

ECONOMIC MARKET REVIEW AND OUTLOOK

June 30, 2010

Economic growth is primarily created through a combination of three drivers: increasing population, higher productivity levels (the amount each worker produces), and financial leverage. While both the U.S. and the world as a whole continue to benefit from the first two drivers, the third driver, financial leverage, is currently in decline.

Financial leverage is simply the borrowing of money. The effect of borrowing money is an increase in the amount of assets, and, therefore, the size of the economy. For example, if you have \$100 in assets, you could borrow \$50 and purchase additional assets to bring the total to \$150. While your net worth, defined as assets minus borrowings, remains at the original \$100, your assets have grown, and so has your portion of the economy.

Starting in the 1980's, both individuals and governments in most of the developed world became increasingly comfortable with adding to their borrowings as interest rates generally declined. This allowed the economy to grow faster than it would have otherwise. While some warned of the dangers of higher debt levels, default levels remained low and the economy generally performed well with only a couple of minor recessions. This, it seems, gave individuals and governments increasing confidence to take on even more debt.

All of this, of course, eventually led to the financial turmoil that hit us in 2008 and the sovereign debt crisis currently unfolding in Europe. Worldwide, governments reacted to mitigate the severity of the crisis by a combination of lowering the cost of money (interest rates went to near zero) and by borrowing more money and spending it to offset the drop in borrowing and spending in the private sector. Thus far, this strategy has met with some success and a real crisis in the form of economic depression has been averted.

It was this combination of easy money and government stimulus programs worldwide that led to our view late last year that not only would the economy in the U.S. grow, but that it would grow at robust single digit rates for the next two quarters. In fact, the economy grew by 5.6% in the 4th Quarter of 2009, but came up a little short in the 1st quarter of 2010, growing by just 2.7%.

We further predicted that after an initial rebound, economic growth would slow to a 1% to 2% rate to last for an extended period of time. Why such a slow down? Government stimulus programs were only temporary, yet the high levels of debt accumulated by both individuals and governments will take years to reduce. Thus, domestically, the U.S. economy will have only two of its three drivers supporting growth. Fortunately, a fourth driver has emerged in the form of rising wealth in developing countries, providing growing markets for U.S. products and services.

Equity Indices	2nd Qtr.	12 Mo.
S&P 500	-11.43%	14.43%
S&P 600	-8.73%	24%
Russell 1000 Growth	-11.75%	13.62%
Russell 1000 Value	-11.14%	16.92%
EAFE (US\$)*	-13.75%	6.38%

Total Returns for the period.
*an index of foreign stocks.

Interest Rates	3/31/10	6/30/10
90 Day US T-Bill	.16%	.18%
10 Yr US T-Bonds	3.84%	2.97%

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Recent declines in stock prices and bond yields are reflecting investors' realization that the period of slower growth may be upon us sooner than many expected. Economic statistics released over the past two months certainly point to a slowing economy. Financial markets, however, typically overreact to changes in the economy, and that may be the case today. For example, yields on U.S. Treasury Notes and Bonds have fallen dramatically in recent months. This has caused us to seek ways to protect against the risk of falling bond prices should yields rise over the next year as we expect. And, while we are concerned about a slowing economy's effect on corporate earnings, the breadth and depth of the recent drop in stock prices has created attractive opportunities in the stocks of many companies that are not dependent on consumers borrowing to buy their products. Finally, the sharp rise in the value of the U.S. Dollar, caused by Europe's debt problems, has led us to increase our allocation to international equities.

As investors we don't have a say in the direction of the economy or the markets. But regardless of the environment, the task remains the same: to work diligently to find the best opportunities while being mindful of the risks. Your team of investment professionals at Goelzer continues to be dedicated to this task. Please call us anytime if questions arise or you would like to discuss our outlook and strategy in more detail.

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