The single biggest driver for the economy and investment returns is the deleveraging process which we are currently struggling through. Arguably, we have successfully transferred debt from the financial sector to the U.S. government through the Federal Reserve's quantitative easing programs. And, bank loan portfolios are smaller given the decline in loan demand which is consistent with the deleveraging process. As we move through the long process of reducing debt, economic growth inevitably moderates as resources are applied to debt reduction rather than fixed investment and consumption within the economy. As a result, expected returns on financial assets are lower. Therein lies the challenge facing investors – how to invest in today's financial markets where the price of risk is distorted and the rewards are substantially less than investment returns of prior years.

In 2008, during the height of the financial crisis, we realized that structural problems in the economy and capital markets were real impediments to credit expansion, fixed investment and capital formation. We determined that until three things were addressed, the U.S. economy would realize slow growth for the foreseeable future and financial assets would produce mediocre returns from an historic perspective. The three things we were looking for included:

1. A plan to reduce the growing Federal debt
2. A plan for the Federal Reserve to withdraw its stimulus from the market
3. Financial regulatory reform that had teeth and would protect investors

Nearly four years have passed since the financial crisis and federal debt has increased from $884 billion to $1.55 trillion while the budget deficit has increased from $160 billion to $1.3 trillion. The Federal Reserve has implemented two asset purchase programs totaling $1 trillion and is nearing the time when they will implement a third round of open market security purchases. In addition, the Dodd-Frank Act is so mired in minutia it now totals over 2300 pages. The Volker Rule, which is designed to restrict a bank's ability to speculate in the derivatives market and trade for their own account, has still not been implemented because the bank lobbying effort has been effective at pushing back on it.

The International Monetary Fund recently released a revised global economic forecast cutting its outlook for global growth to 3.5% in 2012. We think that is still too high. The developed countries, which include the United States, Japan and much of Europe, have accumulated too much debt in order to sustain their existing standard of living. In the face of slowing global economic growth, these countries are forced to reduce their leverage and shrink their banking system. The process of deleveraging will be painful and long and will act as a barrier to sustained economic growth. The good news is that the process of deleveraging tends to be deflationary and interest rates will likely remain low for a protracted period.

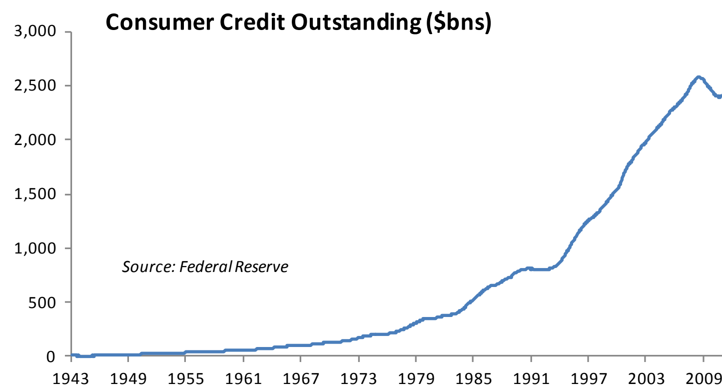
In our 2012 Economic Outlook, we discussed our expectation for a slowdown in the domestic economy in the second half of the year, China's economy to slow, and Europe to be mired in a severe recession. We continue to hold to that view. What we did not fully appreciate at the time was the use of monetary stimulus that the Federal Reserve deployed and the impact that would have on the economy and investment opportunities. *While we expect that there will be another round of stimulus from the Federal Reserve, we believe that each successive attempt at injecting stimulus into the system will have a reduced impact on economic growth and financial markets.*

This economic cycle appears more anemic than others. The long list of structural problems imbedded in our economy and capital markets acts as a type of friction which makes the economic machine less efficient. The cumulative effect of these problems is that wage growth is virtually non-existent, job growth is lower than it should be at this point in the economic cycle, private credit expansion is constrained and fixed investment is being postponed. We expect that the election and the uncertainty over corporate and individual tax policy will be critical issues for the financial markets as we head into the fall. *Throwing more money into the system in an attempt to prop up economic activity has helped to this point; however, now we are left with a large debt burden, anemic economic growth, and no plan to address the problems.*

The Economy

We believe that there are structural problems in the capital markets and the economy that are constraining economic growth. These structural problems are impeding private credit expansion, fixed investment and capital formation which are requirements for any economy to experience sustained growth. Further, until the structural problems are addressed, we believe the Federal Reserve will continue to apply forms of stimulus in an effort to maintain our current level of economic activity. We expect another round of quantitative easing over the next four months.

There are three things that concern us about current economic activity. First, the household sector does not have a large cushion for discretionary spending. In general, consumers will reduce consumption and cut back on purchases when they are wary of the economy's prospects. Consumer confidence shrank in June falling to its lowest level since December. In addition, retail sales continued to decline in June falling three months in a row during the second quarter, the first time since 2008. Household spending remains highly dependent on income growth which is much more constrained than in previous cycles. Consumers will borrow in order to meet monthly expenses and we have seen an increase in the level of consumer debt in the face of weak income growth since the beginning of the year. In addition, rising food prices are becoming a concern given the draught conditions in the Midwest; however, we expect that mortgage refinancing and lower oil prices are providing modest support to demand growth going forward. The bright spot in consumption has been the improvement in the housing sector over the past quarter. We have seen an improvement in home prices in major markets, as well as a pickup in new construction. While we would not characterize this as an acceleration in activity, it is definitely an improvement. With the pickup in housing, we would expect an improvement in consumer activity to eventually follow.



The second concern is the moderation that we are seeing in manufacturing activity. As companies rebuilt inventories following the supply chain disruptions last year, manufacturing was one of the strengths in the domestic economy through the first half of the year. However, with the lack of demand and economic uncertainty, we are seeing a moderation in U.S. manufacturing. While admittedly not the best gauge of manufacturing activity, the Purchasing Managers Index posted a 49.7 in June which may confirm a contraction is taking place.

The third concern is the lack of job growth and private credit expansion at this point in the cycle. At this point in the recovery, as banks accumulate excess capital and businesses pursue expansion plans, we would expect to see an acceleration in job growth coupled with private credit expansion. However, structural challenges and a lack of demand growth are forcing businesses to be more cautious with expansion plans and banks are just sitting on excess capital as loan growth remains meager. Bank lending to small business declined again in June and until we see a significant increase in lending to small business, we expect economic growth to moderate. *Also, we are nearing the time when the government reduces its subsidy currently offered to the banks by eliminating the 25 basis point interest rate on excess reserves held on deposit with the Federal Reserve. This would be a positive in our opinion since it would force the banks back into the business of making loans and managing their risk.*

State & Local Governments

We have seen an increase in the number of cities and local governments filing for bankruptcy this year. In California, four major cities including Stockton and San Bernardino have filed for protection under chapter nine of the bankruptcy code so far this year. *We do not see an outbreak of defaults of municipalities; however, we do believe that there will be a continued increase in municipalities seeking to restructure their outstanding debt*. In general, tax revenues for states have increase over the past year. We still believe general obligation and essential service revenue bonds are some of the safest investments one can make. However, municipalities with large unfunded pension liabilities and those that took on too much debt to fund special projects such as arenas, convention centers and waste disposal systems are particularly vulnerable to further credit deterioration. In the extreme, we expect California and Illinois will ultimately require federal assistance since their unfunded pension liabilities are so large they are essentially irreparable. Other states will require assistance as well, and what that looks like, we have no idea.

Paul Newman said "we live in a world where lemonade is made from artificial flavors and furniture polish is made from real lemons." So, you have to read the label and this applies to municipal bonds where you can think you're investing in one thing and it turns out that you have the debt of something else. In the municipal market, we are most concerned with Tax Increment Finance (TIF) Districts and Economic Development Zones which rely on additional taxes (not property taxes) to fund the interest expense and debt service. During an economic down turn, the projected revenues from the TIF may fall short of projections. Many of these issues are examples of the "buyer beware" market that has developed in securities market and only the most knowledgeable analysts can navigate the cumbersome offering documents to understand the security's structure.

Europe

The debt crisis in Europe is a key driver for economic activity and investment valuations, and cannot be ignored. In our recent *Investment Perspective – Italy, the Next Chapter in the Eurozone Crisis*, we discuss our case for why Italy will ultimately require a bailout. Unfortunately, we expect there is not enough money between the European Union and European Central Bank to prop up the failing countries, and at the same time, provide stimulus for economic growth. In addition, the economic system in Europe is less efficient as cultural differences between the countries apply friction to manufacturing and trade which continue to bog down their economic system. Over the quarter, investors forced interest rates higher in Spain and Italian Government bonds as the EU struggles to contain the debt problem.

Source: Barclays Capital

One of our concerns has been that, as European banks shrink in size and bolster capital, lending to emerging market economies will slow. Roughly half of the lending to emerging markets comes through European banks. A recent report from the Institute of International Finance confirmed that within the past three months, 48% of emerging market banks indicated that funding conditions had tightened, while less than 9% had indicated that conditions had eased at the end of June. This survey shows a worsening in overall emerging market lending conditions for the fourth straight quarter.

WINTHROP
Capital Management

Investment Strategy

For the second half of the year, we expect low single digit returns in domestic equities and fixed income sectors, and performance for both the developed and emerging markets sectors to lag domestic equities. This expectation is based on existing fundamentals and the expectation that the Federal Reserve initiates another round of stimulus, but does not account for any unpredictable brinksmanship in Congress with respect to the "fiscal cliff."

We are beginning to see the negative impact that the European debt crisis is having flow through corporate earnings this last quarter. This is consistent with our original outlook for 2012, in which we expected that the U.S. economy and corporate earnings for the second half of the year would reflect the dramatic slowdown in the Eurozone and China. Wall Street earnings estimates for the S&P 500 have been lowered from a 14.3% increase in earnings down to a modest 5.8% increase. Excluding the financial sector, earnings are now expected to decline by -0.6%. *Stock prices trade on changes to expected earnings and lower second quarter earnings is obviously is not a catalyst for equity price appreciation.*

Yields on U.S. Treasury hit historic lows again this past quarter as the yield on the 10 year U.S. Treasury note dropped to a stunning 1.46%. The Barclays U.S. Aggregate index has increased 2.37% for the first half of 2012. With our expectation of more Federal Reserve intervention in the bond market through another asset purchase program combined with a deceleration in domestic economic growth, interest rates will remain low and could fall further over the near term. However, we expect that any additional stimulus from the Federal Reserve will have less of an impact than prior programs given the lack of private credit expansion, low income growth and political environment. Both high yield and investment grade corporate bonds offer good relative value, but investors have to look harder. Several of our higher coupon investment ideas, including the M&I Bank 5.00% of 2017 and Biomet 10.375% of 2017, have been tendered as companies continue to have ready access to the credit markets at lower interest rates. For investors looking for income, we still see value in preferred stocks of regulated industries. The U.S. banking system is very well capitalized in anticipation of the Basel III capital requirements which go into effect in 2013. Bank preferred securities of issues such as BB&T, Wells Fargo and JP Morgan Chase offer investors' yields between 5.625% and 7.5%. In addition, several utility companies including Georgia Power and American Electric Power have preferred securities outstanding with attractive yields. We are less excited about the preferred securities in the REIT sector since it is not regulated and the valuations supporting the assets in the REITs are likely overvalued at current cap rates.

Our *2012 Economic Outlook* discussed our view that China's economy would slow in 2012 based on the expectation of a severe recession in Europe and China's transition to more of a consumer driven economy. Our view still holds and we are seeing China struggle with slower growth and increased wage pressure as the growing middle class demands high wages. *Inevitably, we expect one of China's chief exports will be inflation as rising labor costs are reflected in prices of goods being shipped.* As we discussed earlier, roughly 50% of the credit flow to emerging markets comes from the European banks. And, as the European banks shrink their balance sheets, credit flows to emerging market economies will suffer. As a result, we expect emerging market economies will struggle until the point that credit flow is replaced by other sources.

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