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INDEPENDENCE
FINANCIAL

QUARTERLY ECONOMIC UPDATE

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A review of 2Q 2011

QUOTE OF THE QUARTER

“Failure is not fatal, but failure to change might be.”

– John Wooden

QUARTERLY TIP

Do you regularly log into your bank account or credit card to verify charges? If you don't bank online - do you carefully check your monthly statements? If not, you should.

Fraudulent charges are all too common these days, and some “clever” thieves make small, seemingly insignificant charges (\$9.99, \$19.99) - most likely in hopes that you won't notice, or that you'll decide the amount is too minimal to bother with. If you don't recognize a charge, call your bank or card provider immediately. Aside from the importance of getting your money back, it's vital that they know of the fraud. It means your account info may be compromised, and most banks will help you by looking into the fraud and by issuing you a new card or account number to protect you from future erroneous charges.

THE QUARTER IN BRIEF

For the first time in four quarters, U.S. stocks did not advance. The S&P 500 lost 0.39% in 2Q 2011, a quarter marked by worries over the debt carried by multiple European nations, the wrap-up of the Fed's second installment of quantitative easing, high gas prices and indications that the recovery was stalling. Yet as June ended, encouraging domestic indicators and better headlines from overseas helped to renew the collective appetite for risk.¹

DOMESTIC ECONOMIC HEALTH

Much was made of the “soft patch” the economy had entered into this spring. Some key indicators seemed to confirm it. Consumer spending – which had increased by 0.6% in March – was just +0.3% for April and flat for May. When adjusted for inflation, personal spending actually decreased by 0.1% in both those months. Retail sales were up 0.3% in April, down 0.2% in May. On the other hand, durable goods orders – down 2.7% in April – improved by 1.9% in May.^{3,4}

Unemployment actually increased in the quarter. In March, the jobless rate was at 8.8%; in May, it had climbed back up to 9.1%. By May, annualized inflation had cranked up to 3.6%, and gasoline prices had risen 36.9% in a year. On the bright side, monthly consumer price increases had moderated: after 0.5% gains in the federal government's Consumer Price Index in February and March, prices respectively advanced by just 0.4% and 0.2% in April and May. Wholesale inflation was more pronounced, what with energy costs and supply disruptions in the wake of the March earthquake and tsunami in Japan: producer prices increased by 0.8% in April and 0.2% for May, bringing 12-month wholesale inflation to 7.3% in May compared to 5.8% for March.^{5,6,7}

As for the key American snapshot of the manufacturing and service sectors, the Institute for Supply Management's non-manufacturing index went from 54.6 in May to 53.3 in June; its manufacturing gauge defied expectations, moving north to 55.3 in June from May's 53.5 reading.⁸

In April, citing concern over the ballooning U.S. deficit, Standard & Poor's cut the credit outlook for America from “stable” to “negative”. Moody's Investors Service made no such move. The federal debt ceiling was reached on May 16, and Treasury Secretary Timothy Geithner noted a hard deadline of August 2 to raise the debt cap. Congress mostly dithered on the issue during May and June, playing politics first and striving for compromise second. The Federal Reserve's second round of quantitative easing ended June 30 and the impact wasn't as harsh as feared: though the end of QE2 meant the end of \$600 billion thrown at the bond market, bond yields and stock prices actually increased slightly on July 1.^{9,10,11}

GLOBAL ECONOMIC HEALTH

As the quarter ended, Greece seemed poised to stave off a near-term default with \$17 billion more in loans from the International Monetary Fund and the European Union. Greece's parliament passed an austerity bill on June 29 including \$40 billion in tax hikes and budget cuts.¹²

That wasn't the only notable economic development in Europe in the quarter. The European Central Bank raised its key interest rate to 1.25% (and seemed poised to raise it again in early July), making a move before the Bank of England and the Fed. Annualized inflation in the Eurozone was at 2.8% in April; it ticked down to 2.7% by June. Retail sales in the EU slumped by 1.1% in May, and by 2.8% in Germany. On the upside, Germany's manufacturing orders rose by 2.9% in April and 1.8% in May, and German business confidence improved in June.^{13,14,15}

China's official manufacturing index declined in each month of the second quarter, falling to 50.9 by June. Its annualized inflation rate hit 5.5% in June, the highest in 34 months. Elsewhere, there were other signs of a slowdown: India's PMI slipped in both May and June, reaching a low unseen since September. The key PMIs in South Korea and Taiwan also fell, with Taiwan's showing sector contraction. Business sentiment in Japan fell to its lowest level in five quarters in 2Q 2011, an effect of the triple tragedy the nation suffered in March.^{16,17}

WORLD MARKETS

The world's major stock market indices posted widely varying quarterly results. In Europe, Germany's DAX advanced a healthy 4.8%, and Ireland's ISEQ gained 2.7%; England's FTSE 100 managed to gain 0.6%, while the Dow Jones STOXX 600 slipped 1.1%. While the Nikkei 225 actually advanced 0.6% for 2Q 2011, the bulk of important indices in Asia did not (Kospi, -0.3%; Sensex, -3.1%; Hang Seng, -4.8%; All Ordinaries, -4.8%; Shanghai Composite, -5.7%). Brazil's Bovespa went -9.0% for the quarter. The MSCI World and Emerging Markets indices respectively lost 0.28% and 2.11% last quarter.^{18,19,20,21}

COMMODITIES MARKETS

While May and June were trying, the quarterly performances were not all bleak. Reviewing metals on the COMEX, we see that gold gained 4.4% (its eleventh positive quarter in a row) to go +5.7% for the year. Other metals posted quarterly losses (silver, -8.1%; platinum, -3.2%; palladium, -0.9%). The U.S. Dollar Index retreated 2.2% for the quarter.^{22,23}

Moving to energy and crops, oil lost 10.6% in 2Q 2011 for its worst quarter since 4Q 2008 as the International Energy Agency elected to free up global reserves. While several key crops have had a great run over the past 12 months, the quarter was not kind to them: corn lost 10.0%, soybeans slipped 8.2% and wheat lost 20.0%. Rice pulled off a 6.1% quarterly advance.^{24,25}

REAL ESTATE

Instead of a bottom, we got a double dip: in June, the April S&P/Case-Shiller Home Price Index came out and revealed a 4.0% year-over-year decrease in collective house prices across 20 metro areas. As for other barometers, June existing home sales (as measured by the National Association of Realtors) were down 15.3% from a year ago while June new home sales were up 13.5% from a year before.^{26,27,28}

Mortgage rates fell in the quarter. Here were Freddie Mac's Primary Mortgage Market Survey interest rate averages from March 31: 30-year FRMs, 4.86%; 1-year ARMs, 3.26%; 15-year FRMs, 4.09%; 5-year ARMs, 3.70%. The numbers from the June 30 survey: 30-year FRMs, 4.51%; 1-year ARMs, 2.97%; 15-year FRMs, 3.69%; 5-year ARMs, 2.97%.³⁰

LOOKING BACK...LOOKING FORWARD

The mixed 2Q performances of the major indices aren't so bad when you consider the volatility (and swoon) of June.¹

% CHANGE	Y-T-D	2Q CHG	1-YR CHG	10-YR AVG
DJIA	+7.23	+0.77	+27.01	+1.82
NASDAQ	+4.55	-0.27	+31.49	+2.84
S&P 500	+5.01	-0.39	+28.13	+0.79
REAL YIELD	6/30 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	0.75%	1.15%	2.54%	3.52%

Sources: online.wsj.com, bigcharts.com, treasury.gov, treasurydirect.gov - 6/30/11^{1,30,31,32}
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.

The new quarter begins with a few questions. Will a QE3 be needed? Will inflation become more of a factor? Will cheaper commodities help U.S. companies? Will Greece require further bailouts or loans before 2011 ends? Are Spain, Italy and Portugal next on the EU/IMF rescue list? How long can world financial markets put up with inaction on the U.S. debt ceiling? And finally, will Wall Street earnings be as impressive as some analysts think? It promises to be an eventful quarter.

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