



A Return to Reality—It Will Always Be About the Economy, Silly!

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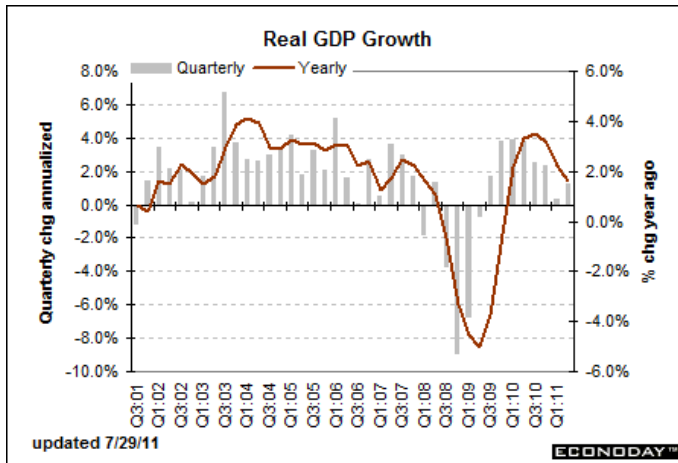
Now that the budget debates are over and signed by President Obama (more work to be done, but it'll get the debt ceiling raised and our AAA rating will remain intact), the attention of investors has returned to the economy. While concerns about the U.S. debt crisis had certainly been a downward driving force on the market as we headed into the eleventh hour, it isn't that there weren't signs of a slowing economy. This was all too similar to the most recent renewed worries over Greece's debt problems which also drove the markets lower at the time. There was a similar anticipation by investors that upon moving past the debt issues here in the U.S. that global markets would again rebound.

While this was the initial reaction early this past Monday from global investors, it was short-lived as investors began to redirect their attention on recent economic news reporting more weakness in the global economies, especially here in the U.S. Not that we haven't seen such reports over the last few months on a regular basis, but investors appeared to ignore much of the economic news as they focused much of their attention on the international debt issues.

To illustrate why we don't get distracted by the reports that flow out of so many corners, including the media and Wall Street, we simply need to look at all the worry, generated from a rating cut on U.S. debt as a result of potential defaults by the government, which were tremendously overblown. While not raising the debt-ceiling may have created a lack of available funds for making immediate payments, it did not mean that the United States could not pay its debt. Rather, it was a demonstration of the ineptness of our politicians to handle the situation. To look at this in a clear light, despite the fear of a decline in the rating of U.S. debt, bond prices recently rose pushing interest rate yields lower at the very time these fears were at their highest. It seems that despite concerns over our financial inabilities, the U.S. is still considered to be the "safe haven" of choice in a world of turmoil. This is what we would have expected—perhaps this alone helps put some of the fears in the marketplace aside.

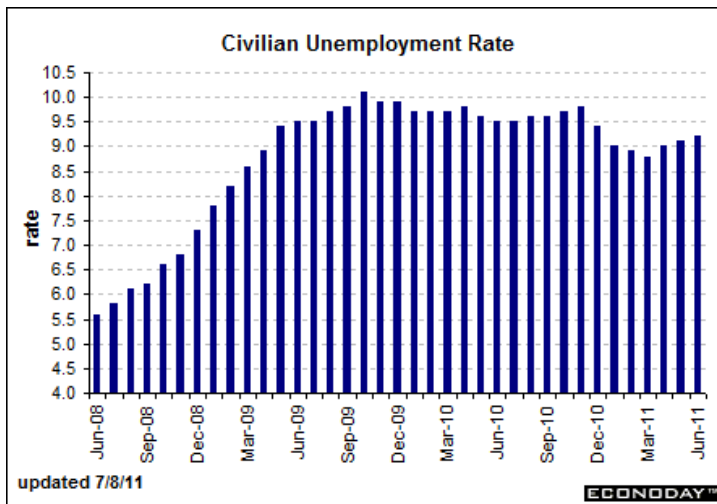
So What Should We be Concerned About and Why is the Market Suddenly Falling?

Here's a smattering of *recent* reports that we find troubling:



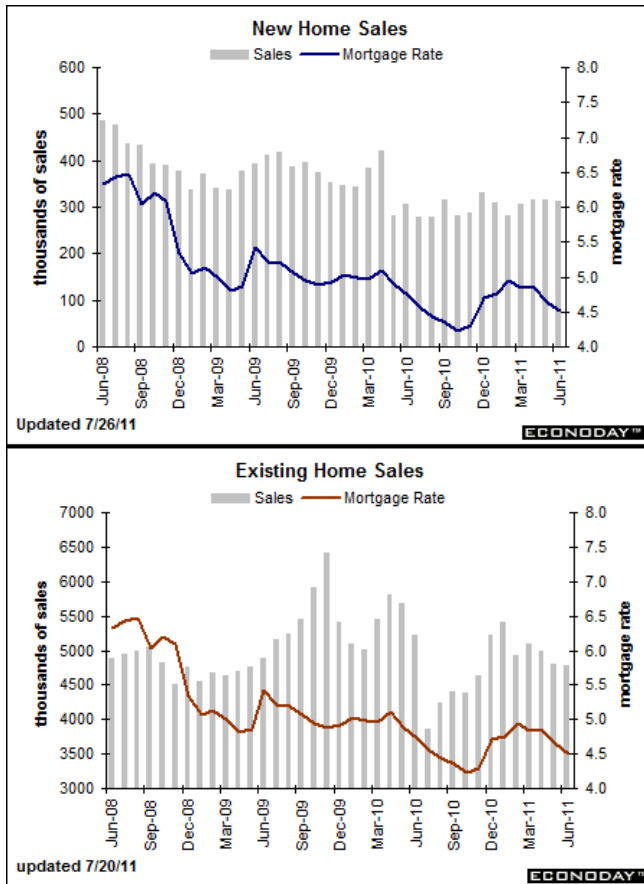
- GDP in the first quarter (Q1:11) was revised to show annualized growth of 0.4%, down from the previous number of 1.9%, while the initial report on Q2:11 is 1.3%. First quarter showed practically no growth, and unfortunately, the second quarter number is subject to two revisions over the next two months and will most likely be revised lower.

- The July *ISM* (Institute of Supply Mgt) *Manufacturing Index* for national manufacturing activity, while still showing growth in the U.S., again trended lower with a further decline in new orders and a dramatic lowering in the backlog for future orders. This was also seen in the service sector for the *ISM Non-Manufacturing Index* with weakness in both of these categories, as well.



- First time unemployment claims have been declining, which is generally a good sign of improvement. However, following a weakening trend in employment in each of the last two months, negligible additions in conjunction with a falling trend in business activity, leads us to believe employment is not improving.

In addition, several companies including Merck, Goldman Sachs, Cisco Systems, HSBC, Royal Bank of Scotland and Borders have recently announced layoffs which have sent the Challenger Job-Cut Report 60% higher bringing its forecast of a future reduction in employment to a 16-month high. Borders announced that it will be going out of business and will be closing all of its stores and laying off 10,700 employees in the near future. And finally, in a recent Wall Street Journal survey, 65% of businesses that responded said lack of consistent demand in business activity was the main reason they are not planning to hire more employees.



- Existing Home Sales have been trending down from an annualized level of 5.4 million units in January to a current level of below 4.8 million units. Further, while Housing Starts for new homes is running at above 400,000 annualized units of single family homes, New Home Sales are coming in barely over 300,000 annualized units, meaning we're still building more than are being sold. Surprisingly, housing permits, a sign of future activity in the construction of new homes is running at 624,000 with only a small number of these outside the single family home category. Given the weakness reemerging in the employment picture, it does not bode well to add to the supply of existing and new homes already on the market.

- And finally, not wanting to show that only the U.S. is seeing issues with economic weakness, Australia recently announced that a combination of the strong Australian dollar, overseas competition and rising electricity prices were behind the decline in its manufacturing sector that pushed its PMI report to 43.4, well below the 50 level needed to show an expansion. New orders actually fell 14.4 points to 40.2, pushing both this component number and the overall level into recession territory. In addition, although continuing to show a level of expansion at above the 50 mark, India's manufacturing fell to a 20-month low in July as a result of India's central banks raising interest rates 11 times in the past 18 months in an effort to slow inflation. Similarly, China's manufacturing is at a 28-month low following numerous increases in its interest rates, as well, in an effort to keep inflation at bay by slowing the Country's growth rate.

What Does This All Mean?

We have been watching closely as the current economic weakness has intensified over the last few months. We realize that there are many who continue to look for a stronger second half of 2011. Many were originally anticipating a robust pick-up during the third and fourth quarter. However, we are now hearing a more sullen discussion, dispelling current weakened activity as recessionary, with much less certainty of this outlook.

Tomorrow's July employment report will definitely help bring clarity in terms of the current outlook for further economic activity. However, given earlier reports released for second quarter and recent months, we believe that most growth outlooks will need to be adjusted to bring a more realistic light on where the economy, and therefore the market may be heading for investors. We alluded to a number of events that we have been referring to as the *Perfect Storm*. It is realistic to believe that a slowdown in the U.S. economy will have a definite slowing effect on overseas economies, while the slowing economies overseas will be harmful to manufacturing activity here in the United States. The declining U.S. and global stock markets are beginning to show that investors are finally taking the current slowing into greater consideration. We expect this to continue.

What to do Now?

The market has given up ground to the chagrin of many investors, both professionals and individuals. We give the following suggestions to those who have been inquiring as to what to do: 1) reduce exposure to the market by raising some cash—but not foolishly, 2) hedge your downside risk, which means you can still participate in any upside move in the market, albeit with lesser potential, while at the same time reducing your downside risk that may be caused by a major fall in the market, 3) hold dominant companies in your portfolio that will continue to grow or have strong future potential, and 4) begin to watch for solid investment opportunities that become undervalued in terms of current and future valuations and potential.

The direction will continue to be clear—the road, however, is getting a bit rough and a little bumpy. Please feel free to call us if you have questions on what is going on in the markets or need some help with your investments.

~Mark Gaskill, Chief Investment Officer

~Julie Bryan, Director of Research, CFA

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