



# Fort Washington Investment Advisors, Inc.

A member of Western & Southern Financial Group

JULY 2010



## Markets at an Inflection Point

**Nicholas P. Sargen, PhD**  
*Chief Investment Officer*

With results for the second quarter now in, there has been a pronounced shift in sentiment among investors about the prospects for the global economy. Until late April, market participants were hopeful that the U.S. and international economies were on the path to a self-sustaining recovery. More recently, however, problems in euro-zone have spawned talk of a “double-dip” in Europe, and investors have become concerned about a possible weakening in China. At the same time, the job picture in the United States turned less favorable in May, and recent economic data point to a slowdown ahead.

Amid these developments, there has been a significant re-pricing of market risks. U.S. and international equity markets have fallen by 15% -20% from their recent highs. In the U.S. bond market, long-term treasury yields have fallen by a full percentage point from their levels in early April. In Europe, sovereign spreads versus German government bonds have widened, while the euro has weakened considerably.

In our judgment, the problems in Europe and uncertainty about fiscal and regulatory policies in the United States are likely to contribute to softer growth in the industrial countries. That said, we continue to believe the risk of a “double dip” is low in the United States and Asia.

We share investors’ concerns about Europe, mainly because the debt crisis in Greece has morphed into a problem for other southern European countries and European banks. Nor do we see a quick resolution to the crisis. Policymakers effectively have created a European version of TARP to buy time for the problem countries to bring their fiscal houses in order. However, the policy actions have not convinced investors that Greece, and possibly Portugal and Spain, will be able to avoid debt rescheduling. Furthermore, European banks have experienced funding problems, which have required the European Central Bank to infuse added liquidity. It remains to be seen whether the announcement of “stress test” results for European banks on July 23rd will have a calming effect.

By comparison, we view conditions in China and Emerging Asia more favorably. While economic activity in China and the Far East appears to be moderating, the region should continue to be the leading engine of world recovery. In our view, the Chinese authorities are prudent in tightening monetary policy to counter a potential property bubble and incipient inflation pressures. They also have responded to growing international pressure by allowing the Chinese currency to appreciate gradually. While growth in China is poised to downshift from double digit rates, we do not foresee a precipitous slowdown that would jeopardize economic expansion in the region.



The U.S. economy continues to perform between Europe and Asia, with real GDP growth estimated to have expanded at a 3% rate in the first half of this year. This constitutes a sub-par recovery, given the severity of the recession in 2008-09 and the persistence of high unemployment. The bright spot is the corporate sector, where profits have risen significantly, as margins have improved and top-line revenue growth has begun to expand. Thus far, however, businesses are adding to the workforce at a modest pace of about 100,000 new jobs per month, which is just sufficient to keep the unemployment rate from rising. Meanwhile, investors are digesting the impact of legislation on the healthcare and financial sectors, prospective outsized budget deficits, and likely changes in tax policy as the Bush tax cuts are set to expire at the end of this year. Consequently, the debate over whether the economy is on the road to self-sustaining recovery is likely to continue into the second half of this year and possibly into 2011.

Weighing these considerations, we have made some changes to our outlook, especially on the interest rate front. Previously, we believed the Federal Reserve would begin to tighten monetary policy later this year and that treasury yields would rise on the back of heavy treasury issuance. In the wake of the recent developments, however, we now expect the Fed to keep rates unchanged well into 2011. Nonetheless, we do not find treasuries attractive at current yields, and we are continuing to overweight corporate bonds, which offer better relative value.

On the equity side, we continue to view the recent sell-off as a correction, but soft economic data could spur further declines. With the S&P 500 index having fallen about 15% from its peak in late April, valuations are beginning to look interesting, and we would consider adding to equities if the market declines further. Meanwhile, we are keeping stock-bond allocations close to their strategic normal allocations for balanced portfolios.

*Past performance is not indicative of future results. This publication contains the current opinions of Fort Washington Investment Advisors, Inc. Such opinions are subject to change without notice. This publication has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Fort Washington or its affiliates may from time to time provide advice with respect to acquiring, holding or selling a position in the securities mentioned herein. Information and statistics contained herein have been obtained from sources believed to be reliable but are not guaranteed to be accurate or complete. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of Fort Washington Investment Advisors, Inc.*

©2010 Fort Washington Investment Advisors, Inc.

