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WEALTH ADVISORS

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COMMENTARY

“When you come to the end of your rope, tie a knot and hang on.” – Franklin D. Roosevelt

Another volatile quarter has officially concluded. The market was fraught with waning economic data, a second Greek bailout and concerns of a U.S. federal government shut down, but closed on a high note to keep the bull market rally largely intact. The U.S. economy showed signs of a general slowing or soft patch on continued weakness in home sales, a drop in durable goods orders, worsening unemployment figures and a corresponding drop in consumer confidence. This culminated in a first quarter Gross Domestic Product (or “GDP”) figure of 1.9%; a far cry from the 3.1% advancement in the fourth quarter and 2.6% in the third quarter. Once again, investors were given plenty of reason to cut the rope and de-risk their portfolios given the aforementioned frailty in the market. However, patience proved the better part of valor once again as investors were quickly rewarded at quarter end with one of the sharpest weekly advancements in two years driven by abating consternation over debt and economic conditions. This marked the second time that the mettle of the recent bull market was clearly tested with the outcome overwhelmingly encouraging.

Non-US markets held up surprisingly well as a weaker dollar helped propel the developed international equity market, as measured by the MSCI EAFE Index, to a quarterly gain. This came despite political instability in parts of the Eurozone and Middle East, renewed fears of a Greek default and increasing apprehension in Portugal. In late June, the crisis was at least contained as the Greek government passed a package of new austerity measures to satisfy the EU (European Union) and IMF’s (International Monetary Fund) conditions for another bailout. While the Greek government has been successful in satisfying short term requirements, a long term solution remains cloudy and may prove a formidable overhang on the overall prospects in the Eurozone region.

As the equity markets vacillated, the fixed income markets benefited with most asset classes generating strong quarterly results. The quarter concluded with the scheduled end of the second round of Quantitative Easing (QE2) amid little fanfare. With short-term rates near 0% and nearly \$2 trillion of Quantitative Easing in place, the Fed has been extremely accommodative. The evidence suggest that they have succeeded in their stated objectives of promoting a sustainable economic expansion, preventing deflation, and lifting stock prices by keeping fixed income yields low. The Federal Open Market Committee (FOMC) kept key interest rates unchanged, but did note that the “economic recovery is on a firmer footing” and that “overall conditions in the labor markets appear to be improving gradually”. Municipal securities fared well on reports of cost cutting measures and better than expected revenues. As noted above, a weaker dollar also pushed foreign bond prices higher and made them one of the clear performance leaders during the period.

EQUITIES

In a troubling divergence from last quarter, a myriad of key U.S. economic data, including unemployment, manufacturing and GDP surprised to the downside and pointed to slower economic growth. The confluence of waning data and a negative credit outlook from Standard & Poor’s rating agency provided a challenging market for investors to navigate. Fortunately, some of the macroeconomic weakness dissipated in the last week of the quarter to allow major domestic indices to post their eighth quarter in the last nine of positive returns. Once again, roughly 70% of the S&P 500 Index companies reported operating profits for the first quarter 2011 that exceeded analysts’ expectations. Aggressive cost cutting persisted for the ninth consecutive quarter and exposure to

developing market economies pushed earnings higher. Earnings among S&P 500 companies posted double digit growth for the sixth quarter in a row. At current levels, the domestic equity market is trading at roughly 14x current EPS and 12x 2012 EPS expectations. Overall, the more defensive sectors of the market led the way with Healthcare the clear favorite. In stark contrast to last quarter, the Energy sector struggled as lower expectations for economic growth tempered demand for oil and the U.S. government released oil from their Strategic Petroleum Reserves.

The sovereign debt crisis in the Eurozone continued to headline news this quarter shifting from Portugal back to Greece and more recently to Italy and Ireland. In this environment International equity markets, as measured by the MSCI EAFE index, advanced 1.8% during the quarter, which outpaced domestic markets. Currency exposure for US investors continued to provide a noticeable tailwind as the Euro advanced 2.4% versus the Dollar, and is up nearly 8.0% for the year. There remains a clear divergence of returns across the benchmark index with Germany and France advancing 7.0% and 5.2% respectively, while Greece dropped roughly 16.2%. Developing non-US markets, as measured by the MSCI Emerging Markets Index, continue to struggle as inflationary pressures and strategic monetary tightening threaten to thwart economic prosperity. Overall, the index dropped 1.0% led by Russia and other Eastern European countries.

FIXED INCOME

On May 16th, the U.S. Treasury reached its debt ceiling of \$14.3 trillion dollars. The debt ceiling is the maximum amount of debt the government can carry. It was implemented to give Congress an additional check on national spending. In light of this development, Standard & Poor's rating agency downgraded their outlook on the U.S. from stable to negative due to large budget deficits and the rising risk of a debt policy stalemate. Additionally, the \$600 billion expansion of the Fed's \$2.7 trillion balance sheet (aka QE2) concluded at quarter end. That said, the Fed will maintain a neutral policy stance via the reinvestment of principal payments. Despite all this, the 10-year Treasury yield declined from roughly 3.5% to 3.2% as investors sought relative safety from a burgeoning debt crisis abroad. The decline in yields produced a strong gain of 2.3% for the quarter for the bellwether fixed income benchmark, the Barclays Aggregate Bond Index. Rising anxiety regarding the Eurozone peripheral crisis and waning economic data domestically helped higher quality investment grade securities modestly outperform their lower quality brethren. Tax-exempt municipal bonds rebounded nicely during the quarter with intermediate and long term securities outperforming US treasuries on light new issuance and improving fundamentals.

2011 MARKET OUTLOOK / TACTICAL POSITIONING

Despite a buoyant start, the second quarter was characterized by increasing investor anxiety. Supply chain disruptions emanating from Japan resulted in a corresponding production slowdown and poor economic growth, as measured by first quarter GDP. Furthermore, disappointing employment figures, a rekindled Eurozone debt crisis and a festering debate over the U.S. debt ceiling has left investors with a multitude of macroeconomic factors to consider. In spite of investors unrelenting angst regarding the recent pullback, the conditions that typically lead to good equity market returns are abundant. There remains plenty of liquidity and stimulus with zero short rates and a manageable, though challenging, budget deficit. Inflation is low even accounting for the rise in commodity prices. Interest rates around 3% on the 10 year Treasury bond provide minimal value and little competition as nearly 20% of the S&P 500 constituent companies boast higher yields. Corporate balance sheets are in great shape and companies continue to generate significant excess cash. The macroeconomic concerns and uncertainties are real, but they provide ample opportunities for patient investors. We believe this correction, as with the one last year at this time, to be transitory and should provide an attractive entry point for some of the cash sitting in non-performing money market funds. Within domestic equities we remain bullish on large cap stocks relative to their small and mid cap counterpart and favor growth over value. Both the Healthcare and Technology sectors remain attractive and we are maintaining our

overweight to these sectors. The tactical tilt to emerging markets, Asia specifically, remains in place as we anticipate further upside potential given their stable fiscal footing and attractive growth prospects. The municipal bond allocation implemented at the beginning of the year has provided strong relative performance during the quarter as predictions of record defaults failed to materialize.

We continue to work diligently to help you achieve your investment goals. Please call us if you have any questions.

Very truly yours,

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