Market Commentary
The European Debt Crisis – Real or Perceived Economic Threat?
Third Quarter 2011

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The US equity markets stalled in the second quarter of 2011 after posting solid gains in 2010 and the first quarter of this year. The following table shows the percent change for both the Standard & Poor's 500 Stock Index and the Dow Jones Industrial Average for the past 18 months:

	Percent Change			
Index	Full Year 2010	1st Quarter 2011	2nd Quarter 2011	1st Half 2011
S&P 500 Stock Index	12.8%	5.4%	-0.4%	5.0%
Dow Jones Industrial Avg.	11.0%	6.4%	0.8%	7.2%

The sluggish second quarter was influenced by several economic releases indicating a slowing economic recovery, with the employment outlook looking particularly bleak. In addition, Greece has been in the headlines for the past two months with concerns over its ability to meet its debt obligations and the steps needed to be taken by the Greek government with European Union (EU) assistance to avoid a default. This, in particular, roiled the global financial markets in May and most of June.

It is no secret that several other EU country members are in straits similar to Greece but in varying and probably lesser degrees. These include Ireland, Italy, Portugal, and Spain.

Probably the best barometer of a country's fiscal health is the market yield on its 2-year maturity sovereign debt. Shown below are charts depicting the yield history on two-year bonds of Germany and Greece from July of 2010 thru mid-June this year.

Source: Mish's Global Economic Trend Analysis

Irish and Portuguese two-year yields are also trading at new heights of 12.28% and 12.44%, respectively. Italian and Spanish yields are beginning to move out of normal high quality ranges with yields of 3.05% and 3.52% suggesting problems but still are within a highly manageable level. The remaining EU members appear to be in good shape and nowhere near problem status.

Many investors are beginning to argue that a Euro-member default or several defaults would be sufficient to cause a Euro crisis and a banking panic, and possibly derail the present worldwide economic recovery. Like most arguments there are two sides to a story and the truth generally lies somewhere in the middle. NOCM subscribes to this view and believes there is cause for concern but not to the point of significantly altering our long-term investment posture. The economic facts simply do not warrant the extremes. The countries so far involved in this fiscal crisis are not major economic forces in the overall economic picture as the following depicts:

Comparative Gross Domestic Product (Purchasing Power Parity Basis) Results: 2010

Region/ Country	Country Ranking	GDP (PPP) $ (Trillions)	GDP As % World
World	N/A	74.26	100.0%
European Union	N/A	15.17	20.4%
United States	1	14.66	19.7%
China	2	10.09	13.6%
Japan	3	4.31	5.8%
India	4	4.06	5.5%
Germany	5	2.94	4.0%
Top Five		**36.06**	48.6%
Italy	10	1.77	2.4%
Spain	13	1.37	1.8%
Greece	38	0.32	0.4%
Portugal	49	0.25	0.3%
Ireland	56	0.17	0.2%
Top EU Fiscal Problems		**3.88**	**5.2%**

Source : International Monetary Fund, World Economic Outlook 2010

The countries generally considered to have or potentially have fiscal problems only contributed about 5% of world GDP in 2010. Italy and Spain constitute the largest portion of that with their debt levels manageable with some austerity measures. Any resulting slowdown should not have any material impact on the world economy.

This conclusion is further reinforced by the January 2011 economic outlook update published every six months by the International Monetary Fund (IMF). The following tables show projected economic growth for 2011 and 2012 by advanced and emerging nations, geographic areas, and specific countries:

Figure 1. Global GDP Growth
(Percent; quarter over quarter, annualized)

Source: IMF staff estimates.

Overview of the World Economic Outlook Projections

			Projections	
	2009	2010	2011	2012
World Output	-0.6	5.0	4.4	4.5
Advanced Economies	-3.4	3.0	2.5	2.5
United States	-2.6	2.8	3.0	2.7
Euro Area	-4.1	1.8	1.5	1.7
Germany	-4.7	3.6	2.2	2.0
France	-2.5	1.6	1.6	1.8
Italy	-5.0	1.0	1.0	1.3
Spain	-3.7	-0.2	0.6	1.5
Japan	-6.3	4.3	1.6	1.8
United Kingdom	-4.9	1.7	2.0	2.3
Canada	-2.5	2.9	2.3	2.7
Other Advanced Economies	-1.2	5.6	3.8	3.7
Newly Industrialized Asian Economies	-0.9	8.2	4.7	4.3
Emerging and Developing Economies	2.6	7.1	6.5	6.5
Central and Eastern Europe	-3.6	4.2	3.6	4.0
Commonwealth of Independent States	-6.5	4.2	4.7	4.6
Russia	-7.9	3.7	4.5	4.4
Excluding Russia	-3.2	5.4	5.1	5.2
Developing Asia	7.0	9.3	8.4	8.4
China	9.2	10.3	9.6	9.5
India	5.7	9.7	8.4	8.0
ASEAN-5	1.7	6.7	5.5	5.7
Latin American and the Caribbean	-1.8	5.9	4.3	4.1
Brazil	-0.6	7.5	4.5	4.1
Mexico	-6.1	5.2	4.2	4.8
Middle East and North Africa	1.8	3.9	4.6	4.7
Sub-Saharan Africa	2.8	5.0	5.5	5.8
South Africa	-1.7	2.8	3.4	3.8

The emerging nations are driving world economic growth at an increasing pace and the Euro area is only projected to be a mild economic influence.

The question of a banking or financial panic has been mitigated somewhat by the release of the results of a "stress test" conducted by the European Banking Authority. This exercise started in March of this year and was concluded last week. The test was designed to determine which of the largest 90 Eurobanks would be able to maintain the required amount of capital under the test simulations of a deep, two-year economic downturn. The results released last Friday said eight of the 90 banks the authority examined would fall short of capital requirements by a total of $3.54 billion (which banks rely on to soak up potential loan losses). Analysts had expected as many as 20 to fail with shortfalls of tens of billions of new capital needed. Analysts immediately cited the test as being overly lax and inconsistently enforced. The eight banks that failed included five from Spain, two from Greece, and one from Austria. NOCM concludes "the jury is still out" on this issue but any crisis is more likely to be psychological than a long-term economic impairment.

<u>Conclusion:</u>

Despite the fiscal problems the US and other countries face in coming years, the current economic conditions provide a sound economic backdrop for reasonable equity markets. Valuations are not excessive and continued strong growth in the emerging nations sector allows a long period of above-average worldwide growth.

The investment areas that we think offer the best 3-5 year return potential, outlined in our last commentary, are still appropriate today. They are as follows:

1. Large capitalization, US-based companies with a growing international exposure. Our preference is the growth side of this arena, but there are also many good opportunities on the value side. Both will benefit from emerging-nation growth.
2. Mature, large capitalization firms, with above-average dividends and the ability and history of increasing the dividend rate annually. We believe there will be P/E ratio expansion with this group as competing interest rates remain low.
3. Energy (oil, natural gas, etc.) and commodity (steel, aluminum, chemicals, etc.) oriented companies. While commodity prices in general weakened during the past recession, we believe prices will continue on an upward trend.
4. Selected exchange traded funds which allow our clients to participate in specific international segments of the economy in a diversified fashion.

Our client portfolios are presently well-represented in these areas but we will continue to evolve the accounts to reflect changing opportunities.

David J. Szatkowski, CFA
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