but the consensus required to negotiate these bailouts has created rifts among EU nations.

One stipulation of receiving the bailouts is that Greece must implement austerity measures. This has angered Greek citizens and led to social unrest. Prime Minister Papandreou managed to get approval from the Greek Parliament to put these measures in place, but the bitter wrangling needed to achieve the goal suggests approval of further measures may be difficult.

All of this has contributed to market volatility. Other EU nations (i.e., Ireland, Portugal, and Spain) face high levels of debt and may need help. Many European banks hold large amounts of sovereign debt. Investors fear that, if there were a sovereign default, the banks would suffer.

MARKET COMMENTARY (CONT.)

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Of equal concern may be the public debt here in the U.S. The government has pushed up against the federally mandated debt ceiling and cannot borrow more unless the ceiling is raised. Because roughly 37 percent of last year's budget was financed through borrowing, the ability to issue debt is essential to keep the government running. Default is unlikely, but the situation could lead to a partial shutdown of nonessential government services and benefit payments.

Congress will almost certainly raise the debt ceiling—it has done so 78 times. But partisan battles over how to reduce the deficit are likely. As with many uncertain outcomes, we may see heightened market volatility, given the potential implications of not raising the debt ceiling.

Diversification can reward investors

The second quarter saw an escalation of geopolitical concerns, particularly with regard to European debt. Renewed market volatility reminded investors of the importance of keeping a sharp focus on risk and of recalling the lessons of the past. Markets will fluctuate over time, but with well-diversified portfolios, long-term investors are better positioned to weather volatility and increase the likelihood of predictable investment results.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Free Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. It excludes closed markets and those shares in otherwise free markets that are not purchasable by foreigners. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.*

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