



A View from the Tower

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2nd Quarter Investment Overview

Dwayne White, Executive Vice President, CFA
816/751-4275

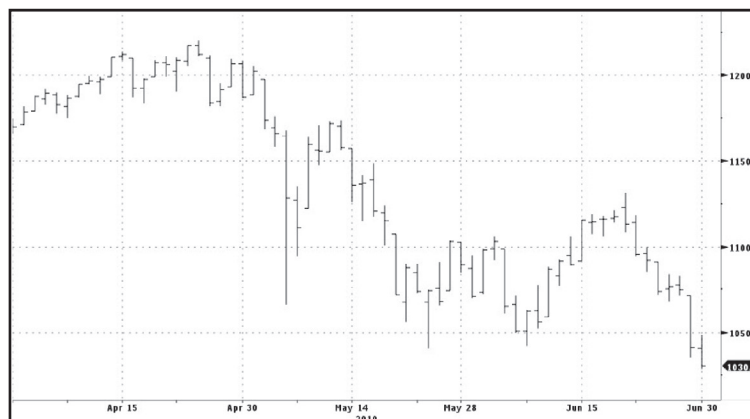
Vicki Hohenstein, Senior Vice President, CFA
816/751-4254

Joe Sweeney, Senior Vice President
816/751-4280

Jenna Rose, Vice President
816/360-8622

The events of the 2nd Quarter demonstrate the inter-connectedness of the world in which we live and invest.

S&P 500 Chart



source: Bloomberg

In the beginning of the second quarter, stock prices continued their cyclical bull market ascent that had begun in March of 2009 and had temporarily hesitated in January of this year. Reinforced by rising stock values, the mood of investors was generally positive as the economic recovery began to gain some traction. But the debt crisis trouble that had been brewing across the Atlantic spilled over to markets around the world. Fearing a recurrence of the too recently experienced financial crisis of 2008, the potential of a Greek default was tagged “Lehman Brothers II” by the media (referring to the Lehman bankruptcy in September 2008 which caused markets to unravel). Seeking to decrease their leveraged positions, investors turned sellers and the stock market correction began. By the time the fear of a contagious global credit crisis was waning, the question turned to “who is going to lead the global economic recovery?” Europe was definitely weakened. China had tightened some real estate lending practices, hoping to dampen inflationary pressures and reduce their growth rate from the 12% range to 10%. Recovery would depend on the USA. But after a series of mediocre economic statistics were reported, including unemployment that was still too high, the adverse effects of financial regulation were unknown, and there was a huge oil spill in the Gulf of Mexico, the market correction was stretched out as pessimism grew. The S&P 500 closed the quarter out at 1031, raising the question whether the bull market was over.

As of 6/30/2010	Quarter to Date	Year to Date	Trailing Twelve Months
S&P 500	-11.43%	-6.65%	14.43%
DJIA	-9.36%	-5.00%	18.94%
MSCI AC World	-12.12%	-9.37%	11.76%
MSCI AC World ex-US	-12.45%	-11.06%	10.43%

How much should we care about Greece? and Portugal and Spain? The European crisis was the biggest and most important story of the 2nd Quarter.

An economic principle states division of labor increases productivity. Simply put, it is more productive to build a jet airliner in the USA and it's more productive to assemble computers in Malaysia. The two main effects from this are the world becomes more intertwined economically (correlated) and the improved productivity creates a higher standard of living.

In the period after World War II, it was commonly said that when the United States catches a cold, the rest of the world gets pneumonia. But when a country as small as Greece catches a cold, we'll feel the aches, too, because 1) overall global growth is reduced 2) a flight to safety will increase the value of the US Dollar, decreasing the competitiveness of our exports 3) deflationary pressures occur if the stronger dollar causes commodity prices to fall 4) increased economic uncertainty could keep US interest rates lower longer than practical, causing monetary dislocations. So it's not just about Greece, it's about the concern of a contagious self-feeding economic slowdown and perhaps a broader financial crisis. All this occurring at a time when global growth is slowing and the world-wide recovery is considered very fragile.

But is the global economic recovery fragile? Last November the Organization for Economic Cooperation and Development (OECD) predicted its member countries would grow their GDP by 1.9%. In early June, they revised and raised its growth forecast for both 2010 and 2011 to 2.7%. When including China, a non OECD member, the worldwide growth rate is projected to increase 4.6% this year and 4.5 % next. Similarly their forecast for the US was raised from 2.5% to 3.2% this year and next. With at least a temporary resolution to the European crisis, the GDP forecast for the European Union became 1.2% up from .9%. While those numbers are not robust and below the "hoped for" growth rate, they are much better than fragile. Realizing such forecasts are frequently revised, these rates reflect an economy which is continuing to grow, will produce profits, incomes and potentially more employment opportunities in the future.

China

China has become a major player in the global economic/investment scene, ranking second behind the US economy in GDP and the largest of those countries grouped as "emerging markets". Questions surfaced this quarter regarding China's economic staying power. Perhaps as important as what they have done is what they haven't. China and other emerging markets largely escaped the financial damage from crisis of 2008 due to the lack of over-leverage in their economy. As with other markets, their stocks were pummeled in the correlated credit crisis of 2008, but importantly

their equity indexes bottomed in October 2008 and began their recovery five months before the US market.

But in the 2nd quarter of this year, their performance frequently lagged other emerging and developed markets; giving rise to the speculation their "miracle" was ebbing. A more accurate interpretation is the Chinese have become concerned about the inflationary threats caused by price bubbles and have implemented measures to restrain that activity. Their policy decision was to slow the rate of growth, curb the excesses before they got out of hand, and build a slower but more enduring economic expansion. We regard this choice as sound and recognize China is a key player in the pivotal and attractive emerging market scene.

Correlations

So what is the implication for the stock market? We have noticed that stocks are showing an increased tendency to move in the same direction at the same time or to be highly correlated. Sometimes this condition is referred to as a "macro market", a market with such a significantly strong driver of stock prices that it overwhelms other factors. The world-wide financial crisis during the second half of 2008 is the most recent example. A desperate demand for liquidity caused the sale of stocks without regard to their specific characteristics; they just had to be sold, hence high correlation.

As the economic expansion begins, the better stocks produce higher returns than their less successful brethren and the correlation between stock performance diminishes sharply, perhaps by as much as a third. This cycle is different. The increased correlation among stock price movements has persisted and is now at record levels. Research (Ned Davis Research, Inc) shows this "correlation effect" actually has been increasing since 2001 or roughly when the technology stock bubble burst. Several theories seek to explain this phenomenon. The first is globalization. As mentioned previously, international business activities, trade and financial dealings have connected more countries than ever. Second, the conduits for international investing have multiplied with investment managers directly purchasing stocks on foreign exchanges, the number and variety of mutual funds and more recently exchange traded funds (ETF's) have flourished. The third cause of increased correlation among stock price movements rests with the expanded use of computerized high volume traders (HVT). These traders initiate buy and sell orders covering huge baskets of securities, without regard to their stock specific characteristics.

With high correlations a matter of fact in today's investing environment, there are several important implications for portfolio strategy, including 1) while diversification is more important than ever, it is more difficult to achieve, 2) finding and actively exploiting less correlated asset classes or market themes is critical to improved performance (such as underweighting financials during a credit crisis), and 3) readily shifting asset allocation to the proper risk/return solution in the increasingly fluid capital markets.

Income Enhancements

Another portfolio investment theme that cuts across several concepts is the capture of return from income producing strategies. The timing appears appropriate for a significant portion

of total return to be achieved from dividends and other income producing strategies. Dividend cuts were numerous during the financial crisis of 2008 as corporations scrambled to maintain liquidity. Two years later, with the help of very low interest rates and a fully functioning credit market, corporations have rebuilt their balance sheets and many are flush with cash. To enhance the return to their stockholders, companies have several choices for using that cash; capital expenditures, acquisitions, buying back their own stock or increasing their dividends. There can be sound reasons for each of those choices and at this time the choice of increasing their dividend has more merit than usual. With interest rates at very low levels (to obtain a return greater than 1% on a US Treasury Note requires a 3 year maturity) even small dividend increases are very meaningful. With the GDP currently expanding, businesses are in the improving earning position of the earning cycle. Finally the uncertainty of tax policy and financial regulation will likely be resolved soon. Although dividend paying and dividend growth are clear choices for enhancing income, other meaningful strategies exist. Some that may be appropriate for your portfolio are investing in preferred stocks and convertible securities or selling call options. Please discuss the potential for these structures with your Tower Wealth portfolio manager.

Inflation/Deflation watch

For those who remember or have studied the inflationary period of the 1970's, it's hard to envision deflation. Recently investors have witnessed asset value deflation in housing and stock prices in 2008, but a general decline in prices is different. With Core CPI falling to 1.1% on a year over year basis, the slowest growth since 2003 (NDR), the trend of disinflation (a declining rate of inflation) is more widespread throughout the economy. Typically slack in the economy in the form of low manufacturing capacity utilization and high unemployment are the cornerstones of determining the course of inflation and interest rates. This recovery, dominated by consumer deleveraging, is altering the course of monetary policy.

One of the methods of deciphering monetary policy is to observe the changes in the monetary base. In late 2008, the base exploded as stimulus/liquidity by different methods was injected into the system to prevent a financial meltdown and get economic activity to perk up. Investors believed by this point in the cycle, that is, 18 months after the stock market low and a year after the recession ended, the Fed would be withdrawing those additions or we would face an inflationary spiral. But at this time, neither has occurred as deflation or at least disinflation maintains the upper hand. Stay tuned.

In conclusion, our research supports the conclusion the April-June period was a correction in the on-going cyclical bull market which began in March 2009. At the July 2 low 1) the market was oversold and sentiment was deeply pessimistic 2) interest rates and inflation were low with the Fed postponing any thoughts of increasing rates 3) stock market breadth, advance/decline lines and accumulation statistics had returned to positive and 4) early indications were earnings season would be positive, showing sufficient growth to support a continuing, albeit modest economic recovery punctuated by periods of faster and slower growth statistics. Stocks are most likely to present a similar but leading pattern.

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