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market update

The sharp sell-off in the equity markets since late July at first appears related to renewed problems in Europe, this time related to concern over financing of Spanish and Italian debt and to the downgrade by S&P of U.S. Treasury debt to AA+. These are both serious issues, particularly the involvement of Spain and Italy in the debt crisis. However, we believe that the underlying fear in the market is that of a global economy slowing into recession. This has been reinforced by the weak second quarter GDP report in the U.S. and negative revisions to prior quarters' growth, continuing problems generating jobs, poor economic reports from Europe, and even some slowing in the Asia economies.

Over the August 6 weekend, the European Central Bank (ECB) announced that it would begin buying Spanish and Italian debt in an effort to reduce interest rates relative to market levels. This is likely to be the ECB's first venture into quantitative easing, a welcome shift for a central bank that had been leaning against efforts to stimulate growth. In the U.S., the S&P downgrade, however merited, makes a third round of easing by the Federal Reserve more likely. They meet this week and a program to purchase additional Treasury debt, this time including longer maturity issues, is a possibility. This surge of liquidity is also showing up in Asia as Japan has moved aggressively to weaken the Yen. If developed market economic weakness worsens, we would expect emerging market central banks to join the process and begin reducing rates to sustain their own growth.

These sort of liquidity boosts have supported asset prices over the past year, but have not generated much in the way of sustainable economic growth. The other lever that governments have is fiscal policy. Here the need to balance budgets both in Europe and the U.S., to address long-term structural problems, limits what can be done. The deal reached to expand the U.S. debt ceiling further complicates any effort to stimulate the economy in the near-term.

The U.S. equity market has looked interesting to us because of the reasonable valuations, growing earnings and dividends, and the ability of corporations to support prices through the use of their historically high cash levels to effect mergers and buy their own stock. If we are indeed slipping into recession, then these props to the equity market have been rightly challenged in the past week.

Over the next several weeks there will be much news about the debts of various nations, actions by central banks, and promises from politicians. Most important to the long-term health of the market will be signs of economic growth, and these will be the numbers that will hold the most interest. Volatility in the markets will be high in reaction to each announcement. Stocks that we have historically emphasized, larger better financed companies with dividend growth, should do better in this uncertain environment. We will wait for actions that may stimulate growth to become more aggressive.