



The S&P 500 ended a volatile second quarter right where it started, flat for the period but still 5% higher on the year. We believe market performance over the rest of the summer and into year-end will be determined by three overriding issues:

- 1) the European sovereign debt crisis
- 2) a U.S. debt ceiling agreement, hopefully one reached before the August 2<sup>nd</sup> deadline
- 3) a bounce back and strengthening in the domestic economy over the second half of the year

To a not inconsiderable extent these issues and their resolution are interrelated. The European debt crisis and the threat of financial contagion certainly pose a significant risk to the global economy and sluggish U.S. recovery. A deal on the federal debt ceiling that includes moderate near term cuts in spending, some entitlement reform that at least makes a start at reducing exploding longer term government debt levels, combined with a few revenue opportunities would be viewed very positively by the markets. A sizeable increase in the debt level would also be preferable to a temporary band aid. Anything less than a \$2 trillion increase would imply another contentious debt ceiling debate before the 2012 election and more uncertainty for financial markets.

A debt ceiling agreement along these lines would be broadly stabilizing for financial markets and enhance Europe's ability to deal with its own debt and banking problems. Progress in Europe and a favorable resolution on the debt ceiling would boost confidence and provide greater certainty for both investment and employment, all positives for economic growth.

The European crisis and debt ceiling debate reflect deeper underlying issues and challenges to the developed economies of the industrial world. They are issues and risks that will be with us and with investors for some time. A more robust U.S. recovery and employment picture must likely await structural change: tax reform and simplification; a lower corporate tax rate (U.S. and Japan have the highest stated corporate tax rates among the G-20, so jobs unsurprisingly go elsewhere); serious entitlement reform – the key to any solution to both our short and long term federal budget deficit; a “rationalization” of government itself.

In a very real sense, the future is now and has arrived on the periphery of the Euro Zone and in the debt ceiling debate in the halls of Congress. The next couple of years are critical, and markets will clearly be watching the U.S. and Europe to see if we can muster the courage, the will, and the wisdom to tackle spiraling debt and spending, to reform government and entitlements that future generations cannot afford. Government is the last major industry or sector that has not been rationalized. It has continued to grow as other sectors from farm to factory to banking have shrunk in number but grown in productivity and output. The rationalization of big government is a potential game changing trend to keep your eye out for into the future and ardently wish for as an investor.

## Conclusion

The issues and risks discussed above are well known to the markets, and if not fully discounted in the event of unfavorable outcomes, at least partially reflected in current market valuations. Notable fundamental positives are also present in the market and global economy. Corporate profits and dividends are at a new record high in 2011 and global GDP is also at a record level and still growing at a very healthy 4% rate. Valuations are historically cheap. According to Bloomberg, based on cash flow, earnings, and book value the S&P 500 is the “cheapest in 26 years” (Bloomberg 6/22/2011). The S&P 500 remains 15% below its all time high of mid 2007 (@1576), and below the levels of January 2000.

So the risks to investors are significant, pose the threat of financial contagion, and will be difficult to resolve. But investors who await a more certain and perfect environment will have to wait a long time. In the mean time, high quality stocks may continue to grind out higher earnings and dividends. There are no easy or riskless investments in today’s world, but at least good global companies can adapt to change, make good investment decisions, and go where there is growth and opportunity. Despite the headwinds, American industry and equities have shown resilience. This is indeed what we have witnessed in the past two years, as the growth in corporate profits and cash flow coming out of the worst financial crisis since the 1930’s has been nothing short of remarkable.

<i><b>2011 Global GDP Forecasts (GDP Growth, %)</b></i>		
<u><b>Global</b></u>	<u><b>2010</b></u>	<u><b>2011</b></u>
U.S.	2.9	2.5
Euro Area	1.7	2.0
Japan	4.0	- .3
Pac Rim (ex Japan)	8.9	7.5
<i>China</i>	10.3	9.2
Latin America	6.3	4.6

*Sources: IMF, ISI Group, BAML*

## Good News

### China

China's second quarter GDP 9.5%, above forecasts...*Dow Jones 7.12.11*

Wen says China inflation rate will be "firmly under control" and pointed to moderation in lending and an oversupply of industrial products and an abundance in grain. *ISI 6.26.11*

China emerges as the dominant buyer of commodities globally - accounting for 21% of the world's corn consumption, 40% of copper and 39% of cotton. Chinese demand helps underpin commodity prices. *WSJ 6.23.11*

China overtakes US as top energy consumer. China now accounts for 20.3% of global demand, ahead of the US with 19%. *AP 6.8.11*

McDonalds Corp to open 700 stores in China by 2013. *Dow Jones 4.29.11*

McDonalds Corp planning second yuan denominated bond offering. *Dow Jones 6.23.11*

Starbucks to create China and Asia division, one of three corporate divisions. *7.11.11*

YUM Brands buys popular Chinese hot pot chain. *4.29.11*

Nestle offers \$1.67 B for Chinese candy maker. Chinese confectionary market climbed 63% to \$9.2 billion in 2010 from 2005. *WSJ 7.12.11*

VW considering new entry level brand for China. *Reuters 4.27.11*

China may start new sovereign fund to invest in oil, gold. *Reuters 4.25.11*

Hong Kong weighs launch of yuan gold futures. *MarketWatch 5.13.11*

### Canada

#### **All is well up north**

Canada gains Conservative majority government in elections, seen as good for corporate environment. Canadian Prime Minister Stephen Harper's Conservative Party ended seven years of minority government. Canada seen opening up to foreign investment. *FT 5.2.11*

Chinese homebuyers spreading wealth make Vancouver pricier than Manhattan. *Bloomberg 5.16.11*

### Australia

#### **Mixed bag in Australia**

Australia predicts uranium production to double in four years. *Fox 5.13.11*

### Emerging Market

#### **Economic development in the BRICs solid**

Global fast food chains turn to Russia for growth: McDonalds now has 277 stores, YUM has 160 store KFC chain, Starbucks has 50 cafes, Subway plans to grow to 1,000 stores from 250 by 2015, Papa John's plans to expand to 200 restaurants. *Reuters 6.23.11*

## Bad News

### China

China's June CPI rose 6.4% y/y, above estimates. *Bloomberg 7.10.11*

China purchasing manager index fell to 52 in May from 52.9 in April. *FT 6.2.11*

High profile IPO's on Hong Kong Exchange trade poorly. Prada trading debut clouded by sell off. *Bloomberg 6.23.11*

Benchmark Hang Seng Exchange trades at 11.5 times earnings, close to the lowest level since March 2009. *Bloomberg 6.24.11*

Some in market fear that Chinese slowing economy might stall, fear weakness in renminbi. *FT 7.6.11*

Record crude steel output weighs on iron ore supply. Iron ore spot prices fluctuate at high levels.

Iron ore inventories at ports reach all-time high. *CEBM research 7.12.11*

### Japan

#### **Tough times in Japan; waiting for full resumption of auto production and parts and of electronic components.**

Japan may have no nuclear reactors running by next May 2012 should a round of tests by the government cause further delays to restarting idled units. *Bloomberg 7.10.11*

Munich Re estimates global economic losses from natural catastrophes in the first half of 2011 at \$265 billion. Highest ever annual loss record after just 6 months. Japanese earthquake losses account for \$210 billion of losses. *Dow Jones 7.12.11*

### Europe

#### **Not their first rodeo**

Up to 1 in 6 European banks set to fail stress tests, according to Eurozone sources close to the European Banking Authority. *Reuters 6.28.11*

#### **Daily Debt Debacle Déjà Vu**

EU forced to rescue Greece - again. Spanish bonds rate spreads explode. Trichet says risk signals "red alert." UK's Melvyn King says crisis in Europe is threat to UK banks. Moody's warns Italian banks. Euro government institutions on watch for ratings downgrade. *ISI 6.23.11*

Italian government bond yields spike, prompting (again) another Euro zone meeting of the ECB and the European Commission. *Market Watch 7.11.11*

Global regulators poised to set new tiered regime of additional capital requirements of the world's top 30 banks. *FT 6.16.11*

Derivatives cloud the possible fallout from a Greek default. *NYT 6.23.11*

## Good News (continued)

Venezuelan Cisneros setting up joint venture with Chinese banks to carry out Latin American commodities investments. *Bloomberg 6.17.11*

Statoil starts production from Brazil's Peregrino Field. Production from the field will gradually ramp up to a maximum of 100,000 barrels per day. *Dow Jones 4.11.11*

### United States

#### **A lot on the American plate:**

#### **Stock prices remain cheap, corporate profits grow**

Stocks cheapest in 26 years as S&P 500 falls, profits rise. Even if companies posted no growth, price-earnings ratios would be lower than 96 percent of days in the past two decades. *Bloomberg 6.22.11*

Fed's Fisher see economic growth picking up in second half, while remaining slow. *Bloomberg 6.26.11*

#### **Rates remain low**

Yield on 2 Year Treasury note hits record low. *MarketWatch 6.23.11*

Goldman Sachs Commodity Index for food declined 2.8% week over week and is down 11.8% from recent peak. *ISI 6.26.11*

Traders believe that China is on the brink of buying millions of metric tons of US corn. This would shatter the USDA forecast of Chinese buying and keep grain supplies tight even as farmers tend to what is expected to be a record-large corn crop. *WSJ 7.9.11*

#### **Retribution is key**

Osama Bin Laden killed by US forces. *5.1.11*

#### **Public spending fiasco first signs of waning?**

In an act to conserve cash, The Post Office is suspending employer contributions to the Federal Retirement System. *AP 6.22.11*

Atlanta city council poised to cut worker's retirement benefit. Proposed reform would require employees to invest in 401-k style plan. "Atlanta has a \$1.5 billion unfunded pension fund liability that is poised to grow exponentially," according to Peter Aman, city chief operating officer. *Bloomberg 6.24.11*

California reached a deal that raises taxes and some spending cuts to close a \$10 billion gap. Ballot initiative to extend tax increases being considered for 2012. *Reuters 6.28.11*

#### **Some legal resolution to Wall Street mortgage crisis?**

Bank of America and other large US banks close to a \$60 billion financial settlement payout stemming from federal civil mortgage foreclosure claims. *ISI and Barclays 6.28.11*

Dallas-Fort Worth and Houston lead nation in jobs growth. *FW Star Telegram 5.31.11*

## Bad News (continued)

### Australia

#### **Raising taxes on energy while the economy is slowing:**

Prime Minister Gillard unveiled Australia's first tax on greenhouse gas emissions with a \$23 per ton carbon dioxide tax. Australia relies on coal to generate 80 percent of their electricity. The tax is projected to cost A\$30 billion over three years. *Bloomberg 7.10.11*

Australian GDP shrinks 1.2 per cent in the three months to March compared with the prior quarter. *FT 6.2.11*

### United States

#### **America could use some Canadian unanimity**

Budget negotiations stall over spending cuts and tax increases. Shadow of government debt ceiling looms over discussions. *MarketWatch 7.11.11*

The Federal Reserve cuts its economic growth forecast for the second time in 2011, reducing its estimate of 2011 GDP growth to a range of 2.7% to 2.9% down from 3.1% to 3.3%. *Bloomberg 6.22.11*

US employment growth ground to a halt in June with employers hiring the fewest number of workers in nine months. *CNBC 7.8.11*

US multinationals, which employ 20% of the US workers, have cut their domestic work force by 2.9 million while adding 2.4 million overseas in the 2000's. In the 1990's they added 4.4 million jobs domestically and 2.7 million jobs internationally. *WSJ 4.19.11*

S&P slashes outlook on US to "negative" amid soaring debt. S&P raises likelihood that the US will lose its coveted AAA rating. *Fox Business 4.18.11*

The European Debt Debacle (V.10, Summer 2011) brings back perma bear investor pundits: Marc Faber: The Dollar's Value in the Future Will Be Zero, *CNBC 4.18.11*; Roubini: "Perfect Storm" Coming for Global Economy in 2013. *CNBC 7.6.11*

China diversifying away from dollar with European government debt purchases in first four months of 2011. *FT 6.20.11*

Global regulators poised to set new tiered regime of additional capital requirements of the world's top 30 banks. *FT 6.16.11*

NJ seeks bridge loan to cover cash shortage. NJ negotiating a credit line for up to \$2.5 billion to cover a shortfall in the state budget. *CNBC 6.28.11*

Cisco Systems may cut 5,000 to 10,000 jobs in order to meet target of reducing annual expenses by roughly \$1 billion. *MarketWatch 7.11.11*

Democrats balk at Obama offer to raise Medicare eligibility age in deficit reduction negotiations. *Fox Business 7.11.11*

## Energy Renaissance

### **The Greatest Story Never Told**

Two gushers in NE Pennsylvania help illustrate the enormous potential of the Marcellus shale. Each Cabot well is capable of producing 30 million cubic feet of natural gas per day, believed to be a record for the Marcellus. *Tudor Pickering 6.26.11*

The Gulf Coast -led primarily by Houston but including New Orleans and other smaller ports - has emerged as the "most vibrant" of America's three coasts. Energy industry has 55,000 workers in the area. *Forbes 6.23.11*

China kicks off first shale gas tender. China issues its first shale gas exploration tender with an offer of four blocks to a group of Chinese energy companies. *Reuters 6.28.11*

CEO of Continental Resources sees 24 billion barrels of recoverable resources in Bakken. *Forbes 6.27.11*

For the first time since Baker Hughes started keeping separate counts of the number of drilling rigs for oil and gas, the oil rig number tops 1000. Texas has 843 total rigs operating, accounting for 45 percent of all US drilling activity. *FW Star Telegram 6.24.11*

Increased Shale output may reduce US imports of low sulphur crude oil by 500,000 barrels a day within five years as new pipelines carry the oil to refineries along the Gulf, according to a study by Purvin & Gertz. Shale production is forecast to rise to 900,000 barrels a day by 2015 and to over 1.3 million barrels daily by 2020. *Bloomberg 6.15.11*

Exxon finds biggest oil field in the Gulf of Mexico since 1999. Hadrian field is estimated to be 700 million barrels of oil. *Bloomberg 6.8.11*

The Permian Basin experiences a major boom. Three Texas Railroad Commission districts have a total of 366 active rigs, triple the number operating in those districts in November 2009  
*FW Star Telegram 6.24.11*

Chesapeake Energy announces a \$150 million (\$50 million per year) investment into Clean Energy to build out LNG fueling stations to support commercial trucking. Combining new LNG stations with increased availability of heavy duty natural gas engines from leading engine manufacturers domestic adoption of natural gas vehicles could meaningfully accelerate. *RJ Energy Group 7.12.11*

### **Really?!**

Obama administration announces the first Strategic Petroleum Reserve release since 2008. Government releases 30 million of the 60 million total in June and July. *6.23.11*

## The Big Picture

Rush for Arctic's Resources provokes geopolitical territorial tussles. Countries beginning to maneuver for ownership of resources in the Barents Sea, Svalbard Archipelago, the Bering Sea, the continental shelf of the Arctic Ocean (particularly the Lomonosov Ridge) and passage rights in the North West Passage. *Guardian 7.6.11*

Half of TVs to have internet connectivity by 2015. Up from 25 percent in 2011. *CNBC 7.5.11*

UN admits that going Green will cost \$76 trillion. \$1.9 trillion per year for 40 years. Estimates in 2009 were for "only" \$600 billion per year. **Repeat: \$76 trillion.** *Fox Business 7.6.11*

Critically tight 2012 oil supply to push up prices according to Goldman Sachs. Prices projected to exceed recent highs as spare production capacity and inventories are "effectively exhausted." *WSJ 7.7.11*

Specter of Years of Stagnating Wages Haunts Globe. Fork lift drivers in UK make 5% less than in 1978. Median male real US earnings have not risen since 1975. Average real Japanese household incomes after taxation fell in the decade of the mid 2000's. German real household incomes have been falling for 10 years. Across advanced economies, the labor market is becoming polarized into "lovely jobs and lousy jobs," says Alan Manning, of the London School of Economics. *FT 6.27.11*

In a first, women surpass men in advanced degrees as well as bachelor's degrees. Among adults 25 and older, 10.6 million US women have master's degrees or higher, compared with 10.5 million men. When it comes to finishing college, roughly 20.1 million women have bachelor's degrees, compared with nearly 18.7 million men. The gap has remained steady in recent years. Women first passed men in bachelor's degrees in 1996. *AP 4.27.11*

United Nations Department of Economic and Social Affairs urbanization statistics predict that as the less developed world grows more urbanized, from 2009 to 2050, **approximately 6 million people per month will move to the city.**

## Follow The Money

### Mergers and Acquisitions

#### Biggest Worldwide Announced Deals in the Second Quarter, 2011 Ranked by deal value, net of debt as of announced date, in \$ billions

<u>Buyer</u>	<u>Seller</u>	<u>Deal Value (\$B)</u>
Johnson& Johnson (US)	Synthes (US)	21.50
Porsche Automotive (Germany)	MAN (70%) (Germany)	13.86
Vivendi (France)	SFR (44%) (France)	11.03
Carrefour, BTG, BNDES (France, Brazil)	CBD(Brazil)	10.7
SAB Miller (UK)	Foster's Group (Aust)	10.11
Capital One (US)	ING Direct (US)	8.88
Takeda (Japan)	Nycomed (Swiss)	8.7
Microsoft (US)	Skype (Luxembourg)	8.5
Exelon (US)	Constellation Energy (US)	7.84
Barrick Gold (Canada)	Equinox Min (98%) (Aust) Bid 2	7.44
Teva Pharm (Israel)	Cephalon (US) Bid 2	7.07
Texas Instruments (US)	National Semi (US)	6.49
Telemar (Brazil)	TNL (24%)Brazil Tel(51%)(Brazil)	6
Williams Co (US)	Southern Union (US) Bid 2	4.99
Applied Materials (US)	Varian Semi (US)	4.97
ConAgra (US)	Ralcorp (US)	4.89
Solvay (Belg)	Rhodia (France)	4.76
Lactalis (France)	Paramalat (71%) (Italy)	4.68
Energy Transfer (US)	Southern Union (US)	4.17
Maple Group (Canada)	TMX (Canada) Bid 2	3.73
Investor Group (Sing,HK,US)	Frac Tech (73%) (US)	3.66
AES (US)	DPL (US)	3.53
Thermo Fisher Scientific (US)	Phadia (Sweden)	3.52
International Paper (US)	Temple Inland (US)	3.51
Marathon Oil (US)	Hilcorp Resources (US)	3.5
PNC (US)	RBC Bank USA (US)	3.45
Bain,Hellman&Friedman(US)	Securitas Direct Sverige (Sweden)	3.44
Arch Coal (US)	International Coal (US)	3.35
QIC (Aust)	Queensland Motorways (Aust)	3.32
Mizuho Fin (Japan)	Mizuho units (Japan)	3.24
Glencore (Swiss)	Kazzinc (42%) (Kazakhstan)	3.2
Ashland (US)	Int'l Specialty Prod (US)	3.2
Investor Group (UK,Can,France)	SPIE (France)	3
Sealed Air(US)	Diversey (US)	2.91
Intact Financial (Canada)	AXA Canada (Canada)	2.76
	<b>Total</b>	<b>\$209.90</b>

Source: WSJ/Dealogic 7.1.11