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August 2011 Market Update

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Debt debate looks to be resolved—for now

Markets don't like uncertainty, and the ongoing debate about raising the debt ceiling has provided a large dose of doubt and confusion. Though Republicans and Democrats reached a tentative agreement to avert an immediate crisis, they failed to agree on enough spending cuts or tax hikes to permanently reduce the national debt. At least their last-minute deal will lift the debt ceiling and implement some fairly significant requirements for forthcoming spending cuts.

All of this has happened under the watchful eyes of the ratings agencies, which have threatened to downgrade U.S. debt for the first time in history. The critical element at play here was that the government needed to enact a plan before the August 2 deadline cited by the U.S. Treasury Department. This prompted an extremely busy and tense few days, as Congress and the president worked to hash out a plan over the last weekend in July. Some investors had worried that the government might forego paying interest on its debt—in other words, default—if a compromise had not been reached. The more likely scenario, however, would have been a deferment of government expenditures. At the moment, it looks as if both possibilities have been avoided.

Downgrade is still a possibility

Ratings agencies have been particularly interested in this debate and have stated that the AAA rating for the United States is at risk. Despite passage of the debt ceiling bill, a downgrade is still a possibility if rating agencies believe that the compromise lacks sufficient fiscal controls.

The outcome of a downgrade is unclear, as it would be the first time that the U.S. did not command a coveted AAA rating. Some investors, for example, might be required by mandate to sell Treasuries because they would be rated below AAA. Forced selling, however, would likely be limited. The more significant effects would probably be on treasury yields. A downgrade could cause heightened volatility in bond markets.

Despite these legitimate worries, it is worth keeping in perspective that U.S. public debt and deficits are still substantially lower, as a percentage of gross domestic product (GDP), than those of other nations (see Figures 1 and 2).

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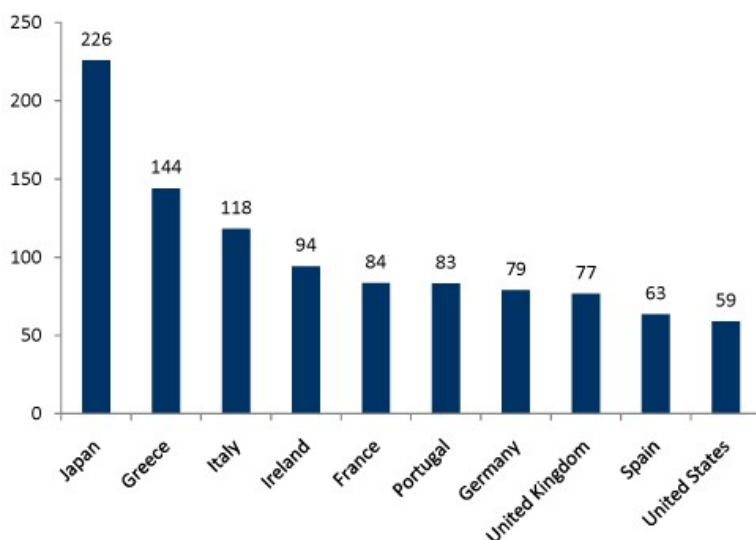
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419 W. High Avenue | New Philadelphia, OH 44663 | 330-308-9707
5775 Perimeter Dr., Suite 230 | Dublin, OH 43017 | 614-761-9087
212 N. Washington St. | Millersburg, OH 44654 | 330-674-5070
7325 Production Dr., Suite C | Mentor, OH 44060 | 440-266-0928

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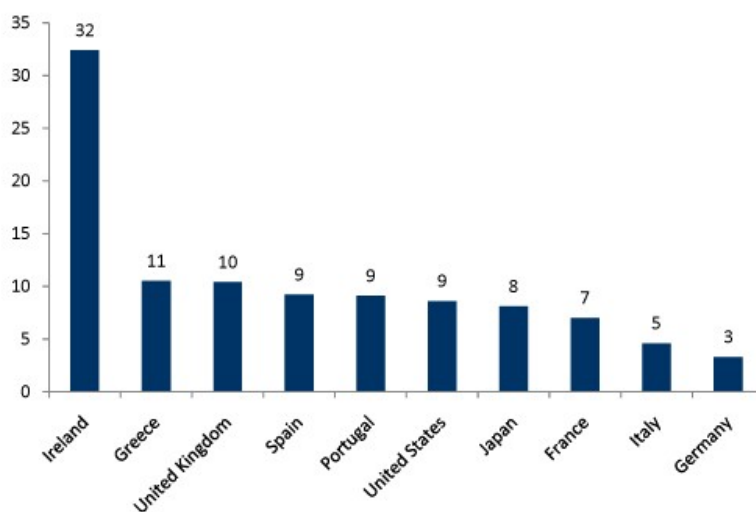
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Figure 1: Public Debt: Percent of GDP in 2010



Source: CIA World Fact Book (Figure represents cumulative total of all government borrowing less repayments denominated in a country's home currency.)

Figure 2: Budget Deficit: Percent of GDP in 2010



Source: Bloomberg

Volatility in equities persists

As noted previously, markets react negatively to uncertainty; so, not surprisingly, the last week of July was the worst for domestic markets since July 2010. The S&P 500 Index lost 3.37 percent for the week, though the month was slightly better, showing a 2.03-percent loss. The Dow Jones Industrial Average lost 3.57 percent for the week ending July 29 and was 2.05 percent lower for the month.

Markets have definitely been more volatile, as evidenced by the VIX, which spiked nearly 5

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points higher during the last week of July, ending at 25.25. The last time the VIX was at these levels was during the sharp selloff in March 2010.

International markets have also struggled, affected by further concern over the ongoing Greek debt situation. Another deal brokered by the European Central Bank, and sponsored in large part by Germany and France, helped avert systemic problems for the time being. But markets responded with continued skepticism. The MSCI EAFE Index lost 1.59 percent for the month while the MSCI Emerging Markets Index dipped 0.74 percent for the same period.

Bond markets face uncertain times

Fixed income markets saw their share of volatility, as the uncertainty in Washington intensified. There was substantial buying in 10-year Treasuries at month-end, pushing yields down to 2.79 percent from 3.16 percent at the beginning of the month. This left the Barclays Capital Aggregate Bond Index up 1.59 percent for July. Riskier assets also gained during the month, with the Barclays Capital U.S. Corporate High Yield Bond Index moving 0.47 percent higher on a price return basis and 1.16 percent on a total return basis.

The outlook for Treasury yields is unclear, given that there is the potential for a downgrade of U.S. sovereign debt. On the one hand, the textbook expectation is that investors should demand higher yields because of higher theoretical default risk. On the other hand, fears that spending cuts may hinder economic growth could cause a “flight to safety” and drive yields down instead.

Economic fundamentals steady but weak

The U.S. economy continues to struggle. Manufacturing remains positive but has slowed considerably since the beginning of the year. The unemployment rate is still elevated, at 9.20 percent.

A troubling development in late July was the release of initial GDP growth estimates of only 1.30 percent for the second quarter of 2011; a downward revision of first quarter GDP from 1.90 percent to just 0.40 percent was published at the same time. Previously, the Bureau of Labor Statistics had estimated that inventory growth had contributed 1.31 percent to first-quarter GDP. But, after receipt and processing of all the data, it turns out that inventory rebuilding contributed only 0.32 percent.

As for what held back growth in the second quarter, weak consumer spending was a major factor. In particular, sales of motor vehicles and parts detracted 0.65 percent from headline GDP. There is some evidence that the earthquake in Japan may have slowed inventory buildup in the first quarter and hurt consumer spending on automobiles in the second quarter. But, despite this mitigating factor, it is clear that a robust economic rebound hasn't materialized so far.

Although still in the doldrums, the U.S. housing market showed some signs of stabilizing, after the seasonally adjusted S&P Case-Shiller 20-City Home Price Index was revised upward. The index showed home prices rising 0.44 percent in April and falling only slightly in May. It is far too early to call this a rebound, but the data may at least suggest that the worst in terms of price declines is over.

MARKET COMMENTARY (CONT.)

The outlook for investors

To be certain, markets have navigated uneasy times before. Because much of the current confusion has been created by Washington, it is no surprise that Congress enjoys one of the lowest approval ratings in its history. Still, for investors in risky assets, uncertainty is to be expected. Reacting to short-term market swings can be a challenge, given that rallies and selloffs are difficult to predict. As a result, we believe that investors who stay the course and follow a disciplined process are positioned to experience better portfolio outcomes.

***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.*

Authored by Simon Heslop, CFA[®], director of asset management, at Commonwealth Financial Network.

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