

**Ladenburg Thalmann Asset Management**  
**Market Commentary**  
**July 2012**

**Overview**

Instability and market volatility returned in the second quarter due to renewed global economic concerns. The European debt crisis has once again come into the spotlight, and despite an agreement between European leaders to create a single supervisory body for Eurozone banks, there are still many details to be hashed out. Further problems also persist domestically surrounding the level of U.S. debt, U.S. tax codes, and healthcare costs. Other concerning statistics are the slightly contracting U.S. manufacturing sector and the high unemployment rate at 8.2%. In spite of these facts, the S&P 500 was down only -2.75% in the second quarter and is still up +9.49% for the year. Although we see reasons for concern, it is important to look past the headlines and concentrate on facts in order to avoid making investment decisions based on emotion. While many companies have lowered future earnings estimates, corporate profits are still near record highs and consumers continue to spend at a healthy rate (the US personal savings rate is at 3.9%, we consider 3-5% to be a healthy number). GDP for the first quarter came in at 1.9%, and although we would like this to be closer to 3%, this means the US economy continues to expand. Due to these uncertainties, we continue to stress the importance of managing downside risk, and hold a conservative stance in our strategies to manage against market volatility but stay invested in equities and are pleased with their continued outperformance.

**Domestic Equities**

It's hard to believe that equities (measured by the S&P 500) are only down -3.4% since the market peak on 10/9/2007 and are up +115.9% since the market low on 3/9/2012 after enduring what has been considered the worst recession since the Great Depression. The recovery process has certainly not been without bumps in the road with the S&P 500, for example, peaking on April 2nd of this year at a high of 1422 and then falling to 1267 on June 4th, a 10.9% correction. Even with this recent pullback in the market, domestic equities are still positive for the year and are actually above historical norms. Additionally, relatively inexpensive valuations (measured by the Price to Earnings ratio; P/E) on equities and low yields on fixed income point to equities as a more favorable investment. Although slowing as of late, corporate profits continue to come in above expectations and business investment in equipment and software has increased 10.8% annually since Q2 2009 and now stands at \$1.18 trillion. Continuation of these trends should positively impact the markets, but it should be pointed out that for the first time in three years, the U.S. manufacturing sector index came in below 50, at 49.7 for June, signaling contraction in the sector. It is unclear if this is just a blip or an actual slow down. The manufacturing renaissance we've experienced in America can be partially attributed to the long term devaluation of the U.S. dollar, making domestic manufacturing more appealing. Over the past few quarters the dollar has gained significant ground against most major currencies as investors searched for the least risky investment, which could have contributed to the slip in manufacturing. We expect volatility and uncertainty to persist in the equity markets and so we continue to favor large and mid cap stocks over small cap and growth stocks, due to their defensive nature.

**International Equities**

After a strong first quarter, international equities gave back much of the gains experienced this year. International developed equities (MSCI EAFE Index) returned -7.13% and emerging market equities (MSCI EM Index) returned -8.89% for the second quarter. The performance of these markets is very much driven by the performance of the underlying currencies, which will continue to be dependent on the health and security of the European Monetary Union. Beyond international developed and emerging markets, frontier markets outperformed most other broad based international equities. With less reliance on Europe and lower valuations, we expect frontier markets to be a growth driver within our portfolios. We continue to favor emerging and frontier markets over international developed markets due to the expanding middle class, lower levels of national debt and higher growth rates.

### **Fixed Income**

Fixed Income markets had strong returns for the second quarter despite market volatility. The Barclays Intermediate Government/Credit Index returned approximately 1.47%, while 10 year Treasuries (measured by the iBoxx \$ Treasury Total Return 10 Year Index) returned 10.44% for the quarter. The 10-year Treasury bond closed the quarter with a yield of 1.65%. To put this in context, the low during the 2008 financial crisis was 2.10%. In spite of these near record low yields, there's no guarantee they won't go lower. Both Germany and Japan, considered less secure than the U.S., have lower rates on their 10 year bonds. If our economy continues to slow, it is possible U.S. yields will head lower. We continue to favor high quality corporate and high yield bonds (U.S. companies are sitting on nearly 2 trillion dollars worth of cash, nearly double what it was in 2000) over Treasury investments.

### **Alternatives**

Commodity prices collapsed in the second quarter, led by oil, which lost -17.53% (WTI Crude Oil). Concerns over slowing global growth and perceptions of declining geopolitical risks caused this collapse. MLPs (Master Limited Partnerships) and Gold offered some downside protection to the portfolios in the second quarter, with MLPs returning -2.28% (Alerian MLP TR Index) and Gold returning -2.89%. MLPs continue to add high quality yield in comparison to other non-yielding commodities. The ability of gold to act as a defensive hedge was lessened by the strengthening U.S. dollar, but we maintain conviction in gold's hedging capabilities against further market turmoil.

### **Real Estate**

After six years of a depressed real estate market, the sector has begun to show some signs of life and has once again started to contribute to our country's economic growth. The sale of new and existing homes is rising which is a positive indicator that there is a bottoming occurring in real estate prices. For instance, sales of new single-family homes through the first four months of 2012 are up 15.3% from last year and starts of single-family homes are up 18.9%. That being said, even with historically low mortgage rates, high credit standards make it extremely difficult for potential home owners to get a loan which will ultimately lead to a lethargic recovery of the housing market.

### **Conclusion**

Despite on-going fears, we believe at least a portion of the worst case scenario regarding the European debt crisis has already been priced into the markets. This does not mean that global markets will be unaffected by additional negative data out of Europe. Rather, if the European debt crisis is met by a more favorable outcome, we would expect markets to rally, in spite of the possible slow growth of the U.S. economy. As mentioned, we continue to hold a conservative stance in our portfolios, focusing on the use of alternatives to provide added downside protection, all while maintaining ample equity exposure to capture any upside surprises in the markets.

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