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

INVESTMENT UPDATE

June 2012

Economic Conditions & Market Outlook

Since 2010, the month of May has been challenging October for the dubious distinction of being one of the most predictably unpredictable periods of the year for investment markets. There have indeed been other months in recent years that have provided much more dramatic day-to-day market volatility - with August 2011 likely remaining the winner in that category for many years to come - but Mays of late have provided investors with more than their fair share of head-scratching and hair-pulling market moves and attitude shifts.

There is no particular rhyme or reason for this unpredictability, no confluence of economic releases or market reports that are unique to this month and carry with them the potential to sully an otherwise fine time of year. Quite the opposite, it is the randomness of these multiple events that compounds their drag on the markets, making their collective impact more negative than what it might have been were they anticipated or isolated.

Case in point, in May 2010 investors were increasingly rattled by the growing economic and environmental taint of the BP oil spill disaster, the fallout from the market's 'Flash Crash' when the Dow Jones Industrial Average briefly plunged nearly 1000 points and the then unexpected revelation that European sovereign debt concerns, and Greece in particular, was an even bigger problem than had been projected earlier.

Fast forward to May 2012 and the investment markets were again put on edge by a triage of unexpected negatives, in addition to general concerns about stagnating economic growth. Billion dollar trading losses at worldwide financial stalwart J.P. Morgan that were larger than previously announced, the total fizzle of Facebook's much-ballyhooed and largest-ever initial public stock offering and again elevated concern about European sovereign debt. While the last issue can hardly be called surprising at this point, mid-May European elections did again put that continent's lingering debt problems front and center in investors' minds.

Europe's renewed negative influence on the overall market's psyche was succinctly captured by Philadelphia Federal Reserve President Charles Plosser during a May 28th interview with the Wall Street Journal, when he noted that, "You get a good labor number, you get a good industrial production number, but if you have bad news from Europe it's completely swamped." And our neighbors across the Atlantic have indeed been recently saturating investors with plenty of doubt, distraction and uncertainty.

In actuality, it is likely that investor concerns over Europe will continue to ebb and flow for years to come. We recently had heard the term "bottomless crisis" used to describe the European debt/currency/political imbroglio and, while not very uplifting, it is likely quite apt. Clearly, there is no magic elixir that will rapidly cure all of that continent's ills; its eventual recovery will be prolonged with plenty of relapses along the way. Until then, global investment markets will most likely vacillate between viewing Europe as half-sick or half-well, depending on what other factors and events may be vying for the market's attention at that particular moment.

May's market relapse was very much in contrast to the first four months of the year when investors chose to focus on the more positive side of economic data and market news. And for good reason…many economic and market fundamentals were relatively attractive and trending in the right direction. In aggregate, such is still the case. But a softening in several upward economic trends, combined with the event surprises noted earlier, has recently tempered investor enthusiasm and weighed on market momentum.

For example, one month ago the U.S. Department of Commerce estimated 2012's first quarter annual rate of gain in gross domestic product to be 2.2%. GDP is the broadest measure of all the goods and services produced in the U.S. economy and, despite having various nuances and subtleties, the number does provide a general indication of overall U.S. economic health and, as such, is closely watched.

During the last week of May, the Commerce Department revised that first quarter percentage GDP gain downward, with the revision showing annualized GDP growth of 1.9% for the January through March timeframe. While still expanding, this revision showed the economy's growth had cooled since growing at the fastest pace in a year and a half during the final quarter of 2011, when it logged a growth rate of 3.0%. Part of that quarter's rapid acceleration was driven by companies rebuilding then-depleted inventories, a temporary phenomenon. But the tempering of current quarter to quarter growth, combined with the recent downward GDP revision, elevated investor concerns that economic expansion would remain lackluster near term.

Similarly, Labor Department numbers released on June 1 indicate overall unemployment crept up to 8.2% during May and added far fewer jobs than economists had forecast. ADP payroll data released a few days earlier showed U.S. private-sector jobs increasing by 133,000 for the month. While this figure is indeed a further improvement on April's private-sector jobs growth number, overall expansion in U.S. employment remains tepid in comparison to prior recession bounce backs and reinforces concern that the ongoing economic recovery will likely remain somewhat slow, if not sluggish. It would appear that hopes of experiencing a further acceleration in the economic turnaround will have to remain on hold for now.

Despite this, many economic indicators are rather positive. Housing figures released in May were notably optimistic on several fronts. New home sales continue to improve on a month-to-month basis, with April's sales being 9.9% higher than April 2011. National Association of Realtors data also showed that existing home sales for April rose 3.4% from the previous month and that home prices are up 10% from the prior year. The National Association of Home Builders/Wells Fargo Housing Market Index of homebuilder confidence also jumped to a five year high in May, far surpassing consensus estimates.

Encouraging this continued improvement in housing data is the fact that mortgage rates are at record lows and are currently under no pressure to move upward. Mortgage delinquencies for the first quarter of 2012 also fell to their lowest level since the end of 2008. While individual mortgage foreclosures will likely remain a lingering problem in targeted U.S. locations that were most impacted by the bursting housing bubble, the fact that an apparent bottom has been reached in nationwide delinquency rates is a significant positive.

An improving economic climate is also reflected in data showing modestly renewed consumer spending and an uptick in consumer sentiment. The recent Commerce Department report showed a first quarter consumer spending increase of 2.7%, slightly under the 2.9% increase anticipated, but it was indeed the biggest gain in consumption since the fourth quarter of 2010. Retail and auto sales also logged modest growth. Most important is that the trend continues to reflect a growing economy. While some observers wish for aggressive expansion on the consumer spending front, we are quite content with smaller but steady increases since over-the-top consumer spending and excessive leverage helped contribute to the mess we are finally leaving behind.

Corporate earnings growth continued at a rather remarkable pace, with over 65% of the S&P 500 companies exceeding analyst expectations for the quarterly earnings reporting season that ended in early May. Recent Commerce Department data showed companies had registered their largest quarterly gain in profits since the last quarter of 2009; with corporate profits also being up 14.8% on a year over year basis for 2012's first quarter. While this string of positive corporate earnings news helped propel the market upward through the end of April, any lingering lift from those upbeat numbers was clearly squelched by May's malaise.

Data released in early May by the Institute of Supply Management showed U.S. manufacturing activity unexpectedly rose to 54.8 in April from 53.4 in March, as measured by its manufacturing purchasing managers' index, and provided a pleasant upside surprise to start off the month. On June 1, the same national ISM number was released for May and, while just under economist forecasts for the period, it still showed healthy expansion with a reading of 53.5. Any index number above 50 indicates manufacturing growth and it was the 34th consecutive month that the U.S. manufacturing sector has moved in the right direction.

However, current investor sensitivity to all things potentially negative was clearly evidenced when one day prior to the national ISM number's release; investment markets blanched at the news that the ISM-Chicago index, just one of the 14 geographic regions that contribute to the overall ISM index, had reported a second month of softening growth but still logged a solid 52.7, well above the index's growth baseline of 50. While that one region's measure is important due to its sensitivity to various auto industry suppliers, both the market's and media's apoplectic response to the disappointment was disproportionate to the data and indicated just how nervous and uncertain investors had become in a relatively short period.

This conflicting mix of economic information that had investor's flummoxed and frustrated throughout May is illustrated in back-to-back lead story banners from the financial news. A May 16th Bloomberg headline read, '*S&P 500 Snaps 3-Day Slump on Better-Than-Forecast Data*'; only to be followed the on May 17th by an AP headline exclaiming, '*Stocks Fall on…Worrisome Economic Reports*.' Add to this the surprise negatives mentioned earlier and it's no wonder the equity markets behaved badly for the month.

And behave badly they did indeed. The Dow Jones Industrial Average fell -6.2% during May, that index's largest monthly decline since retreating -7.9% in May 2010. The S&P 500 and Nasdaq Composite indices also logged drops of -6.3% and -7.2%, respectively. May's slumping stock prices clearly impacted the year-to-date performance of all three major equity indices, with these benchmark measures remaining positive for 2012 but markedly lower than one month prior. On May 31st, the DJIA gain for the first five months of the year was 1.4%, the S&P 500 index was ahead 4.2% and the Nasdaq Composite was up 8.5%. Clearly, any positive fundamentals that exist have been recently trumped by the onslaught of unpleasant surprises, dour economic data and negative market momentum.

Finally, it is also noteworthy that the U.S. political climate will likely increasingly roil the waters as the year progresses. While investors can be somewhat relieved that a repeat of last year's demonstration of legislative ineptitude will not again be in the offing for July and August, that is small consolation when knowing that once again extending the federal debt-ceiling, so-called 'Taxmageddon' and ongoing deficit spending issues are all on the horizon for year end. Add to this the incessant negative din of presidential election campaign rhetoric and it's no wonder market confidence may remain somewhat challenged in the interim.

Trying to invest during such times of conflicting economic data and vacillating market movements can lead to a Mr. Miyagi (think *Karate Kid*) approach to portfolio management, where 'risk-on' is followed by 'risk-off', 'risk-on', 'risk-off', etc. While our view is that proactive portfolio management in any market environment is essential to success, overreacting in conditions like these can quickly lead to investment managers chasing their tails. At present, we choose to follow another Mr. Miyagi admonition which is, slightly paraphrased, 'Find balance…balance is key. When balance good, investing good. Balance bad, better pack up, go home.' All of the investment management moves we have made throughout May have emphasized enhanced portfolio balance and increased stability…an appropriate position to have entering the uncertain summer months ahead.

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 allocation*** level for managed portfolios is currently at ***mid-point*** equity exposure based on each client's investment policy. In total, this target allocation level was ***reduced two steps*** in range throughout May from the *maximum* equity target position that was maintained at the end of April. This notable ***equity rollback*** was in response to the increased ***market uncertainty*** detailed throughout this *Investment Update*. While the long-term fundamental ***risk/return*** potential in equities remains ***more attractive*** than either bonds or cash, we will remain ***cautious*** until present volatility subsides.

- The ***portfolio composition*** of all investment policies ***continues to be modified*** in response to ***changing market conditions***. Due in part to the reduction in equity allocations, ***portfolio betas*** of all target portfolios had been ***pared*** an average of 20% from the end of April to mid-May in an attempt to ***lessen the impact of market volatility***. This was a reversal from the earlier months of 2012 when overall portfolio beta levels had been steadily increased in response to appreciating markets and an attractive potential reward relative to risk.

- Our ***large-cap equity bias*** remains, as does our overall ***value-style leaning***. The slight shift in higher equity level target portfolios towards more growth-style exposure mentioned in the prior *Investment Update* was moderated by mid-May, with even ***greater reductions in growth-style*** concentrations made in ***balanced target portfolios*** to further dampen volatility. Most all foreign equity exposure at present comes primarily via select ***multi-national companies*** offering ***superior returns/less risk*** compared to pure foreign-based firms.

- It should come as no surprise that equity sector diversification remains a priority, as does regular portfolio rebalancing on a security by security basis to targeted portfolio levels. ***Profits were taken or losses capped*** throughout the period when risk/return potential deteriorated on several equity/fund holdings.

- Exposure in the ***Financial*** and ***Industrial*** sectors have been most ***notably reduced*** since April's end, while weightings in certain defensive sectors such as ***Healthcare*** and larger ***Telecom*** have typically ***increased*** in relative proportionality. ***Technology*** sector exposure remains close to S&P 500 index ***benchmark level*** for more ***growth-oriented*** target portfolios but has been ***markedly reduced*** in target portfolios that are ***balanced or income*** by definition.

- The aggregate ***equity yields*** in all target portfolios have been ***above historic norms*** for quite some time. The ***return opportunity*** offered by high equity yields will continue to be ***emphasized*** in our portfolio structure near term, as it provides both a ***tempering influence*** to ongoing ***market volatility*** and partially ***compensates*** for the much ***lower than normal interest rates*** currently available in ***fixed income*** investments.

- Ultra-short-term fixed income exposure continues to be ***significantly below target levels***, except during tactical portfolio repositioning or rebalancing. As noted previously, ***interest rates*** in fixed income investments remain at ***historic lows*** and the current economic environment makes it unlikely that interest rates will rise significantly in the near term. Because of this, the overall ***average duration*** of our bond portfolios has been extended a bit but still remains on the ***short to intermediate side*** because even longer term rates are largely less-than-compelling. ***Select individual bonds*** with ***longer maturities*** are added where advantageous.

- ***High-quality preferred stocks,*** viewed more as a fixed income position in portfolio management, continue to be used in ***moderation*** to enhance yield. Likewise, ***select fixed income exchange traded funds*** that offer ***attractive yields*** along with ***notable diversity*** are also being added in limited quantities where deemed appropriate. Overall fixed income ***diversification and credit quality*** remain constant and critical considerations for all portfolios.

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