

## **Summer is for Watching, Fall and Winter will be Better**

Since the financial firestorm of 2008 the level of monetary stress inflicted on investors has been much more than at any time in recent history. We have been fielding questions that while very intuitive, have much more to do with fear than anything else.

Fear is a very good emotion in regard to investing if you can temper it with common sense and if you don't let it take too much control. That said the majority of questions we have been getting clearly show that nearly all investors don't want to go through what they did in 2008.

As stated in many of the StraightTalks over the last ten years, our job is to take macroeconomic information provided by reliable sources and forecasts from the best analysts in the world and offer sound investment advice. This can be used to appropriately manage your accounts and help explain why we do what we do. We take that macroeconomic data and combine it with the best managers (from our research) in each sector or style to construct a sound, diversified portfolio that is constantly monitored.

This process has worked extremely well in regard to our performance versus the markets or more to the point, our benchmarks. If we can continue to adhere to that process (Modern Portfolio Theory - achieve the highest return for the least amount of risk) then we have done our job.

The one thing we don't do is try and time the market – it is a fool's game for many reasons. We can, however, make minor adjustments within our process to make sure we have the most efficient portfolios at each point. The truth is if the markets go down your portfolio will as well, though if we are doing our job properly, not as much as the market.

The continuing moral of StraightTalk is much the same – if you consistently have the best portfolio in every cycle (which is our mission) then your accounts should outperform.

For this StraightTalk I felt it important to dive a little deeper into what we believe is coming for the next several quarters. It is information that allows us to try and stay ahead of the upcoming trends. I believe that the markets will be volatile through the summer and at times will yield some great buying opportunities. Interest rates will stay low until next year allowing for a strong rebound through the end of the year and hopefully providing a base for the next several years.

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*For more in-depth market analysis, please read on...*

### **2011 Year to Date Market Performance\***

**S&P 500**  
**4.96%**

**Dow Jones**  
**7.25%**

**NASDAQ**  
**3.75%**

**MSCI EAFE**  
**3.29%**

**BarCap US**  
**Aggregate Bond**  
**2.81%**

**Morningstar**  
**Large Cap Core**  
**4.40%**

**Morningstar**  
**Mid Cap Core**  
**7.47%**

**Morningstar**  
**Small Cap Core**  
**7.10%**

*\*Market Data  
supplied by  
Morningstar  
through 6/29/11.  
All returns are  
with dividends  
reinvested.*

## 2<sup>nd</sup> Quarter 2011    Sonny Mehra    Research Director

With so much uncertainty and fear surrounding global economies these days, we feel that it is our responsibility to shed some light on the key issues. There are a number of areas that will present both concerns and opportunities in the coming weeks, months and years.

In the next six months, some issues will continue to plague the market. Once those are worked out, however, the stock markets should return to an upward trend. To date, this year has looked very similar to last. Just as we had a correction in late spring/early summer of 2010, this year is looking to go in much the same way. This correction will hopefully be of a lesser magnitude, with the subsequent rebound coming in the fall and winter months.

The concerns in Europe, the recent sharp rise in commodity prices coupled with the disaster in Japan and weather related disasters in the U.S. have caused a short-term drag on the global economy. These issues should be worked out in the next one or two quarters. We have already seen prices on most commodities fall, which will ease the burden on companies as well as consumers. Due to the correction in commodities and the eventual return to normalcy in Japan, there should be an uptick in both manufacturing and consumption in the coming months. It is our expectation that the final half of this year will be relatively strong for stocks. We are not expecting huge returns in the stock market, but we are hoping that the S&P will reach double digit returns for the year.

We would now like to take some time to dig deeper into some of the key areas that have been on investors' minds. We will start by focusing on the United States and then shift to Europe and emerging markets. We will also look at commodities, inflation and interest rates and see what is in store for each.

### **United States**

There has been plenty of recent news on the budget and overall deficit of the United States. While there is no doubt that we need to cut spending and address the deficit, it would be dangerous to do too much too soon. The economy is improving, but is far from being in great shape. As we have seen in Greece and other European Union periphery countries, austerity measures may lower spending, but they will also curtail growth. It is a concern to us that politicians will use deficit reduction as a political tool in order to drum up support for next year's elections. It is likely that no large changes will happen prior to November 2012, but hopefully the budget problems will be looked at more seriously after.

The single biggest problem for the U.S. is one of growth. The U.S. needs to experience strong, sustained growth to pull itself out of the wake of the 2008 global financial crisis. Restoring the long eroded manufacturing base in America could potentially provide this needed growth. As we have moved jobs out of the U.S. and into countries like Mexico and China, the U.S. has lost a big part of its economy. The stage could finally be set for a reversal in that trend, however.

Wage inflation in the emerging markets, coupled with rising currencies has allowed the U.S. to become more competitive with countries like China. There, for instance, wages are rising at double digit rates and this, along with the appreciating currency, has increased their cost of manufacturing. If production shifts back to the U.S., manufacturing may supply strongly needed growth, helping with high unemployment and the federal deficit.

The United States' financial system has many kinks that need to be worked out. Among them are dealing with entitlements, taxes, and putting in place the right policies to spur growth. Hopefully, the president and congress will do the right things to help fix the problems we're facing in the coming years.

## **Europe**

As troubling as things seem here, they're even worse in Europe. The entire EU is threatened by Greece's possible debt default. The austerity measures Greece put in place last year have done little to help with their budget deficit, while at the same time their economy continues to contract. With the prospect of another bailout from the EU and IMF and another round of austerity measures possibly on the way, it would seem that the situation will get worse before it gets better.

The debt problems in troubled European countries will likely exist for a while, as the bailouts may not provide a permanent solution. By avoiding a Greek default, Europe is trying to avoid an instance like the 2008 global financial crisis. German and French banks are among the largest holders of Greek debt, and a default on those bonds would severely hurt those banks. In turn, there could be bank liquidity dry up causing further damage to the global banking system. By giving Greece the necessary money to fund their debt the EU and IMF hope that it will buy sufficient time for the holders of Greek debt to stockpile enough capital to deal with whatever might come next.

Most experts believe that at some point Greece will have to default on their debt. Hopefully it will be engineered in such a way as to cause the least amount of damage. Greek 10 year bonds are yielding over 16%, while anything over 6-7% is thought to be unsustainable. Therefore, it would seem that at some point bondholders will accept something less than par, or have maturities extended to buy more time. StraightLine is confident that a suitable solution will be found and the necessary steps will be taken. For the foreseeable future, however, it is important to make note of this when making investment decisions.

## **Emerging Markets**

Emerging markets continue to be the drivers for global growth, but they have recently been hit with high inflation. Most emerging market countries have been tightening their policies in order to battle this problem. There are signs that growth is starting to slow, and there is concern that governments may do more harm than good to their economies.

In addition to inflation there have been some concerns that bubble-like qualities exist in pockets of these economies. In China, for instance, some suspect that real estate may be in a bubble - they may have overbuilt and overextended this market. Real estate is also heavily used as an investment, and this has been driving up property prices. Signs point to the market being overheated, but we don't believe the market is in a bubble. Chinese homebuyers are required to put down at least 40% as a down payment and are far less leveraged than homebuyers here.

As a whole, emerging market equities have underperformed this year, with the MSIC EM Index at a -1.40% return through June 28th. During the same period, the S&P 500 is up 4.09% and the MSCI EAFE International Index is up 1.40%. This underperformance has created more attractive valuations for emerging markets stocks and, once the inflation issue is worked out, it should lead to superior returns in the future. These concerns are temporary, and over longer periods of time the emerging markets remain one of the better investment options.

## **Commodities, Inflation & Interest Rates**

Finally, we will focus on three things that have generated a lot of discussion this year. In our analysis there is some commonality between commodities, inflation and interest rates, as one affects the other. We saw commodity prices rise almost across the board during the early part of the year. This in turn caused inflation to rise, and has started to push interest rates up in parts of the world. In recent weeks, however, we have seen commodity prices fall and therefore inflationary pressures should follow accordingly.

Below ground commodities are becoming more difficult to find and extract. Oil, when found, is often of a lower quality and requires more effort to extract. This drives up the marginal production costs and prices. Also, spare capacity for oil and other commodities has been greatly diminished. When capacity is falling, demand factors become more important. The emerging markets will be the biggest drivers for demand in the coming years. Despite its population, China only accounts for 10% of global demand for oil, and that number will only increase. The long-term upward trend for commodities remains intact.

It is our belief that commodities should be managed as a small tactical position in appropriate, diversified portfolios. Despite our outlook for higher prices, commodities are notoriously volatile, and blindly investing in them can be dangerous. Already this year we have seen big swings in prices, and it does not take much to set things off.

Commodity prices have affected inflation expectations for this year. The rise in commodity prices caused the prices of many goods and services to increase as companies had to pass some of the costs on to consumers. Prices have recently eased, though, and we can expect that inflation numbers will start to come in lower, particularly with a slowing global economy. Inflation will likely remain high in the emerging markets, but will ultimately be brought under control. In the developed world, inflation numbers will start to come down within the next one or two quarters as the price shocks from earlier this year wear off. Looking ahead further, we expect that inflation will remain fairly subdued in developed countries, as they continue to experience subpar growth.

According to a press conference on June 22nd, 2011 with Ben Bernanke, chairman of the Federal Reserve, the Fed will not be raising interest rates for an extended period of time. It likely will not happen until there is a sustained period of both economic growth and a decrease in unemployment.

Overall, we expect that markets will continue to be choppy, with many ups and downs. We are still optimistic that some of the concerns that are present will be worked out. It is important to remember that even though things can seem pretty scary at times, the stock markets have still managed to produce significant returns since the 2009 lows. We are always monitoring global events and have the ability to adjust portfolios as needed. Your trust is absolutely essential to what we do, and we thank you for it. If you have any questions or concerns please contact us.

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**StraightLine**  
**165 Kirts Blvd., Ste. 600**  
**Troy, MI 48084**  
**www.myrplan.com**  
**866-401-5238**