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2011 Midyear Update: Markets at a Crossroads

The powerful rally in risk assets that began in March of 2009 stalled in the second quarter, amid worries about a slowdown in global economic activity and fears of a default by Greece. By mid-June, the S&P 500 index had fallen by 7% from its peak in early May, while U.S. treasuries rallied. The main factor weighing on markets was disappointing U.S. economic growth, which is estimated to have been running at a two percent annual rate in the first half of the year. This pace is roughly one-half of the consensus forecast at the start of the year.

For a while investors were able to shrug off the slow start on grounds that it was likely to be temporary. However, they subsequently reassessed when the softness persisted in the second quarter and was accompanied by a worldwide slowdown in manufacturing activity. The final blow to investor confidence came in June, when negotiations over a new rescue package for Greece threatened to break down and send ripple effects throughout Europe.

The stock market ended the quarter on a strong note, recouping most of its earlier losses, as the Greek government forged ahead with a new austerity program. As of end-June, the S&P 500 index posted a year-to-date return of 4.9%, while the bond market, measured by the Barclay's Aggregate index, generated a total return of 2.7%.

For the most part, risk assets have fared better in this go-round than they did a year ago under a similar set of circumstances. This primarily reflects two factors that have helped prop up the markets. The first is the strong showing of the U.S. corporate sector, where overall profits are now above the previous peak reached in 2007, while balance sheet positions are strong. The second is the effect that the Federal Reserve's program of quantitative easing had in inducing investors to switch out of safe assets and into corporate stocks and bonds.

Nonetheless, as the second half of the year gets underway, we are struck by the multitude of issues investors must weigh. Among the most important ones we consider are the following:

1. Will economic growth re-accelerate in the second half or stay subdued?
2. Has inflation peaked, or will it continue to climb?
3. What impact will the end of the Federal Reserve's quantitative easing program have, and how will the impasse over the federal budget deficit be resolved?
4. Will developments abroad continue to unsettle U.S. markets, or will they moderate?

We do not subscribe to extreme views on the economy, and believe the outcome will continue to be one of sub-par growth with low-to-moderate inflation. Optimists contend that the disappointing performance in the first half of the year mainly reflects the impact of higher oil prices, which sapped purchasing power from consumers, as well as the effect supply chain disruptions from Japan had on U.S. auto production. With oil prices having fallen by about \$20 per barrel from their recent high, consumer spending is likely to receive a boost while consumer price inflation begins to subside. At the same time, U.S. auto production is expected to rebound now that parts production from Japan has resumed.



We accept that these factors will provide some lift to the economy in the second half. But we are also cognizant that economic policies are about to change. On balance, the thrust of fiscal policy will shift from expansion to restraint, and there is uncertainty about how the completion of the Federal Reserve's program of large-scale Treasury bond purchases will affect the economy and financial markets.

Our view is that the second round of quantitative easing (Q.E.2) that the Federal Reserve launched last autumn had relatively little impact on the U.S. economy, and we do not foresee a material impact from the program being completed. At the same time, we believe the program encouraged investors to take more risk. Therefore, it is possible completion of the program could cause investors to become more risk averse.

On the fiscal front, we are not worried that negotiations over a deficit-reduction package will lead to an impasse that triggers a technical default. But we accept that negotiations could go down to the wire before a settlement is reached. The most likely outcome is that Republicans and Democrats will agree on cutbacks in discretionary programs in order to raise the debt ceiling. However, they are unlikely to resolve their differences over entitlement programs and taxes, and these issues will become the cornerstone of the 2012 elections.

With fiscal policy about to become more restrictive, we are unsure whether the economy will return to the 3% growth trajectory that it averaged in the first two years of recovery. Even if it does, the pace will not be sufficient to achieve a significant reduction in the unemployment rate, and wage increases are likely to remain modest. In these circumstances, there is little risk that core inflation – which excludes food and energy components – will accelerate materially from the current pace of 1% - 1.5%. Assuming oil prices remain around current levels, headline inflation should recede from the current rate of just over 3%.

In these circumstances, we look for treasury yields to stay within the ranges that have held since the Fed launched Q.E. 2. While some commentators believe yields are likely to rise significantly now that the Fed will no longer be making large scale purchases of treasuries, we believe the principal drivers of the bond market will be expectations about the economy and inflation.

International developments will also continue to have an important bearing on the markets. While conditions in Greece should stabilize for a while with implementation of the latest rescue package, we believe the country will ultimately require some form of debt relief. Similarly, turmoil in the Middle East has subsided for the time being, but it could flare up at any time.

Weighing these considerations, we believe the phenomenal two-year run in the stock market, in which it doubled in value from its March 2009 lows, is over. While the market should continue to be buttressed by solid earnings growth and record low interest rates, we believe the recent choppiness will continue until uncertainties about the economy, policies and developments abroad have been resolved.

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