

JULY 2010 ECONOMIC REPORT

August 5, 2010

Barry Glassman, CFP[®], CFS
President

Term of the Month: Lame-Duck Congress

A lame-duck Congress takes place after elections when defeated, retiring lawmakers sit alongside their reelected colleagues until the inauguration in January.

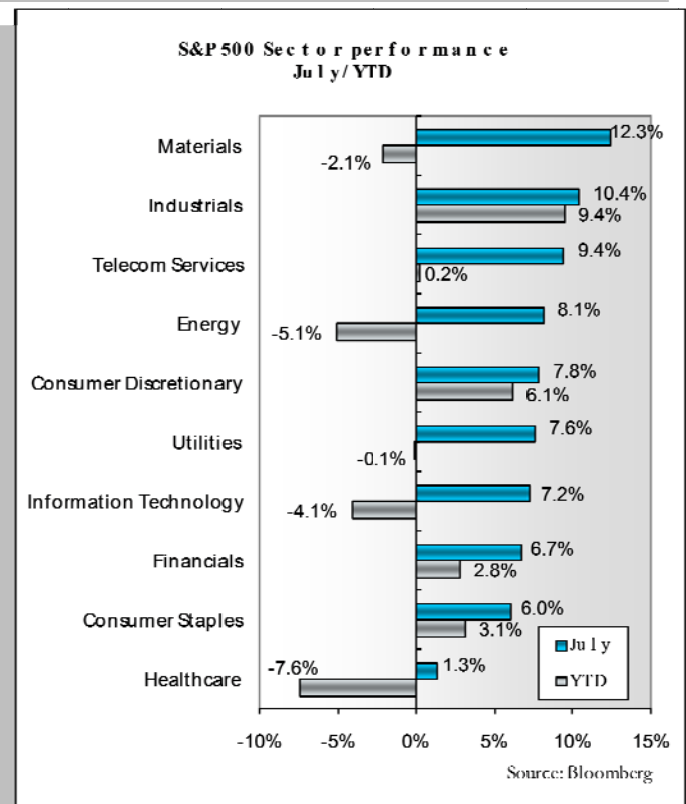
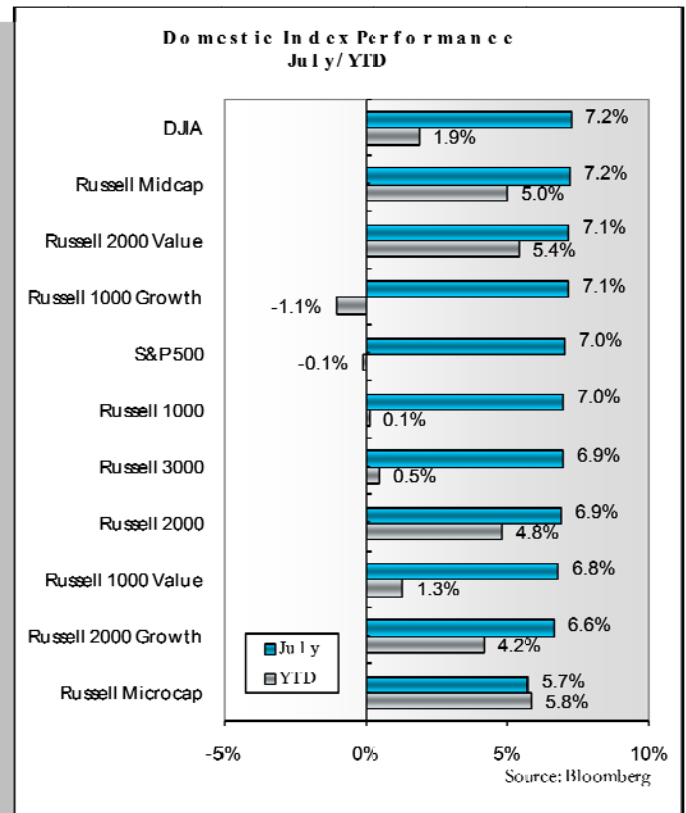


Domestic Equities: Pick a Card, Any Card

Headline US indices rose in concert last month with the help of better than expected earnings from a broad range of companies. The S&P's +7% mark was the 5th strongest July ever, abetted by two +2% days during the month. YTD, there have been seven days with returns exceeding 2%. Although investors often do not complain about increased correlation in positive markets, the nearly identical blue bars on the nearby chart show that style and market capitalization provided little in terms of diversification during the month.

The story was slightly different from a sector standpoint as a hodgepodge of cyclical and non-cyclicals outperformed. Materials led the way with the help of rebounding commodity prices. Agricultural commodities in particular had a strong month (soybeans +11%, corn +8.9), recovering most of their YTD losses. Industrials were a close second, buoyed by a strong start to the earnings season by Alcoa, and upwardly revised nondefense capital goods orders data. From the non-cyclical side, telecom and utility stocks were the biggest positive surprises, as rallies of such magnitude tend to occur most often in more cyclical sectors. Telecom benefited from Q2 earnings coming in more than 9% above expectations, as well as upwardly revised 2011 estimates. Utilities, on the other hand, have reported disappointing figures and are the only sector reporting earnings below analyst estimates (-13.7%). Utilities top-line revenues were also weak (3.8% below expectations). The big positive for the sector remains its relatively high dividend yield. So far this year the search for yield has resulted in the relative outperformance of REITs (4.6% yield) and MLPs (7.0% yield). Although lower than the yield paid by aforementioned REITs and MLPs, utilities offer a 3.9% yield which is well above the S&P's 2.2% yield.

Delving deeper into performance attribution, several trends from recent months reversed course in July. According to Morgan Stanley, companies with a large percentage of sales overseas outperformed those with no foreign exposure (9.5% compared to 6.4% during the month). This occurred despite the fact that companies with less than 20% of their sales coming from abroad outpaced earnings expectations by 15.4% compared to 8.6% for the exporters. The shift in performance could be attributed to two



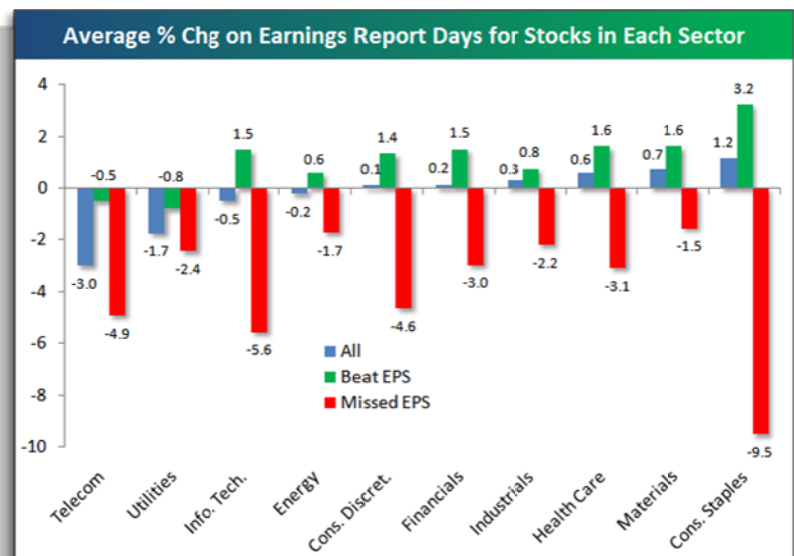


factors: the European bank stress tests results (only 7 of 91 failed), and the USD decline. If the Euro maintains its current level versus the USD going forward, large cap multinationals should benefit.

The other notable trend reversal was that of quality outperformance. The lowest ROE stocks regained the upper hand during the month, outperforming the highest ROE stocks by a wide margin (+11.5% vs. +5.5%). C-rated companies also rebounded, besting A+ rated companies (+11.8% vs. +6.0%). This, in conjunction with rising correlation and falling volatility (VIX fell to 24), resulted in a tough month for active equity managers. Small cap managers faced the stiffest challenge, with only 34%, 39% and 21% of active mutual-funds outperforming the Russell 2000 Value, Core and Growth indices, respectively. Large cap value managers, on the other hand, managed to outperform, aided by higher volatility from financials (Europe stress tests, financial overhaul bill) and energy (BP spill cap and change in CEO), two of the largest sectors in the index.

A trend that remained intact during July was the market's reaction to earnings reports – earnings misses were punished more than earnings surprises were rewarded. The nearby chart from Bespoke exemplifies the large disparity between positive and negative announcements on reporting days (this dynamic also holds true if one expands the data from day-of to 3 days after). This “normal” dynamic elucidates the difficulty of timing market movements based upon earnings, and is just one of the reasons why we employ quality-biased managers with long investment horizons.

Looking ahead to August, with less than 30% of S&P's market cap left to report, earnings headlines should dissipate. The trend thus far has been one of above-expectation earnings and revenue releases (earnings 5.5% above, second highest since 1992; revenues 1% above), and lowered 2011 estimates. Energy (2011 earnings reduced by -9.5%), materials (-7.5%) and utilities (-2.8%) have been the most punished by analysts. If the remainder of Q2 earnings season follows a similar path, additional downward revisions will most likely come from utilities, as more than 60% of companies have yet to report. Of the other negatively-revised sectors, only 15% of materials and 30% of energy companies remain in the earnings announcement queue.



Sources: Deutsche Bank, S&P, Morgan Stanley, Bespoke, Morningstar

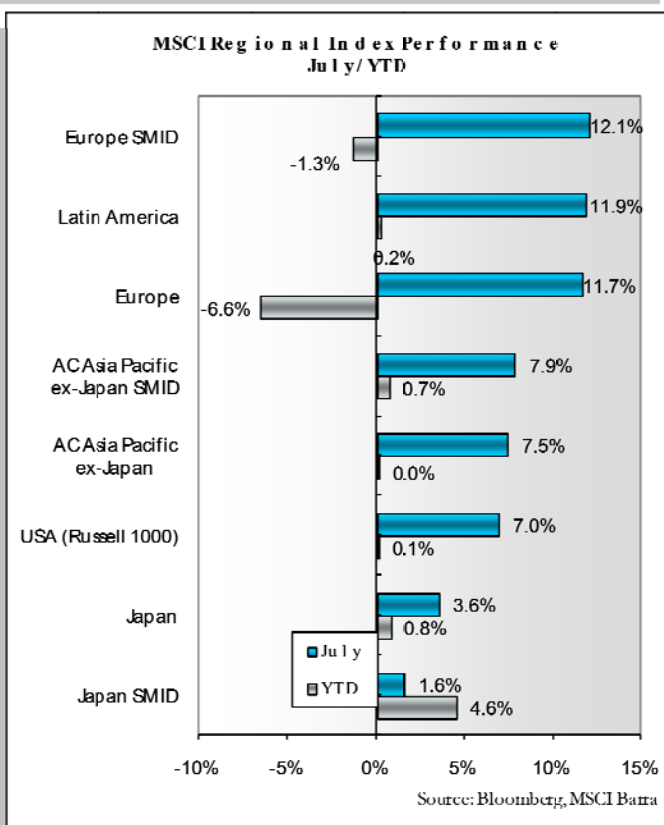
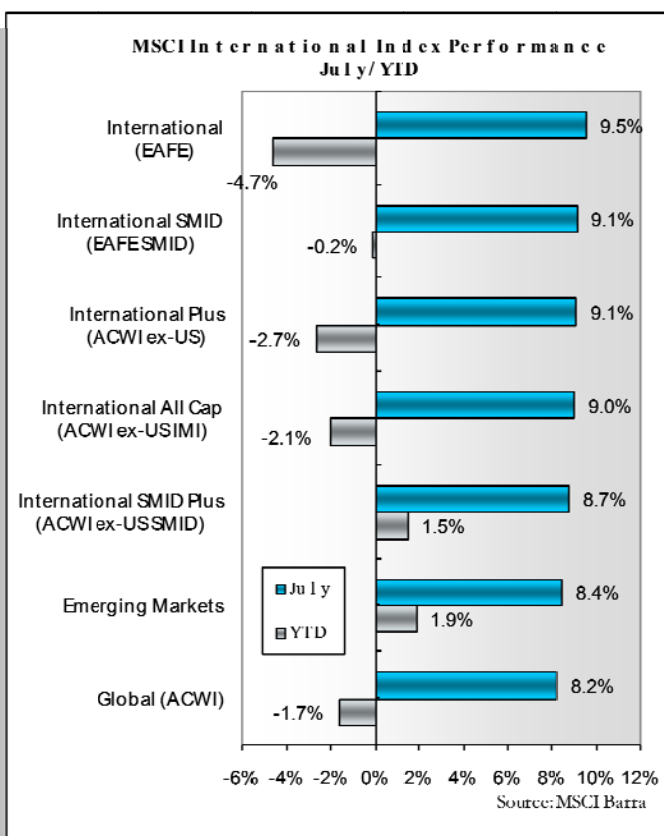


International Equities: Rebound in July

Q3 started off in a strong way for international equities, with every ACWI country except Israel posting a positive return. Apparently comforted by bank stress test results and strong corporate earnings in Europe, investors flocked to the most beaten up areas of the market. Some of the biggest first half losers rebounded strongly, including top performing markets Greece (+30.7%) and Spain (+22.1%); conversely, investors showed utter disinterest in 2010's strongest markets, with first half leaders like Japan (+3.6%) and India (+0.7%) lagging the broad markets. Overall, international equities performed admirably, with developed equities (MSCI EAFE) up 9.5% and the broader all country index (MSCI ACWI ex-US) slightly behind at 9.1%. Both outperformed the US in July (S&P 500 up 7.0%), though they continue to lag YTD.

Since the apex of the European sovereign debt crisis in March, investors have largely been in a holding pattern due to uncertainty surrounding Europe's banking sector. The results of the bank stress tests on July 23rd, however, eliminated some of that headwind; news that only 7 of 91 banks were inadequately capitalized helped stabilize investor confidence in the region's financial system (despite questions about the efficacy of the test). More than anything, July's stress test results eliminated uncertainty around the tests themselves, and also provided more clarity around the banks' true liabilities (i.e. how much off-balance sheet exposure the banks have to bad sovereign debt). Whether good or bad, the perceived resolution to these stress tests has been good for equity markets, particularly for the much maligned European financials (up 19.6% in July).

Developed Europe as a whole rebounded strongly in July, finishing up 11.7%, its second best July return since the MSCI index inception in 1970. This was the strongest performance among major regions, outperforming the US, Asia ex-Japan, Japan, and broad EM. Currency effects must be taken into account, however, as the euro reversed its recent declines and appreciated 6.7% against the US dollar over the month; in local terms, the MSCI Europe index returned a less impressive 5.9%. The MSCI Europe index appeared to trade more on fundamentals in July, as lower P/B and lower P/E

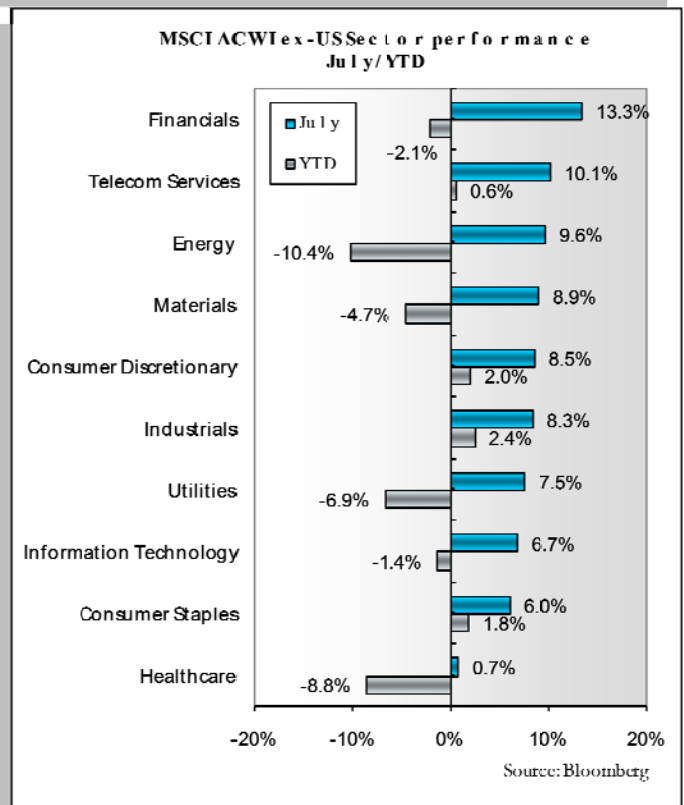
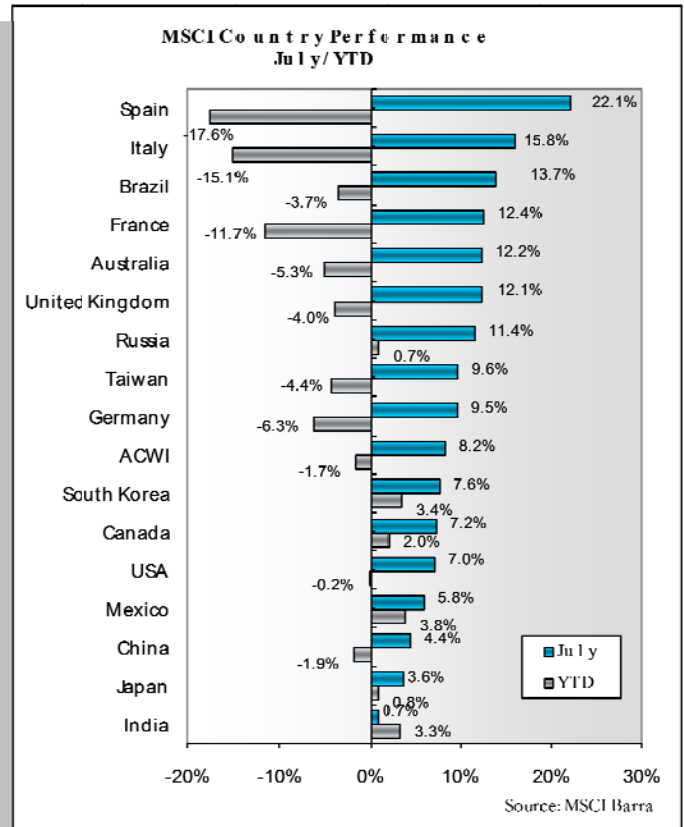




outperformed more expensively valued stocks. This included cheap stocks in the Club Med countries, as each country posted double-digit positive returns in US dollar terms. Outside of the stress test results, strong economic data and corporate earnings during the month also helped to improve confidence in the region. At month's end, 62% of companies in had beaten consensus earnings expectations, with most being driven by sales surprises as opposed to margin surprises – an encouraging sign that underlying demand remains resilient. Economically speaking, a number of indicators were positive during the month, including a rising IFO Business Confidence index, European economic sentiment reaching the highest level in two years, and the PMI Manufacturing index expanding faster than expectations. Additionally, Germany reported that exports rose 9.2% in May, well above the consensus 4% and an indication that the country's core economic driver remains strong. Europe still appears to be attractively valued, as it trades at a 14% P/B discount and 12% trailing P/E discount to the rest of the ACWI index.

Risk-hungry investors largely ignored Japan in July, as the country's MSCI index lagged other regions with a 3.6% return. Continued yen strength against the US dollar aided performance, as the index posted a more muted 1.6% return in local terms. YTD, Japan remains a leader among major developed markets in US dollar terms. Economic data released in July was generally disappointing, as core inflation remained negative YoY and various manufacturing data was weaker than expected, including private machinery orders (a key indicator of domestic corporate spending). Demand for industrial machinery from abroad, however, (particularly Asia) remained strong by comparison: YoY, growth in orders for the private sector was (-16%) while growth in overseas orders was an astounding +130%. Despite pockets of strength, Japan's prospects seem less attractive on a macro level. Ongoing political uncertainty in the country (due to a split legislature) is serving to undermine confidence in the government's ability to combat the country's fiscal and economic problems.

For the first time since January, emerging markets lagged developed on a monthly basis (largely due to currency tailwinds in Europe). YTD, however, the emerging markets index remains far ahead (+1.9% vs -4.7% for EAFE). July saw investor preference shift from Asia to Latin America, as the latter outperformed the former by more than 6%. Smaller Asian





countries like Indonesia (+6.3%), Thailand (+6.1%), Malaysia (+5.6%), and the Philippines (+2.9%), global equity leaders during the first half of 2010, all finished among the bottom third of the ACWI index during the month. Latin America, meanwhile, was bolstered by double digit returns from Columbia (+13.2%), Chile (+12.1%), and its biggest component, Brazil (+13.7%). Brazil is bouncing off very sluggish performance thus far in 2010, and remains a negative (-3.7%) returner YTD. Though July's commodity strength was certainly a tailwind for the country's equity markets, Brazil's top performing sectors were financials and consumer discretionary, an indication that investors are increasingly more interested in domestic, consumer-facing companies (which ultimately will be positive for the country's equity markets as it transitions away from being more commodity-centric). At 10.2x forward P/E, Brazil is actually trading below Europe's valuation and is cheaper than the U.S. on a P/B basis.

China reverted to laggard status in July, finishing among the bottom five ACWI countries at 4.4%. Investor concerns surrounding the country's apparent cyclical slowdown continued, and were amplified by various economic data released in July. China's manufacturing PMI fell for the third consecutive month, and now sits just barely in expansionary territory at 51.2. Real GDP growth also slowed in the second quarter, falling to 7.2% QoQ from 10.8% in Q1. The health of Chinese banks is also coming into question following the country's explosive credit growth over the last 18 months. While the government successfully reined in new loan creation this year, the massive amount of liquidity pumped into the system (\$1.4 trillion in 2009) has created a potential property bubble that has left banks vulnerable. Chinese regulators are ordering "worst-scenario" stress testing of the nation's largest banks, assuming 60% home price declines instead of previous requests for 30%. The severity of the stress testing underscores the government's concern about the rising risk of delinquency. China is currently trading at well over 2x P/B and at a higher P/E than most other countries. Those valuations seem less than warranted as 12 month forward earnings growth estimates are 28.7%, lower than both the ACWI ex-US index (37.7%) and MSCI Emerging Markets index (50.9%).

The broad international large cap indices outperformed SMID cap indices in July, which is a reversal from trends seen in the first half of the year. YTD, however, SMID remains well ahead. International markets also saw a reversal in sector leadership, as cyclicals returned to the forefront after struggling through most of the first half of the year. As mentioned above, financials were particularly strong in July, posting double digit returns on the heels of renewed confidence in the global banking sector.

Overall, investors are digesting a huge amount of information about sovereign debt, GDP growth, and earnings growth. Some of the encouraging data may seem counterintuitive as many global strategists are vocal in their skepticism on the recovery. For long term investors, much of the data and chatter is short term noise. The best course of action is to stick with the "right" active managers and dollar cost average into global equities. The "right managers" are those with fewer constraints (e.g. global and all cap), and a balance of inexpensive cyclicals and quality growth stocks.

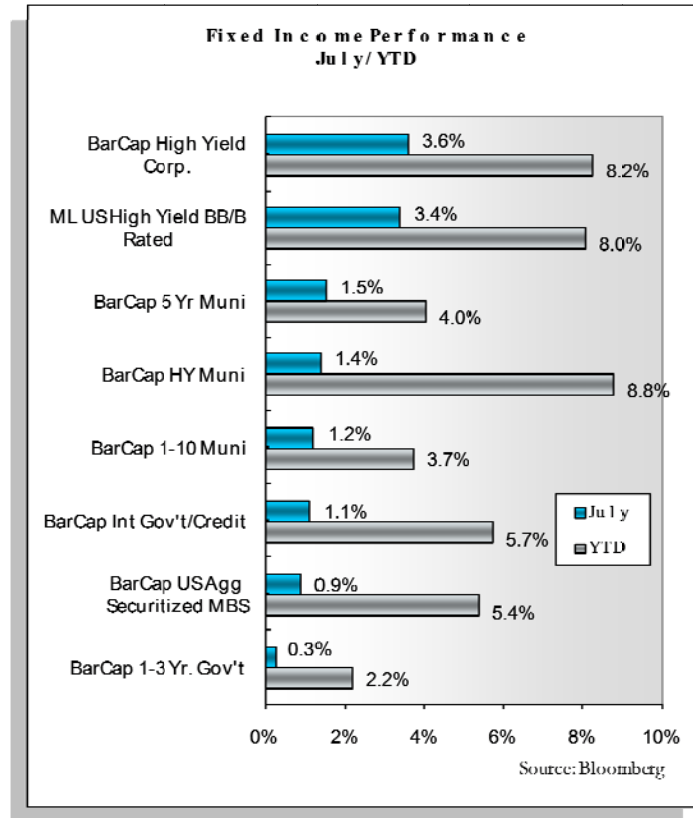
Sources: Morgan Stanley, J.P. Morgan, MSCI Barra, Bloomberg, Economic and Social Research Institute-Japan



Fixed Income: The best of both worlds

Econ: A mixed bag of economic data left many pondering what is next for the economy. Prognosticators are evenly split, with one camp squarely believing that a double-dip recession is imminent, while the others argue that slow growth, not contraction, is in our future. July data releases confirmed the notion that economic growth reached its near-term peak and is in the process of slowing.

Second quarter Gross Domestic Product slowed to 2.4%, from an upwardly revised 3.7% in the first quarter. The second quarter report benefitted from tailwinds associated with the expiring home buyer tax credit; specifically, residential investment jumped 28% during the quarter. The inventory restocking phase, which provided 2.6% of growth in the first quarter, is in deceleration mode after increasing approximately 1.1% in the second quarter. Revisions to the personal savings rate provided a glimmer of positive news. According to the Bureau of Economic Analysis, the personal savings rate reached a near-term peak of 7.2%, before declining modestly to 6.2% in the most recent quarter. Consumers are in an ongoing battle to realign their balance sheets away from the overhang of housing and credit card debt and towards more sustainable long-term savings. It appears as though that process is finally transitioning from fiction to fact.



Housing markets began their post government period in relatively noisy fashion. Existing home sales for the month of June, which were released in mid-July, fell by 5.1%. Existing home sales represent actual closings, not contract acceptances, so this series will experience a smoother transition away from the tax credit. We could see a significant amount of downward pressure on existing home sales towards year end; however, as a growing "shadow" inventory of homes is sitting on bank balance sheets and waiting to be dumped on the market. That would increase the available supply of homes, leading to a second leg down in prices. Conversely, now that first time home buyers can no longer rely on the tax credit, we are likely to see fewer property sales in the lower end of the market, which would artificially inflate sales prices. It is difficult to say which scenario will happen, but there is clearly little reason to be optimistic on the immediate outlook for housing.

The final area of contention was in the enduring debate over the future of inflation or deflation. For the moment, deflationists are winning the battle, as a glut of unemployed consumers and spare capacity in the economy translate into ever weaker pricing power for businesses. The Consumer Price Index (CPI) fell 0.1% in June and the Core CPI Index, which eliminates the volatile food and energy component, increased 0.2% for the month. Owners' equivalent rent, the CPI's corresponding measure of housing costs, increased 0.1%, the first such increase since August 2009. That is likely to be a fleeting gain given the aforementioned downward pressure on housing.



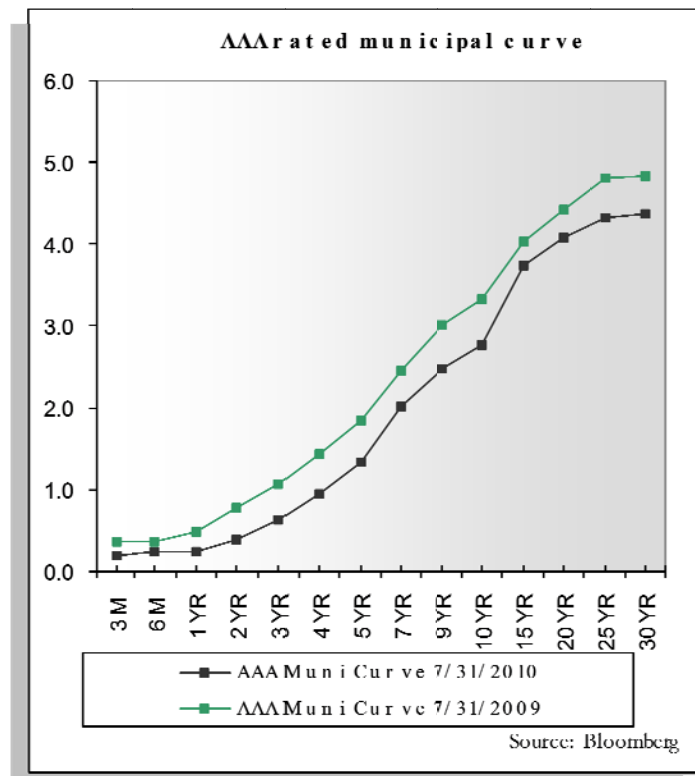
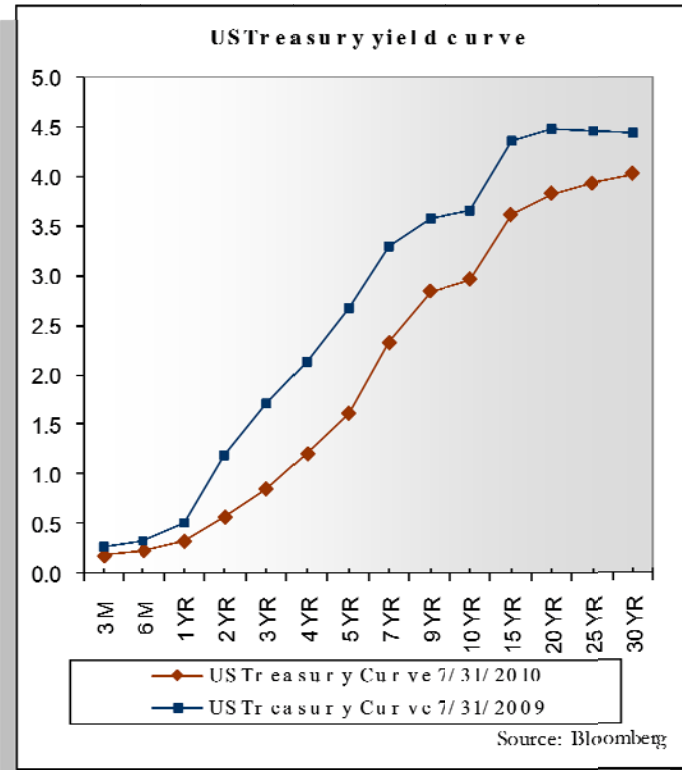
Uncertainty is weighing on consumer confidence. The University of Michigan Consumer Sentiment Survey declined from 76.0 in June to 67.8 in July. Declines were also seen in the present conditions index and the outlook index. An abundance of macroeconomic concerns continue to weigh on consumers and until there is definitive improvement in the labor markets, that concern is unlikely to abate.

Federal Reserve: The Federal Reserve stayed active during the month, despite the fact there were no policy meetings in July. There was one item of particular note that garnered headlines and hindered investor confidence; that was the July 28th release of the Beige Book, a snapshot of economic activity in the various Federal Reserve districts around the country. According to the report, economic activity remained stable in most districts, but a slowdown was reported in the Atlanta and Chicago districts. In regards to labor activity, the Fed noted that employment picked up in 5 districts, while holding steady or declining in the other 7 districts. There was clearly a sense that growth is slowing from its previous pace, but there was no indication that we need to worry about a second recession at this point.

The other piece of news came in the form of a 21-page report from Federal Reserve Bank of St. Louis President James Bullard titled "Seven Faces of 'The Peril.'" In the paper, Mr. Bullard offered analysis suggesting that the US economy is closer than ever before to a Japanese style bout of deflation. The analysis was a rather sobering reminder that despite the general perception that the economy is rebounding from its recessionary trough, significant risks remain in the system. Deflation would be very dangerous at a time when government debt is skyrocketing because it would increase the debt burden at the most inopportune time.

Government Markets: Despite the issuance of nearly \$175 billion in new bonds and notes by the US Treasury, and a more than 7% rally in nearly all US equity market measures, the Treasury market remained range bound with yields ending the month roughly 10 basis points lower relative to the end of June. As a result, the Barclays Treasury index produced nearly 70 basis points of return for the month.

In retrospect, this performance is not terribly surprising. While earnings season produced notably positive news flow, economic data reported in the month was a bit less





convincing. Furthermore the deflation/inflation 'pendulum' has swung back towards the deflation camp. Finally, as investors step away from their desks for a summer break, it seems the Treasury market has set in for a period of low volatility; the Merrill Lynch MOVE index, which captures volatility of 1-month Treasury options on 2, 5, 10 and 30 year Treasuries, hit seasonal lows similar to what was exhibited the last several summers (with the exception of 2009). Together, these points suggest the current range for Treasury yields could remain in place for the near future - to quantify the 10 year treasury closed the month at 2.9%.

Municipal Market: July is typically a busy month for muni investors as redemptions and coupon payments hit seasonal highs, forcing retail and institutional investors to search for reinvestment opportunities in the market. By itself, this trend would usually be enough to generate a solid rally, or at the very least keep performance on the positive side of the ledger. However, July 2010 performance received an additional boost as the muni market entered the month a bit off kilter – at the end of June, valuations relative to Treasuries were at low levels (bonds were cheap on a % of Treasury basis) and as such, the muni market would have likely rallied regardless of the season. The combined effects resulted in strong performance as the Barclay's 1-10 year index generated 1.25% in July - the best monthly performance in 2010.

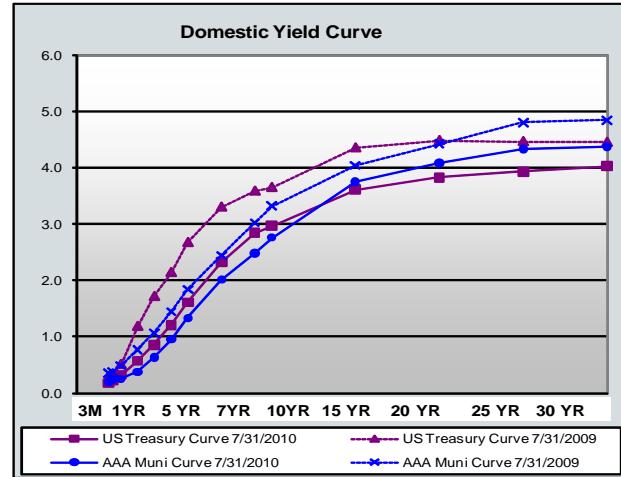
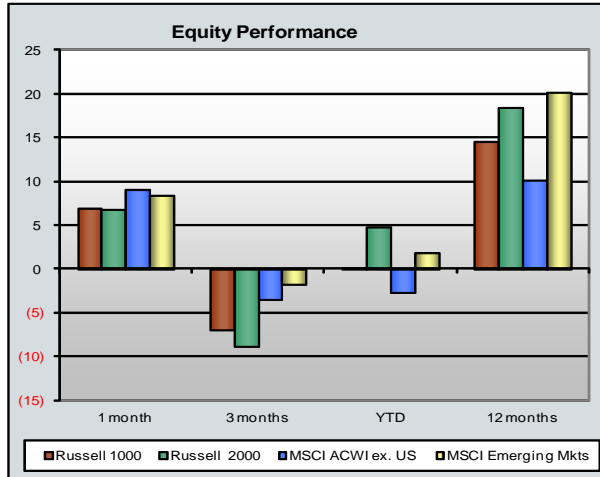
Corporate Market: The strength of June's performance in the corporate bond market carried through to July with the broad sectors of the market posting positive performance. The option-adjusted spread of both the high-yield and investment-grade markets fell in the month with both returning to levels last seen in early May. In retrospect, this is not surprising; the mix of steady Q2 earnings results, stable Treasury markets and mix of less than positive economic data were all supportive of the corporate bond markets. The net result was solid monthly performance as the Barclays Investment Grade Index produced nearly 2% and the High Yield Index generated 3.6%. The leveraged loan markets lagged a bit but still posted a positive 1.6% for the month.

The markets themselves are again showing signs of solid health as issuance stepped up as the month closed. Investment and speculative grade issuers issued \$13 billion and \$4.8 billion respectively in the final week of July and the market was very receptive of these new deals.

Sources: Barclay's, Bloomberg, Morgan Stanley, Municipal Market Advisors and Wall Street Journal



MONTHLY PERFORMANCE REPORT
July 31, 2010



	1 month	3 months	YTD	12 months
Large Cap				
S&P 500	7.01	(6.69)	(0.11)	13.84
DJIA	7.23	(4.27)	1.87	17.28
Russell 1000	6.95	(7.01)	0.11	14.51
Russell 1000 Value	6.77	(7.52)	1.30	15.39
Russell 1000 Growth	7.13	(6.49)	(1.06)	13.65

	1 month	3 months	YTD	12 months
Small/Mid Cap				
Russell 2000	6.87	(8.89)	4.79	18.43
Russell 2000 Value	7.14	(10.48)	5.38	20.11
Russell 2000 Growth	6.61	(7.12)	4.15	16.71
Russell Microcap	5.70	(11.20)	5.83	15.92
Russell Midcap	7.19	(6.90)	4.98	23.21
Russell Midcap Value	7.45	(7.02)	6.50	26.14
Russell Midcap Growth	6.88	(6.78)	3.34	20.17

	1 month	3 months	YTD	12 months
International Markets				
MSCI EAFE	9.49	(3.90)	(4.67)	6.72
MSCI ACWI ex. US	9.06	(3.53)	(2.72)	10.12
MSCI Europe	11.66	(2.39)	(6.55)	7.42
MSCI Japan	3.56	(6.72)	0.82	0.19
MSCI AC Asia Pacific Ex - Japan	7.46	(3.35)	0.01	16.08
MSCI EAFE SMID	9.08	(4.34)	(0.15)	11.42
MSCI ACWI ex. US SMID	8.72	(3.58)	1.47	16.50
MSCI Emerging Mkts	8.40	(1.80)	1.85	20.24
MSCI EMEA	12.79	(2.16)	3.94	24.80
MSCI Latin America	11.92	(1.11)	0.20	29.02
MSCI Frontier Markets	5.89	(4.42)	6.58	4.84

	1 month	3 months	YTD	12 months
Sectors (S&P 500 GICS)				
Consumer Discretionary	7.82	(9.45)	6.11	26.14
Consumer Staples	6.05	(1.22)	3.09	13.34
Energy	8.08	(9.71)	(5.11)	5.68
Financials	6.67	(8.78)	2.75	14.55
Healthcare	1.35	(7.04)	(7.56)	4.30
Industrials	10.35	(7.09)	9.42	28.68
Information Technology	7.19	(7.59)	(4.14)	13.72
Materials	12.34	(5.31)	(2.12)	12.68
Telecom Services	9.38	4.87	0.23	8.23
Utilities	7.56	0.88	(0.12)	9.47

	1 month	3 months	YTD	12 months
Fixed Income				
BarCap 5 Yr Muni	1.50	2.52	4.00	6.50
BarCap HY Muni	1.36	2.88	8.75	22.76
BarCap 1-10 Muni	1.20	2.16	3.69	5.74
BarCap US Treasury 1-3 mo.	0.01	0.04	0.07	0.12
BarCap 1-3 Yr. Govt	0.27	1.17	2.16	2.91
BarCap Int Govt/Credit	1.09	3.20	5.70	7.99
BarCap High Yield Corp.	3.56	1.08	8.23	23.74
Citigroup High-Yield	3.42	1.23	7.68	22.44
ML US High Yield BB/B Rated	3.36	1.77	8.05	20.19
BarCap US Agg Securitized MBS	0.86	3.13	5.35	7.52
JPM EMBI+ Composite	4.38	5.18	9.71	19.30

	Latest Month end (7/31/2010)	3 Months ago (4/30/2010)	Latest Year end (12/31/2009)	12 Months ago (7/31/2009)
Currency				
U.S. Dollar Index Value	81.54	81.87	77.86	79.29
USD vs. Yen	86.47	93.85	93.02	95.56
Euro vs. USD	1.31	1.33	1.43	1.41

	1181.00	1179.20	1096.95	934.40
Commodities				
Gold (\$ per troy ounce)	1181.00	1179.20	1096.95	934.40
Crude Oil (\$ per barrel)	78.95	86.15	79.36	66.94

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