ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT UPDATE

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Economic Conditions & Market Outlook

Even casual market watchers might have observed the inordinate amount of media attention recently given to the so-called ‘quadruple witching’ that happened on Friday, June 17th. This ominous sounding event occurs once each calendar quarter when four separate sets of heavily-traded derivative contracts- market index futures, market index options, individual stock futures and individual stock options- all expire at the end of the same trading day. This confluence of contract expirations can create extremely unpredictable and chaotic equity swings, particularly as the trading day heads into its final hour. To paraphrase the Shakespearean witches who haunted Macbeth, the markets can then behave as if ‘fair is foul and foul is fair’.

Somewhat surprisingly, concerns about potentially erratic market moves from this quadruple witching period proved to be much ado about nothing. In fact, trading activity that particular afternoon was no more dramatic than during other recent sessions when stock market volatility was elevated by a host of issues fueling investor anxiety. These ranged from concerns about the sustainability of the slow-moving economic recovery to fears regarding potential fallout from Greece’s financial crisis. Buffeted by uncertainty and inconclusive economic data, investor attitude turned negative as May progressed and, with few exceptions, has remained rather sour throughout June until quarter-end ‘window dressing’ buying started to buoy the markets toward month end.

While disappointment in the pace of the overall recovery is warranted and econometric indicators have indeed been mixed, we suspect the market’s downward reaction during the past month may be a bit overblown. Despite present handwringing, all is not ‘double, double, toil and trouble’. More on that in a moment.

On the economic front, last week’s scheduled announcement by the Federal Open Market Committee (FOMC) confirmed that the U.S. recovery is continuing at a moderate pace but “somewhat more slowly than the Committee had expected.” Fed Chairman Ben Bernanke suggested that the reason for the recent ‘soft patch’ in the economy is likely a combination of temporary issues, such as higher gas prices and disruptions in the manufacturing supply chain due to the Japanese earthquake tragedy, coupled with more longer-lived problems such as the weak housing market and leaner U.S. consumer balance sheets.

Bernanke reiterated the Fed’s position that overall U.S. economic growth will pick up in 2012 but noted that it has revised its gross domestic product (GDP) midpoint projection down to 2.8% from the 3.2% previously forecast in April. And while improvement in the labor market continues to be stubbornly sluggish, the Fed release did see overall unemployment declining near term from May’s 9.1% rate to between 8.6% - 8.9% and then heading progressively lower to a targeted range of 7.8% - 8.2% in 2012.

As suspected, the FOMC continued to encourage the economy in a monetary manner by leaving the federal funds position unchanged from its current 0.0% - 0.25% rate, noting that “economic conditions…are likely to warrant exceptionally low levels for the federal funds rate for an extended period.” In actuality, the fed funds rate has already been low for an extended period, having remained at this level since December 2008.

The Fed’s reluctance to quantify when it would start to raise rates from this basement-level - which would indicate more robust economic growth is on the way - did not help salve nervous investors who are longing for some certitude. While such predictability would be nice, we agree with Bernanke’s assertion that the timeframe of any upward move in federal funds rate really depends on how quickly the economy, inflation and unemployment continue to evolve. This economic recovery remains a work in progress and establishing nominal timeframes that create a false sense of certainty makes no sense at all.

The FOMC announcement did confirm that the Fed has decided not to introduce a third round of 'quantitative easing' when the thus-named 'QE2' program expires at the end of June. The Fed's purchase of $600 billion of U.S. Treasury debt via QE2 did appear to be successful at defusing the deflationary concerns for which it was intended but any actual contribution it made toward the broader and sustainable economic recovery will be debated by economists for years to come. We suspect the program's demise at month end will be a non-event.

As noted, many economic indicators are sending mixed messages and the recovery's progress has been paced at best but we think that the negative bias of the past few weeks has unduly tainted some of the underlying positives. A more balanced perspective can often be gained by examining multiple points of reference.

For example, the oft-cited Institute for Supply Management (ISM) manufacturing purchasing managers' index dropped from 60.4 in April to 53.5 in May. Is this a portending precursor? Not likely. Some of this decline was undoubtedly due to the widespread but temporary manufacturing supply chain disruptions referenced earlier. Additionally, any measure on this ISM index above 50 is still indicative of 'expanding activity'; so while May's number was not as robust as April's, the trend line is still heading in the right direction.

Similarly, U.S. auto sales fell sharply in May as sellers reduced buyer incentives and some dealer inventory ran low. But the broader durable-goods orders number for the month actually rose a better-than-expected 1.9%, boosted by strong airplane sales. The monthly durable-goods orders tally has been all over the map during the last year, with May's measure being a strong bounce after April's steep decline. Yet, the net movement has remained clearly positive, with overall durable-goods orders increasing 9.7% over the past twelve months.

Any discussion of recent economic events weighing on the markets would be remiss without mentioning the negative overhang of the unresolved Greek debt crisis. One year after initial bailout funding, the country is again in need of a cash infusion and newscasts have again been filled with images of protesters in the streets disapproving of the austerity measures now approved by their parliament. That government spending austerity is required is not debatable but suspecting that the citizenry would openly embrace such a move is bit naïve.

However, when compared to the geopolitical unrest in northern Africa and the Middle East earlier in the year, it is likely that most civil discord in Greece will be inconsequential. Unfortunately, so too will be the newly adopted austerity package. Future debt restructuring of some sort appears to be inevitable for Greece and only time will tell whether the impact of those efforts will be disastrous or something much less dire for both its euro zone neighbors and the global economy. Absent an outright default, we suspect it will be more the latter.

While there may be temptation to chastise the forbearers of democracy for the years of profligate government spending that took them to the precipice, the United States has hardly set a shining example by addressing our own debt concerns. In fact, International Monetary Fund (IMF) recently took the U.S. to the public opinion woodshed when it criticized us for not having a serious enough plan in place to restore our federal deficit to more reasonable levels. Other targets of the IMF's admonishment included Greece, Ireland and Japan; a rather ignominious group to be compared with when referencing debt management.

Lest you confuse this firm with the investing fringe who is suggesting that you line your bunker with gold bricks, the U.S. clearly has the revenue and resources to turn these issues around and is not on the edge of any impending public finance Armageddon. What has been lacking to date is the political will to proactively address these concerns but history has repeatedly shown that we do make the tough decisions when action is required. We encourage readers to remind leaders of both our parties that now would be a good time to start.

While economic factors often influence market moves, we regularly note that the two are not inextricably linked. Investor fear/greed and human psychology are often even more significant market movers, despite both typically being rather short-term and shortsighted. We suspect that a myopic focus on near-term uncertainty and an overreaction to negative headlines is responsible for some of the recent market runoff.

Lost in the shuffle is the fact that the equity markets have had a very good run for the past year. Consequently, some sort of correction should not come as a complete surprise. While current fixation may be that all three major stock indices - Dow Jones Industrial Average (DJIA), Standard and Poor 500 (S&P 500) and Nasdaq - shed nearly 3% during the month of June, often overlooked is that the one-year returns for each index through May 31st were rather remarkable, with annual increases of 24.00%, 23.48% and 25.62% respectively.

As noted in the past few *Investment Updates*, it has become increasingly difficult for companies to post significant upside earnings surprises as the prior quarters to which the new profits are compared climb back to higher levels. Despite this bar being raised, period-to-period corporate earnings comparisons for year-to-date 2011 have continued to show noteworthy improvement. As an example, the most recently released Commerce Department report upwardly revised its quarter-to-quarter corporate profits comparison, showing an aggregate increase of 7.8% as opposed to the already attractive 6.3% rise that had been reported earlier.

From a fundamental perspective, this is notable because earnings growth will tend to push stocks higher, particularly when current prices are lower than the typical price to earnings (P/E) ratio norms. Comparatively speaking, even with the stock price appreciation referenced earlier, increased corporate earnings have helped maintain the 'P' side P/E ratio equation at very attractive levels, eventually enticing buyers to reemerge.

FedEx's mid-June report showing a 33% rise in profit fueled by growing demand provides a compelling example of both; significant earnings growth and the markets' subsequent appreciation thereof. Even more important is that the world's largest air-cargo carrier, a bellwether of global trade and commerce, forecasts much stronger results going forward and are projecting 2012 earnings will well exceed analyst expectations… offering investors hope that the recent market malaise will soon pass like a midsummer's night dream.

Our Tactical Investment Stance

Roof Advisory Group's disciplined investment approach emphasizes adding upside value to client portfolios while also controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and ongoing evaluation of portfolio return relative to various risk measures.

Within this strategic investment management context, the firm makes tactical shifts to address changing market conditions and optimize client portfolio performance. Each client situation is unique but a few of the tactics presently being used across most portfolios managed are outlined below:

• The overall ***target level*** for managed portfolio allocations is currently at ***mid-point equity*** based on each client's investment policy range. The target allocation was ***shifted downward in early June*** in response to ***increased market volatility*** after being at ***maximum equity*** since late-January, with the exception of a very short term tactical move to ***mid-point*** in early March. This brief change was in response to dual unknowns of Middle East unrest and Japan's post-earthquake rebound and ***added significant value*** to client portfolios. As noted, the ***relative risk/return*** potential in equities remains ***more attractive*** than either bonds or cash but we will likely remain as allocated until daily stock market volatility calms a bit.

• ***Portfolio rebalancing*** at both ***allocation and asset levels*** continues to add short/long term value. ***Portfolio composition*** was recently modified to ***reduce risk and capture opportunity*** in the more volatile market and an overall ***increase in equity yield*** resulted in each target portfolio. ***Profits were taken*** and several equity/fund holdings were eliminated when target appreciation was reached or risk/return potential had deteriorated. As a result, ***portfolio betas were pared*** temporarily but new additions are already being made where opportune. Continual vetting of all holdings is part of the firm's ongoing management and portfolio review process.

Diversification is always a priority but unique opportunities in specific sectors are used to ***capture near term appreciation.*** Equity sector weightings are close to benchmark for most balanced/growth portfolios but some ***overconcentration*** exists in ***Industrial/Materials, Telecom & Healthcare***. Aggregate ***Energy*** sector exposure has been reduced from being over-weighted but remains ***at benchmark level***.

Mid-cap equity exposure has been reduced to ***normal*** levels, with ***foreign equities*** remaining ***underweighted***. International exposure comes primarily via concentration in select ***multi-national companies*** that offer superior comparative returns relative to purely foreign alternatives.

• Ultra-short-term fixed income exposure continues to be ***significantly below target levels*** due to very low yields. The ***average duration*** of bond portfolios remains ***short to intermediate,*** with select ***longer maturities*** being used to where deemed advantageous. Fixed income emphasis remains on ***enhancing net portfolio yield*** and ***tempering volatility***. ***Credit quality*** remains a paramount consideration.

E. Jeffrey Roof