

INVESTMENT OUTLOOK

**DIXON, HUBARD, FEINOUR
& BROWN, INC.** *investment
counsel*

- ◆ Stocks regroup in second quarter.
- ◆ Pace of economic recovery slowing.
- ◆ Markets focused on Greek bailout and U.S. debt/deficit reduction.

Also in This Issue

Page 2&3: No Greek-style Debt Crisis for the U.S.

Page 3: Stock Market as a Leading Economic Indicator.

Page 4: Is a Roth IRA in Your Future?

The second quarter turned out to be a tug of war between the bulls and the bears. The early going looked good in April as

strong first quarter momentum carried stocks to new highs for the year. A run of discouraging developments on several economic fronts sent the market south in a steady eight-week slide giving bears the upper hand. A sharp rally in the final week of the quarter brought the market back close to even with most of the major indexes finishing June just about where they began in April.

As safe haven investments, gold and bonds easily outpaced equities for the quarter. The more volatile markets for commodities and emerging market stocks were the clear losers. The strong recovery in stocks at the end of the quarter may be a good indication that the economy will gather steam in the second half of the year and that the two-year uptrend for global equity markets has further to run.

After a second consecutive year of gains in 2010 and a great first quarter, positive investor sentiment for stocks faded rapidly as the European debt crisis reemerged as a threat to global financial stability. All eyes have been on

Second Quarter 2011 Review and Outlook by Whitney Brown

Greece and how the euro-zone authorities can restructure her debt without creating a default. It would appear that the recently passed austerity measures have bought some time for an orderly process to be worked out.

Of far more significance to global markets is what has been happening with the world's most important economies. As the second quarter progressed, economic data were painting a picture of increasingly spotty progress in the U.S. and slowing momentum in the large, fast growing economies of China, Brazil and India. As the quarter drew to a close, there were some indications that the gloomy view may have been overdone.

Looking to the second half of the year, the picture is unusually complex but generally more positive than negative. There are many important issues that have come to bear on the economic and investment outlook. Starting on the plus side, corporate profits in the U.S. continue to be stronger than the economy as a whole. Corporations came out of the recession with very lean cost structures, and productivity has remained high. Financially sound companies have been able to take advantage of large cash reserves and low borrowing costs to upgrade equipment and software, further enhancing productivity for the longer term.

While consumer spending is still restrained, capital expenditures have been a major driver in the current expansion.

U.S. manufacturing and industrial companies have particularly benefitted from strong capital spending. Recent reports indicate renewed strength in U.S. manufacturing after an earlier slowdown due to the spike in energy costs and disruption of supply chains from the Japanese earthquake. Exports have been a very bright spot in manufacturing as the demand from rapidly expanding emerging market economies has held up well for industrial machinery and heavy equipment.

On the other side of the ledger, the U.S. housing market is still depressed. Critical indicators of housing activity such as sales, building permits, and mortgage

(Continued on page 2)



Market Measures	2nd Qtr	YTD
S & P 500 (price)	-0.4%	5.0%
Dow Jones Industrial Average	0.8%	7.2%
NASDAQ Composite	-0.3%	4.5%
Russell 2000	-1.6%	6.2%
MSCI EAFE	0.3%	3.0%
Barclays Capital Inter Gov't/Credit Bond Index	2.1%	2.5%
	6/30/11	6/30/10
10-Year Treasury Bond Yield	3.16%	2.94%
Three-month Treasury Bill Yield	0.02%	0.18%

Second Quarter 2011 Review and Outlook (continued)

(Continued from page 1)

applications remain anemic. Willing buyers find it difficult to qualify for mortgage loans since credit standards have become much more restrictive. A steady supply of foreclosed properties continues to stream onto the market keeping prices down. However, the foreclosure rate has slowed, and there is some anecdotal evidence of capitulation among previously patient sellers as they slash prices for fear of missing out on the current selling season. These are hopeful signs that we could be near a point where supply and demand will come into balance and allow prices to stabilize.

The housing market, of course, is directly affected by the labor market, and the recent flow of data on unemployment has been disappointing. Job creation has slowed, and the level of unemployment claims has failed to improve in recent months. The halting pace of recovery makes many employers reluctant to hire. In many instances, industries that have openings are unable to find the specialized skills they seek among the unemployed. In addition, qualified job seekers may be discouraged from relocating to suitable job locations because they can't sell their homes. There are no quick or simple solutions to the labor or housing dilemmas, but we should expect slow improvement as the economy continues to heal.

Inflation continues as a prominent topic of concern. The easy money policy of the Federal Reserve has weakened the dollar and led to commodity price inflation. Earlier this year high oil prices and spiking food prices alerted investors to the possibility of inflation getting out of hand. Yet, it will be difficult for general inflation to take hold as long as the labor markets in the U.S. remain

weak and industrial capacity utilization remains at levels consistent with slow growth. Producers find it difficult to pass along increased costs to consumers who simply are not able to pay more while living on stagnant incomes or unemployment benefits. Abroad, the faster growing economies in Asia and Latin America are having some success with their efforts to dampen inflation. Despite the short-term surge, inflation should not become a problem for the longer run until the economy demonstrates much stronger and steadier growth.

In all, the economic outlook is for gradual improvement that is consistent with a painstaking recovery from a major financial crisis. The ongoing deleveraging by individuals and governments is necessary, but takes time and dampens the usual risk appetite that follows a more typical recession. Barring a failure by Congress to settle the debt ceiling issue or an unexpected turn in the euro-zone debt saga, the economy should be able to continue muddling through.

Over the summer months, the risks to financial markets are primarily political and hinge on whether or not the negotiations in Washington over the debt ceiling and deficit reduction reach a workable and timely conclusion. So far, the relative calm in the markets implies that the Congress will come to some reasonable compromise. The Federal Reserve will keep short-term interest rates low, supporting equity markets. Stocks should also benefit from any improvement in economic data and favorable earnings reports. Commodities should resume their long-term uptrend as emerging market demand reaccelerates. Bond yields should pick up along with economic growth but remain within the broad trading range of the past two years.

No Greek-style Debt Crisis for the U.S. by Watt Dixon

Over the past ten years Greece has amassed over \$400 billion in debt. A strong Euro and low rates were in place for most of the last decade, making borrowing easy. The crushing blow for Greece came in late 2009 when it became clear the government deficit would be 12.7 percent of its gross domestic product, not the 3.7 percent the previous government had forecast.

Greek bonds were downgraded to "junk" status, pushing yields on their 10 year bond over 17%, up from 6% at the start of 2010. Investors panicked, worrying if Greece's Socialist government might not be able to enact the tough measures needed to reduce this massive budget deficit. Europe's more affluent countries like Germany and France stepped in with a pledge to defend the Euro. The Greek economy continues to shrink.

Some experts have likened the U.S. debt situation to that of Greece. The comparison is made for dramatic effect but really overlooks some very stark differences.

Yes, low rates have allowed excessive borrowing in the U.S., however there are some major differences in these two countries' economic difficulties. The economy of Greece is minuscule compared to the U.S. In addition, the U.S economy is much more diversified than that of Greece, making our earning capacity much greater.

Another major difference is the two countries' currencies. The U.S. dollar is the world's reserve currency, and is managed by a single government. The Euro is used by 17 countries. The euro-zone monetary policy is set not by just what is best for Greece, but what is best for all countries using the Euro. Germany, for example is an economically strong country that prefers higher interest rates to keep inflation in check. In addition, public debt in



(Continued on page 3)

Stock Market as a Leading Economic Indicator by Stebbins Hubbard



In most equity valuation models, stock prices are based on expected future earnings, discounted to a present value. Because a company's profits are linked to the performance of the economy, stock prices are directly

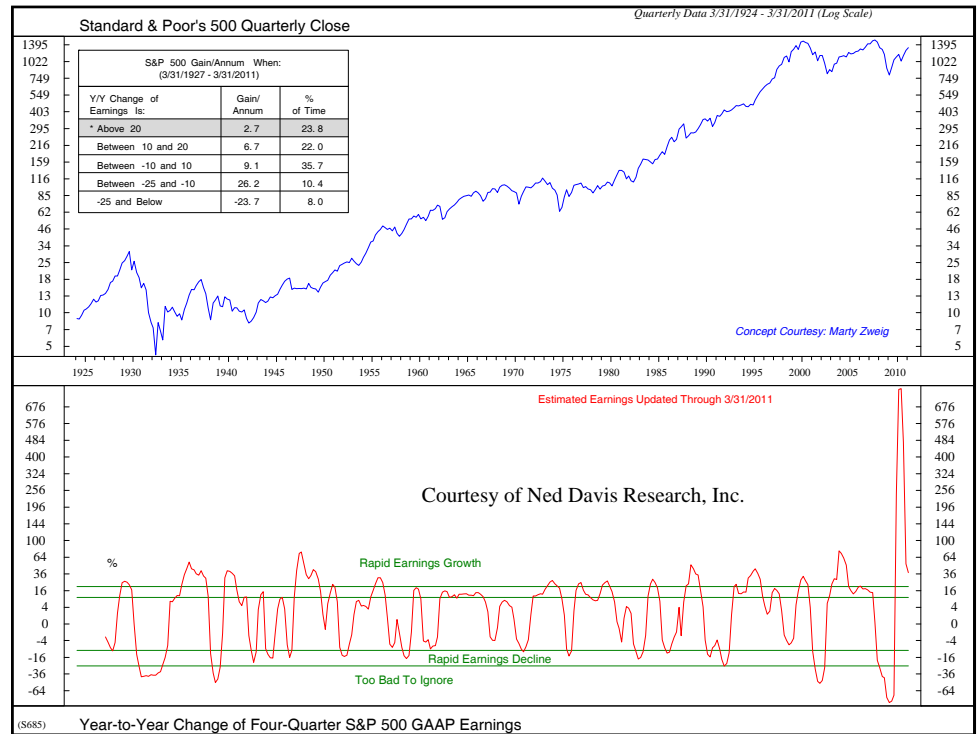
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expectations about the future direction of the economy. It follows then that, if investors are anticipating strong economic growth, stocks will be priced higher due to the earnings growth that would accompany this prosperity. For this reason, stock investors have a vested interest in accurately predicting the future performance of the economy.

The stock market normally anticipates future earnings, and by the time earnings are announced, the stock market has already discounted the news. The chart to the right shows that since 1924 when earnings grew above 20% (year to year), the stock market had only modest gains. But when earnings declined between 10% & 25%, the stock market rose on average 26% per annum.

This implies that the stock

market can be an effective leading indicator of the economy. Other research has shown it to be a more coincident indicator. In either case, popular market commentary that attempts to predict the direction of the market based on current economic data is putting the cart before the horse.



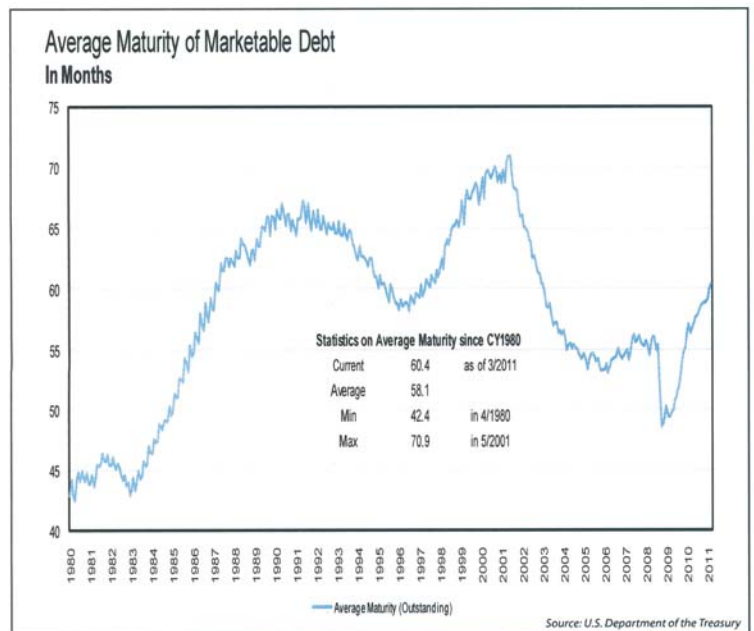
No Greek-style Debt Crisis for the U.S. (continued)

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the U.S. will reach 75% of our country's economy this year. Greece's debt will be about 150%.

While Greece is effectively bankrupt, the U.S. has taken a proactive approach to improving its liquidity. Steps taken by the U.S. Treasury in recent years have reduced the percentage of U.S. debt maturing within three years to the lowest level in over twenty years.

In addition, the chart to the right shows the average maturity of Treasury debt has lengthened to over five years, the most since 2002. By locking in low rates and lengthening its portfolio maturity, the U.S. is buying time to get its fiscal house in order. Extending the average maturity has not solved the debt problem in the U.S., but it has given a window of opportunity to deal with it. The debt level in the United States is certainly cause for major concern, and we have to address it while we still have time.



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Is A Roth IRA in Your Future?

by Ted Feinour



The IRA has become an integral part of retirement planning and savings. Many of our clients ask whether they should establish a Roth IRA or convert their traditional IRA to a Roth. Although there are no upfront tax deductions with a Roth as there are with the traditional IRA, distributions are tax free which provides more control over one's taxes in retirement. Because every dollar put aside in a Roth is your after-tax money, you can withdraw contributions, but not your earnings, at any time without facing taxes or incurring penalties. Roth IRAs also appeal to investors because there are no required mandatory distributions after age 70½, and one has the ability to leave Roth IRAs tax free to their heirs.

There are income eligibility restrictions for contributing to a Roth IRA. In 2011, one can contribute the maximum \$5,000 to a Roth IRA (\$6,000 if over age 50) if you are single and your adjusted gross income is \$107,000 or less or if you are married filing jointly and your income is \$169,000 or less. It is also possible to make partial contributions with income up to \$122,000 if

single and \$179,000 if married filing jointly. Anyone, however, may convert a traditional IRA to a Roth IRA, and income limits on conversions were eliminated in 2010.

Whatever amount converted is taxed up front on the entire amount (except after-tax money in your traditional IRA) at one's top income tax rate. Since the general consensus is that personal income taxes will rise in coming years, some people are willing to pay the taxes now on their retirement savings rather than when they withdraw their money. One may convert some or all of a traditional IRA over several years avoiding a very large tax bill all at once on the total amount converted. There are also no age restrictions for contributing to a Roth IRA, unlike a traditional IRA which prohibits contributions after 70½. One is required to have earned income from employment to contribute. Some firms are now offering Roth 401(K) options which have no income limits.

We would be happy to help you consider the possible conversion of your traditional IRA to a Roth if you are interested, as well as participate with your accountant or attorney in any discussions you may have.