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Market Review

July 2012

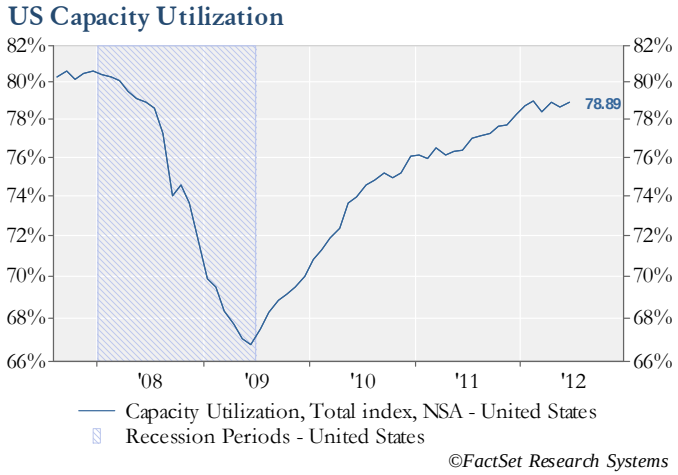
Economic Review

Weak economic data continued to dominate the news in July. The first estimate for second quarter GDP data showed further deceleration in the U.S. economy, registering 1.5% growth. This reflected further contraction in government spending and moderate narrowing in net exports. Consumption continued to grow, albeit at a decelerated pace from the first quarter and private investment showed signs of moderate growth acceleration.

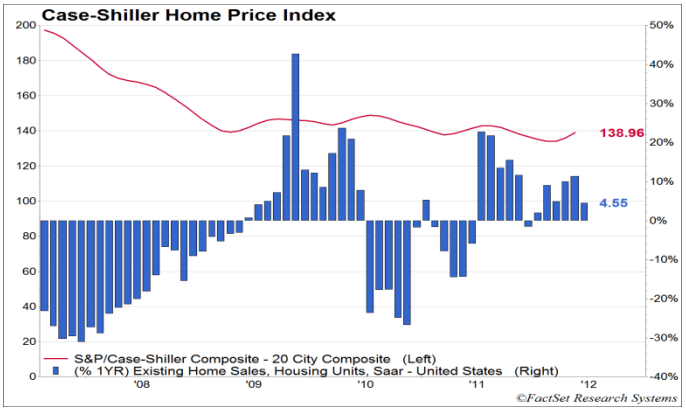
Comparison of Q2 and Q1 GDP			
Component	Q2 estimate	Q1	Difference
GDP	+1.50	+2.00	-0.50
Consumption (C)	+1.05	+1.72	-0.67
Investment (I)	+1.08	+0.78	+0.30
Government Spending (G)	-0.28	-0.60	-0.32
Net Exports (X-M)	-0.31	+0.06	-0.37
GDP = C + I + G + (X - M)			

Source: St. Louis Fed

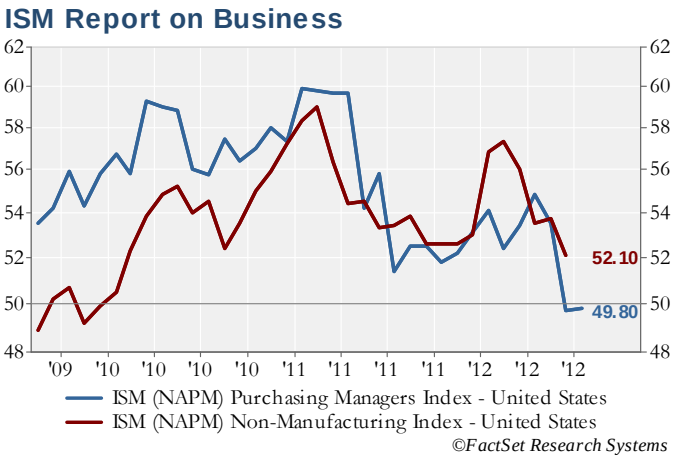
Industrial production rose 0.4% in June on a monthly basis after having declined 0.2% in May. On an annual basis, preliminary estimates suggest that industrial production rose 4.7% through June. Capacity utilization rose 0.2% to 78.9%, 1.4% below its long run (since 1967) average. The Conference Board's Consumer Confidence Index improved slightly in July, rising to 65.9 from 62.7 in June. The U.S. non-farm payroll rose by 80,000 in June, missing consensus estimates of 100,000. The unemployment rate remained unchanged at 8.2%, topping 8% for the 42nd successive month. Jobless claims, however, rose less than forecasted to 365,000 in the last week of July.



The U.S. housing market continued to show mixed results in July. The Case-Schiller Index rose for a second month on a month-over-month basis in July, though prices remain lower than a year ago. June existing-home sales fell 5.4%, while new housing starts rose 6.9%. In addition, RealtyTrac published data indicating that foreclosure activity has risen 1.5% in the first half of 2012, in comparison to the previous 6-month period.



The U.S. ISM Manufacturing Index showed contraction in the sector for the second straight month. The Index registered 49.8 in July, an increase of 0.1 from June's reading of 49.7. This missed analyst expectations of modest growth at 50.2. The New Orders subindex registered 48, a 0.2 increase off of June levels. A reading above 50 indicates expansion and below 50 indicates contraction.



Much attention was given in July to the prospects of additional quantitative easing by the Federal Reserve. A survey conducted by CNBC indicated that 78% of Wall Street professionals expected additional stimulus in the next 12 months, up from 59% in June. The Fed's recent Beige book indicated modest economic expansion, but the agency revised growth estimates downward to reflect the increasing likelihood of further deceleration. The Fed left the Fed Funds rate unchanged at the end of month meeting, and

did not announce the commencement of additional stimulus. Instead, Ben Bernanke promised that the Fed would "closely monitor" current economic conditions, and will provide additional accommodation in the future as needed.

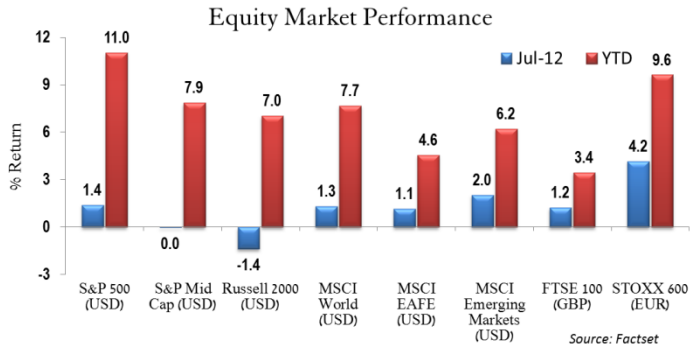
The European Central Bank (ECB) cut its benchmark interest rate 25 bps to 0.75% early in the month. Most of the Eurozone attention focused on Spain this month, where Spanish banks and several regional governments asked for additional funds. The Spanish and Italian regulators also acted to impose a short term ban on short-selling in their equity markets. ECB president Mario Draghi made headlines at the end of July when he promised to defend the Euro by any means necessary, prompting a strong market rally. Despite initial reports that Draghi's comments were supported by Angela Merkel, the German government rejected the proposal to give the European Stability Mechanism (ESM) a banking license. The Germans continued to push for a more integrated fiscal policymaking system. At the end of July, Draghi signaled strongly that the ECB is preparing for another round of bond purchases.

For the second time in less than a month, the Chinese Central Bank cut interest rates, in a bid to spur growth during the country's sixth consecutive quarter of slowdowns. The Chinese economic growth slowed to 7.6% in second quarter of 2012, down from 9.3% in 2011. The latest economic data from China indicated a further deceleration of economic growth. China's industrial production slowed to 9.5% and a massive slowdown in imports widened the trade surplus to $31.7 billion, its widest level since 2008.

Moody's cut Italy's government bond rating to Baa2 from A3, and maintained a negative outlook moving forward. The rating agency also placed the Aaa ratings of Germany, Luxembourg, and the Netherlands on negative outlook due to an increased risk of support for peripheral countries and deterioration of growth in the Eurozone. Additionally, Moody's downgraded one to two notches the ratings of three Italian insurance groups and 13 Italian banks.

Equity Markets

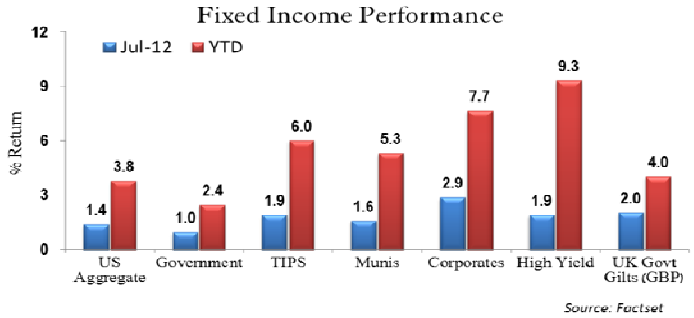
Equity markets continued to add to YTD gains in July as global economic growth concerns, mixed corporate earnings, and the ongoing European debt crisis were all offset by central bank actions and hints of policymaker intervention. The S&P 500 gained 1.4% in July and is up 11% in 2012. European markets rallied toward the end of the month, spurred by ECB presidents pledge to protect the Euro. Emerging markets, however, outperformed for July, adding 2.0%, although MSCI EM Index has underperformed YTD.



Despite last month's volatility, equity markets stayed relatively calm in July, with 3.8% separating the month's high and low. Markets got off to a rough start in July, as the first week and a half saw the S&P 500 lose over 2%. This was attributed primarily to weak June payroll data, and continued concerns over the European debt crisis. Spanish 5-year bond yields hovered over 7%, an unsustainable interest rate for Spain to finance its deficit. Global policymaker comments and several positive earnings surprises helped the markets recover, as the S&P would rally over 3% to close July in positive territory.

Bond Markets

Fixed Income had a relatively strong month. Treasury yields fell across the curve which flattened slightly in July as 2-year yields closed 7 bps lower at 0.23%, 10-year yields finished 14 bps lower at 1.51% and 30-year yields ended the month 18 bps lower at 2.58%. Credit spreads tightened in July with significant narrowing during mid-month Eurozone concerns.



The 10-year Treasury yield fell to a new low of 1.39% in late July. Yields promptly reversed on comments by Mario Draghi, Angela Merkel and Ben Bernanke hinting at additional intervention. The UK 10-year GILT yield fell 16 bps to close at 1.73%. The German 10-year Bund yield fell

21 bps and closed at 1.28 %. The German 2-year Note yield closed the month at a record low of -0.097 %. The negative yields in two-year bonds of several European nations including Germany, Netherlands, Finland, Austria and Denmark have persisted for several weeks now, and are flashing a warning sign about the health of financial markets in Europe as individuals and institutions literally pay for these governments to hold their capital.

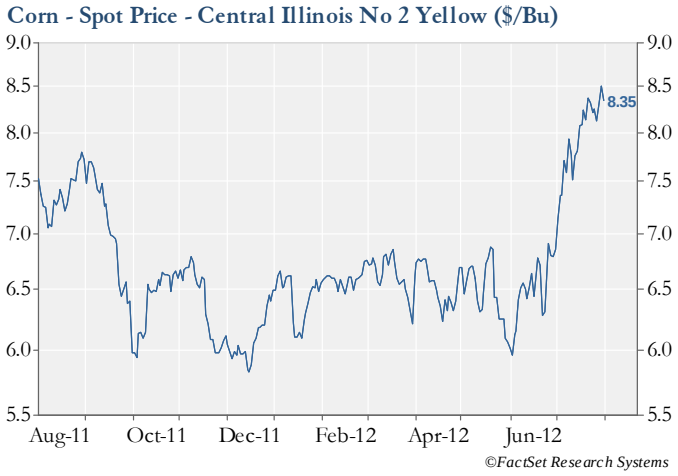
Currency

The US Dollar Index strengthened 1.23% against a basket of six currencies in July and is up 3.05% for the year. The Australian Dollar climbed 2.6% against the US Dollar in July amid speculation of further monetary stimulus by the ECB and the Federal Reserve. The Euro declined against 15 of the 16 major currencies last month. It trended down against the US Dollar for most of the month, slipping close to 5% before making a 2% recovery after the comments from ECB president. The Euro depreciated 2.95% against the US Dollar to close the month at 1.2315. The British Pound slid 0.11% to close the month at 1.5668.

Commodities

Led by agricultural commodities, the S&P GSCI Index rallied 6.4% in July, the highest since October 2011. The Index is still down 1.4% for the year. Except for livestock and industrial metals, all the GSCI sub indices returns were in the positive territory.

Grain markets soared in July as harvest outlooks were downgraded globally due to drought in U.S., Canada and Russia; a sub-par monsoon season in India; below-average rainfall; and repeated frost in Australia. Corn, Wheat, and Soybeans led the rally amongst the 24 commodities that make up the S&P GSCI Index. Corn surged over 28% in July as the mid-west U.S. experiences the worst drought in more than half a century. Wheat increased 17%, while Soybeans increased 15%.



Natural gas in the U.S. rose 14% last month, its second consecutive monthly double digit gain, as warmer than usual weather increased electricity demand and buoyed prices. Natural gas exceeded $3/million BTU for the first time since January and is still down 14% for the year.

Feeder Cattle, Nickel and Lean Hogs had the weakest performance among the S&P GSCI commodities with returns of -9.3%, -5.4% and -4.6% respectively. The prices of Feeder Cattle and Lean Hogs dropped on concerns that more animals would be slaughtered as feed costs increase.

For the year, Soybeans, Corn and Wheat lead the 24 commodities in the S&P GSCI Index with returns of 44.1%, 39.1% and 29.6% respectively. Coffee, Cotton and Nickel had the worst performance year to date with returns of -25.5%, -16.4% and -16.0% respectively.