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**FINANCIAL CONCEPTS, INC. – QUARTER 2 - 2011**

**MARKET RESEARCH & INVESTMENT COMMENTARY 14:**

Dear Clients,

The perceptible cloud of unease has engulfed the markets as a result of uncertainty over the U.S. debt ceiling resolution unknown at the time of this second quarter market summary and a stream of disappointing or at least unsettling economic data culminating in subpar GDP growth in the first half of the year. The current uncertain and volatile market environment certainly dominates the news and colors investment analysis. However, we need to distinguish thoughtful longer term economic and market commentary from politically motivated speech.

As we are located in the Washington, D.C. area, that distinction is foremost on our minds as we develop our market outlook and investment strategy. Clearly, the debt issue has implications for all market and economic sectors. However, perspective is warranted – the bond and equity markets have remained steady with benchmark yields remaining at near historic lows. Market activity suggests that investors have remained sanguine about an ultimate solution or at least discount the most dire of scenarios.

Equity prices only began to weaken recently as the markets are now sending a signal to policymakers that they need to fix the problem and ensure the United States dominant role in a stable global financial marketplace. Indeed, at this writing, there is increased optimism about a government debt resolution which indicates that government leaders are paying attention to what the market is telling them.

Regardless of how the episode ends, the scars may take time to heal. While nothing should be taken for granted or assumed, the bond market remains the safe or low-risk alternative in times of global economic tension. Part of the broader optimism rests in the continued elevated profit levels now at the highest share of GDP in decades, and most firms continuing to beat analyst forecasts. There is clear reason for caution, but recession is an increasingly distant memory as are the depths of the financial crisis.

In the current environment, the focus is on less government spending and paring down the deficit regardless of the ultimate U.S. debt resolution. With respect to the U.S. debt ceiling situation, two benefits from the current debate should be in our sights: restraining entitlement spending and the importance on at least not raising tax rates in the current economic environment. The eyes will be on the Federal Reserve as a source of stimulus with increased government spending largely off the table. There is a broad consensus that a stable and more certain environment for both businesses and consumers would be perhaps an even powerful and welcome “stimulus” for accelerated growth later in the year.

Clearly, the unemployment rate remains persistently high and job growth continues to be disappointing. Combined with the still-weak housing market, consumer spending has stepped back to minimal growth as second quarter consumer spending was effectively flat. State and local government began to recover but is likely to fall back in view of soft regional economies and the Federal spending outlook.

The European economies especially among the PIIGS (Portugal, Ireland, Italy and Greece) remain in unstable financial condition affecting not only those economies but the European banking and financial system. The global expansion expectations continues to be (and is even more so now) on emerging markets and in turn on these economies’ expanding middle class. As we try to assess the environment among the heightened volatility, all of us here at Financial Concepts, Inc. are actively looking for reasonably priced new opportunities that offer risk-adjusted income and returns with the following in mind:

**THE OUTLOOK**

Prudent financial market policies and the collective wisdom of investors put the markets in a much more favorable place compared to the financial crisis of just a few years ago. The interests of markets and government have seldom been so interrelated. The markets will continue to be forward-looking with immediate concern over the debt ceiling and its aftermath.

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The economy is maintaining an expansionary growth path, albeit at a disappointingly weak pace. To the extent the future can be predicted with any degree of certainty or confidence, it is probably reasonable to anticipate slow growth until later in the year when demand should pick up leading to stronger growth prospects.

The outlook suggests patience, selectivity and maintaining liquidity to take advantage of opportunities ahead. For example, continued U.S. deficit issues may suggest looking at equities, over-sold domestic bonds and non-U.S. bonds as alternatives. These are some of the trends that we are looking at:

- Continued commitment by the Fed as evidenced by the low target rate and quantitative easing strategies
- Continued investor risk appetite exemplified by an appetite for initial public offerings (IPO's)
- Corporate profits and cash-rich corporate balance sheets
- Focus on managing Federal deficit expansion
- Global growth from emerging markets
- Market focus on a public debt solution

The clouds on the horizon suggest prudence:

- U.S. debt threat as a dominant concern with the palpable rating downgrade concern which will affect all markets
- Currency instability and global crises (Middle East, European sovereign debt) as reflected in higher gold prices
- The continuing correction in the housing market complicated by foreclosure documentation and servicing issues
- Persistently high unemployment and implications for consumer spending
- Uncertainty and implications for business investment spending
- High market volatility levels

### **Retail Investor Sentiment : Investors Returning to the Market**

American households have been sitting on about \$7 trillion dollars in cash and liquid assets earning a minimal if any return based on data from the Federal Reserve's Flow of Funds statement through the first quarter, a figure that has not moved much during this year.<sup>1</sup> The liquidity level is likely to remain elevated in the current environment until conditions settle later in the year. In the current unsettled environment, investor risk tolerance has taken a pause, preferring bonds to stocks.

## **ECONOMY**

### ***Growth Slows***

The economy grew for the seventh consecutive quarter in the second quarter but at an anemic rate of 1.3 percent, compared to slightly above 2 percent in the second half of 2010 and nearly 3 percent in the first half of last year. Especially concerning was a revised first quarter growth rate of less than one percent.<sup>2</sup> The private sector – business investment and consumer spending – by necessity are becoming larger drivers of the economy relative to government spending.

The consensus view GDP growth forecast has been reduced from 3 percent or close to the long term U.S. growth path.<sup>3</sup> The current pace is not enough to put a dent in the 9 percent plus unemployment rate.<sup>4</sup> Should growth exceed expectations, interest rates could rise sooner than anticipated.

The consumer is the economic "king" accounting for 60 percent to 70 percent of our economy. Consumer spending grew at 4.0 percent in the fourth quarter last year. Second quarter of this year was only 0.1 percent. Sales at U.S. retailers stagnated in June, highlighting weakness in consumer demand. Declining home values and unemployment above 9% are holding back on spending, prompting retailers to offer discounts.

Confidence did rise in the second quarter as households became more upbeat about the state of their personal finances. The Bloomberg Consumer Comfort Index increased to minus 43.9 for the period ended July 10 from minus 45.5 the prior week. Even with the gain, the gauge is lower than it was at the beginning of this year.<sup>5</sup> The Conference Board's Consumer Confidence Index rose in July after declining in June.<sup>6</sup>

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<sup>1</sup> The Federal Reserve's Flow of Funds data combine individual and nonprofit organizations in their tabulation.

<sup>2</sup> U.S. Department of Commerce data and New York Times, July 30

<sup>3</sup> Washington Post, July 30, 2011

<sup>4</sup> The Bond Dealers of America Economic Survey, for example, April 25, 2010, bdamerica.org

<sup>5</sup> Yahoo Finance June 2011

<sup>6</sup> Yahoo Finance July 2011

The average U.S. credit score – a predictor of the likelihood lenders will be paid back – rose to 696 in May, the highest in at least four years, according to reporting bureau Equifax. Delinquencies on consumer loans have dropped 30% in two years, according to compiled data.

Longer term, the consumer has been going through a period of deleveraging, which places a ceiling on consumer spending. After several months of declining consumer credit, volume has risen the fourth quarter of last year and first quarter of 2011. May was the first month of increased credit card borrowing since 2008. Total consumer credit in May (the most recently available financial data) rose by 2.5 percent over a year ago.<sup>7</sup>

New applications for unemployment benefits fell last week to the lowest level in three months, suggesting fewer layoffs in early July than usual, according to government data to the smallest new applications volume since mid-April. Hiring is still slow with U.S. government reporting for June that companies hired a meager 18,000, following a 25,000 gain in May, resulting in an unemployment rate rising to 9.2 percent. The disappointing jobs report sparked fresh worries about a fragile U.S. economy and even the possibility of another recession occurring sometime in 2012 or after.<sup>8</sup> Recession worries for the near term are muted and not the consensus.

### ***Housing Correction Still Has a Way to Go***

Almost 6.7 million U.S. homes were lost to foreclosure, short sales or turned back to lenders between 2000 and 2010, according to Moody's Analytics. Growing evidence suggests that another 3.6 million could meet the same fate all the way up through 2013. Residential home ownership has dropped from the pre-crisis peak levels.<sup>9</sup>

Home sales continue to flounder. Existing transactions dropped by 0.8 percent in June from a month earlier and 8.8 percent from a year earlier.<sup>10</sup> First quarter existing housing sales were ahead of the fourth quarter of last year.<sup>11</sup> The first quarter sales level, however, is lower than a year ago which was the peak of the tax credit induced housing sales mini-boom.

Housing prices continue to slide in 2011 from a year ago. According to the widely followed S&P Case-Schiller house price index, based on the most recent available data, the index showed a 4.5 percent from a year ago, though with a modest uptick from the prior month.<sup>12</sup>

Keep in mind that housing is local – for example, the comparatively recession-proof Washington, D.C. market was the one region that is rising. The consensus is that a national housing price turnaround is perhaps still a year away and longer in some depressed markets.

### ***Will Relaxed Lending Standards Lead to More Business Lending?***

Credit availability may be improving banks have eased standards on commercial and industrial business lending for the last several quarters through the most recent survey period after an extended period of tightening, according to the Federal Reserve's quarterly senior lender survey. The survey also is reporting some gains in business loan demand.<sup>13</sup> The Fed survey is closely watched as a barometer of the business lending market.

### ***Cash Rich Corporate Balance Sheets Remain the Source of Hope for Accelerated Economic Expansion***

Uncertainty continues to govern businesses willingness to invest and hire. However, the corporations are still cash-rich, buoyed by record corporate profit levels in the first quarter and expectation of another solid second quarter profit reporting season. The one bright spot in dismal second quarter GDP report was a gain of 7.1 percent in business investment spending. Yet key sectors such as equipment and software spending have slowed from earlier in the year.<sup>14</sup>

The profit trend numbers clearly demonstrate that corporations have the potential to deploy cash and thus accelerate the pace of economic recovery. The ISM index, the primary measure of business spending plans, shows 25 consecutive months of planned corporate expansion and the most recent reading. There was a slight dip to a still robust 55 in June ('50' is considered "break-even."), although the index has been sliding in recent months.<sup>15</sup>

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<sup>7</sup> <http://www.federalreserve.gov/releases/G19/Current/> July 2011

<sup>8</sup> CBS Market Watch June 2011

<sup>9</sup> Wall Street Journal – March 2011

<sup>10</sup> [http://www.usatoday.com/money/economy/housing/2011-07-20-existing-home-sales-fall\\_n.htm?csp=34money](http://www.usatoday.com/money/economy/housing/2011-07-20-existing-home-sales-fall_n.htm?csp=34money)

<sup>11</sup> [http://www.realtor.org/press\\_room/news\\_releases/2011/04/rise\\_march](http://www.realtor.org/press_room/news_releases/2011/04/rise_march)

<sup>12</sup> <http://wallstcheatsheet.com/stocks/case-shiller-home-prices-may-continues-the-tiny-upward-trend.html/>

<sup>13</sup> [www.federalreserve.gov/boarddocs/snloansurvey](http://www.federalreserve.gov/boarddocs/snloansurvey)

<sup>14</sup> Washington Post, July 30, 2011

<sup>15</sup> <http://www.ism.ws/about/MediaRoom/newsreleasedetail.cfm?ItemNumber=21684>

## ***Inflation Diminishing Immediate Concern but Should be Monitored; Energy prices, Commodity Prices Deserve Scrutiny***

Inflation remains historically low. The 2010 CPI index was 1.6 percent, within the Fed's 1 percent to 2 percent target range. The June CPI was negative for the month and from a year ago due primarily to declining energy prices (and up a modest 1.6 percent in the core CPI measure excluding food and energy).<sup>16</sup> It is too early to determine a trend or merely a one-month "blip," as it was the first negative reading of the year.

Raw materials have risen amid strong demand for commodities from many parts of Asia. China is starting to build strategic reserves in several leading rare earth metals, an effort that could give Beijing increased power to influence global prices and supplies in a sector it already dominates. China controls more than 90 percent of current global supply of rare-earth metals, a group usually classified as 17 elements that are known for their importance in such high-tech applications as weapons and hybrid technologies. Mining companies around the world have responded by taking steps to increase production.<sup>17</sup>

## ***Global Growth Contrasts: Emerging Markets Growing But with Inflation Risk***

Emerging market policy makers are taking steps to contain inflation including capital controls. Inflation fighting strategies in emerging markets lead analysts to worry about dampened demand for exports and global growth, further slowing growth in developed countries. The Chinese introduced policy tightening and have continued the policy this year in response to rising consumer prices.<sup>18</sup>

Longer term, the emerging (and frontier) markets are the engine of global growth. We continue to be persuaded by the analysis that says that emerging economies with growth generated through internal consumer demand – such as India – may outperform external (consumer) growth oriented economies – such as China – which are dependent on growth in the developed markets.

## ***Uncertain Outlook for Fiscal Discipline the Dominant Issue***

On the fiscal side, there is a public consensus for restraining the budget deficit but the degree to which it translates into action is the critical issue. The economy faces another fiscal year of \$1 trillion plus deficits and indeed the forecast is for record deficits in the coming fiscal year. The President's Commission of Fiscal Responsibility and Reform reported its recommendations late last year; the question is the extent to which policymakers will implement them. Perhaps the recent "negative outlook" S&P/Moody's action on the AAA U.S. debt rating may spur action.

Around the globe, the inability to reduce debt continues to cast a shadow over Western economies and the financial health of individuals and indeed created the currency for reluctance to raise the U.S. debt ceiling. The fundamental problem is that reversing the trend of piling on the debt requires some combination of cutting spending, growing income or the economy, and inflation.

Since the fall of 2008, there have been repeated attempts by central banks to cushion the blow of the debt cutting process. Based on the still-developing and fragile economic growth trend and moderate inflation, the Fed will continue to keep rates at the current low level for an "extended period," very likely until at least late 2011. While the market favored the Fed's purchase program to keep rates down, there is the longer term concern that too much ease sets the stage for another asset bubble.

The Fed has signaled that the recovery and timetable for stopping its money printing press are on track.<sup>19</sup> The soon to end QE 2 (quantitative easing) has worried some investors who believed the economy remained weak and could slip into another recession without further help from the Federal Reserve. There was brief mention by Chairman Bernanke of a potential third round of quantitative easing that was essentially quashed soon after.

## ***The State and Local Finance Drag on Economic Prospects***

A downside risk for a few years has been state and local finances. Unlike the Federal government, most states are required to balance their budgets, and the economy and related tax revenues have hit state budgets particularly hard. While belt-tightening has improved state fiscal outlook, budgets will remain constrained for the next few years. Add to those concerns about some local and state governments' capacity to finance looming pension obligations. In addition to the local government effect on the national economy, the state and local finances of course have implications for municipal bond prices and credit quality which fortunately have bounced back from weaknesses at the beginning of the year. The ratings agencies have signaled that the debt ceiling resolution will have a marked effect on state and local bond ratings

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<sup>16</sup> <http://www.bls.gov/news.release/cpi.nr0.htm>

<sup>17</sup> Traders Magazine – March 2011

<sup>18</sup> Investor's Business Daily – March 2011

<sup>19</sup> Bloomberg Magazine - March 2011

## ***Equity Markets Rely on Continued Profit, Economic Growth Trends, Reduced Debt Crisis-Generated Volatility***

Equities rallied across sectors with particularly strong tech sector gains until elevated volatility levels ensued, developing deficit and debt ceiling uncertainty combined with weaker economic data readings as well as probably some profit taking. The Dow, S&P and NASDAQ indices dipped in the 4 percent to 5 percent range for the 3 months ending July 29 from close to the 2011 peaks in late April. For the year, the indices are in positive territory and up by approximately 15 percent to 20 percent from a year ago.<sup>20</sup>

The stock market anticipates the economy as a “leading indicator” and thus the drop is concerning but the question is the duration of the drop. There are three dominant factors leading the performance. First, there is the corporate profit growth with profits at record levels.

The corporate profit share of GDP is at a 60 year high. In spite of the anemic GDP data in the first half, about 83 percent of S&P 500 companies have beat second quarter 2011 analyst estimates according to data compiled by Bloomberg and many have reported record revenues and earnings.<sup>21</sup>

The second pillar is policy, the expectation of Fed policy to keep the recovery on track and “remove the punchbowl” at the correct time to manage inflation and inflationary expectation threats as well as debt ceiling resolution. The third is the return to the consensus expectation of growth and economic recovery for 2011.

While the growth expectations have dimmed, prospects look better as we get closer to year end. There should always be prudence in market strategy and outlook, ensuring that values represent underlying fundamental trends and taking account risk potential.

### ***The International Bond Perspective***

A number of European governments are undertaking programs that could significantly reduce their budget deficits. Many leading emerging markets are implementing steps to deal with global capital flows without undermining international trade and investment. The success of these actions could have an important impact on whether 2011 brings further economic recovery and financial market progress.

While the European Central Bank leadership has stated that the height of the European debt crisis has passed, and its bond program support is being pared down, the markets need to be fully convinced. The discussion of a permanent European fund speaks to the continued concerns as well as periodic “crises.” The riskier European sovereign credits still fetch extremely high yields reflective of elevated default probabilities.

The euro currency will remain exposed to downside risk until there is clear evidence that the series of periodic crises are permanently subsiding. Europe still needs to address its longer term structural issues, and there remains a widely held view that a European default is a distinct possibility during the next few years with Greece the most often mentioned candidate but concerns present among the other “PIIGS” – Portugal, Ireland in particular. Analysts see more European bond turbulence in 2011.<sup>22</sup>

The latest bank stress tests may do little to soothe concerns about capital levels, as a spreading sovereign-debt crisis undermines the attempt to restore confidence in the sector. One of the problems with the credibility of the earlier tests was that there wasn't any specific assumption of a sovereign default, although the EBA said the tests will provide “an assessment of the risks associated with an exposure.”

Europe's biggest lenders are expected to pass the tests, but analysts said the most useful information is to be found in banks' disclosures of their individual exposures to different sovereigns. That should guide investors in developing their stress test analysis.<sup>23</sup>

### ***Gold***

The price has more than doubled in value since late 2006 and by more than 30 percent over the past year driven by the investor concern about risk after the series of financial crises in recent years and national currency vulnerability, hitting \$1,627 from \$1,500 in April.<sup>24</sup> Three factors are at play – near term factors including the European debt crisis aftermath; Mideast instability; the U.S. debt crisis; how much is being bought and sold by national central banks; and long term fiscal and monetary policies.

Certainly, a case can be made for gold and other commodities in a diversified investment portfolio. While prices have surged over the past year, however, gold prices can be volatile. In the 20 years through early 2010, precious metals funds tracked by Lipper, Inc, returned an average annual 6.15%, less than all major sector fund categories tracked over those two decades.<sup>25</sup>

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<sup>20</sup> Yahoo Finance

<sup>21</sup> Seeking Alpha, July 29, 2011

<sup>22</sup> Google/Agence France-Presse December 28, 2011

<sup>23</sup> Bloomberg June 2011

<sup>24</sup> <http://www.goldprice.org/>

<sup>25</sup> Investor's Business Daily, June 2010

Various factors have contributed to the recent pullback in commodities, including concerns about U.S. economic growth, the threat posed by Greece's persistent debt woes, and the debt impasse in the U.S.

### **Real Estate**

Commercial real estate typically follows economic cycles, and as the labor markets improve, so do the numbers of occupancies, which then result in rising rents with generally a lag of a few quarters. Most REITs have been raising equity over the past two years and a commercial buyer with cash is able to purchase a property.

The loans that banks and insurance companies are willing to make are at much lower leverage levels. As commercial real estate prices have fallen, commercial real estate is more attractive to buyer than two years ago. Finding properties with quality tenants and longer term leases is the key to earning a steady stream of cash flow in the present economic environment.<sup>26</sup>

The U.S. FTSE EPRA/NAREIT REIT index bounced back in 2009 and 2010. The rebound enabled REITs to recapitalize and gain favor with dividend-motivated and distressed asset investors. The index was again positive 2011 but at a slower pace of 9.8 percent through the end of July. (The returns were higher in Europe but negative in Asia reflecting the cycle in the respective regions.) Yet, underlying commercial real estate fundamentals are only beginning to show recovery signs and in some markets still weak but perhaps stabilizing depending on the sector.

<b>FINANCIAL MARKET DATA AND STATISTICS FOR AUGUST 4, 2011</b>
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<b>Year to Date Statistics*</b>	<b>Current Rates*</b>	<b>Current Yields*</b>
DOW – ▼ 2.19%	Oil Price @ \$94 barrel	Federal Funds @ 0.25%
NASDAQ – ▼ 2.75%	Gold Price @ \$1641 ounce	30 Y Mortgage @ 4.55%
S&P 500 – ▼ 2.56%	Euro per Dollar @ 0.7041	10 Y Treasury @ 2.620%
Russell 2000 – ▼ 3.26%	Core Inflation – ▲ 3.56%	5 Y CD'S @ 1.88%
CBOE VIX – ▲ 4.78 %	Unemployment @ 9.20%	Money Market @ 0.58%

- Year to date statistics, current rates, and current yields are all from the Wall Street Journal as of August 4, 2011.
- Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs, and expenses. Past performance is not a guarantee of future results.

### **Financial Concepts Unlimited Approach**

Financial Concepts Unlimited continuously monitors and assesses its investment strategy, informed by market valuations and trends along with the underlying data. FCU will evaluate the events and variables as summarized throughout this document. It will then act with prudence upon clear market signals, taking account of potential risk exposures.

We continue to stand by our philosophy of capital preservation and are always looking to manage client wealth with attention focused on the downside. The asset classes and managers we have chosen to provide diversification within our portfolios continue to offer what we think to be an excellent benefit as we incrementally invest our way back into the stock market. This approach to diversification continues to serve us well and continues to drive our firm's philosophy.

<sup>26</sup> Financial Advisor Magazine – March 2011

***In closing,***

I wanted to thank you again for your continued support and state that we remain confident in the enduring power of the financial market's ability to create wealth over the long term, despite the challenges and risks that are a necessary part of the investment process. The overall sentiment from the investment community remains positive.

The economy and markets are certainly experiencing challenges of uncertainty and transition. We must never forget that opportunities for creating wealth are constantly evolving, and as part of our commitment to managing your assets, we are always looking for the best way to implement them.

Finally, as we move through the summer season, we want to take this opportunity to wish the best to you and your families and loved ones and a prosperous second half of 2011.

Sincerely,

*Michael S. Standridge*

*Portfolio Analyst*  
Financial Concepts, Inc.

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All investing involves risk including the potential loss of principal. No investment strategy such as asset allocation and diversification can guarantee a profit or protect against loss in periods of declining values. Past performance is no guarantee of future results. Please note that individual situations can vary. Therefore, the information presented here should only be relied upon when coordinated with individual professional advice. This material contains forward looking statements and projections. There are no guarantees that these results will be achieved.

In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

The price of commodities, such as gold, is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.

International investing involves special risks including greater economic and political instability, as well as currency fluctuation risks, which may be even greater in emerging markets.