

Economic Comments

With ongoing lackluster economic data, the Federal Reserve decided to keep dancing a little while longer by extending Operation Twist through the end of the year. While not as dramatic as a quantitative easing, which is where the Central Bank creates new money by buying financial assets, extension of Operation Twist was the best tool available to the Fed. By extending the long maturity bond buying program, the Federal Reserve is continuing its effort to push long term interest rates artificially lower. Driving this action were heightened concerns over slowing job growth and stagnant American household spending.

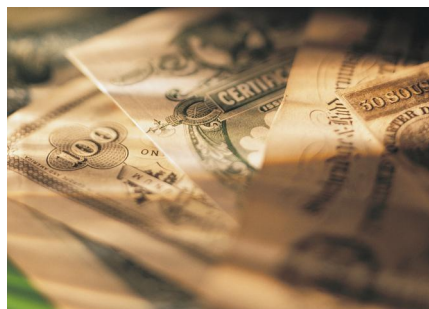
Unfortunately, the driver of the bulk of economic activity, the American consumer, is getting more worried; as a result, they are spending more carefully. Over the last four quarters, personal consumption expenditures have grown at just under 2 percent - the same sluggish rate as gross domestic product.

For the fourth month in a row, the Conference Board announced a decline in its consumer confidence index. The key factors behind the reduced confidence have been labor market weakness and the slowing U.S. economy coupled with the continued European debt turmoil. While gasoline's recent steep price decline and record-low mortgage rates have given consumers some breathing room, more is needed

before they willingly crack open their wallets. Adding to their concerns has been the sharp slowing in the labor market as the 2nd quarter averaged 75,000 new positions/month or one-third the pace of the year's first quarter. Highlighting the slowing economy was the manufacturing sector's June contraction - the first since the start of the economic recovery in June 2009.

Looking overseas, the Euro Zone soap opera continues apace. A sigh of relief was exhaled when June's closely watched Greek election produced a coalition government that aims to stay with the Euro. Adding a new European plot line, an emergency bailout of Spanish banks had to be thrown together as enormous real estate losses forced a re-capitalization of the country's major financial institutions.

The key, and as yet unaddressed, task for European leaders is to show the rest of the world that they are making a credible effort to repair the flaws in the Euro Zone's design that allowed the



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problems in one small country, Greece, to threaten the Euro Zone as well as the whole world.

The most recent financial patch for the Spanish banks is by no means a final cure to the ongoing Euro saga. Despite calls from some leaders for shared oversight of budgets and deficit spending, no concrete proposals have been made. Until a cohesive and complete strategy is crafted, European leaders seem determined to stumble from crisis to crisis without addressing the underlying problems. Until the critical player Germany is persuaded to embrace the problem, each solution will remain only a stop gap measure.

Despite the continued Euro turmoil, there were some bright economic spots during the quarter. Revival of the comatose U.S. housing industry is critical to a broader based U.S. economic expansion. A recent survey showed increases in home prices in nearly all major markets and was received by economists with enthusiasm. For the second straight

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month, prices in the Standard & Poor's/Case-Shiller home price index have increased. Also, gasoline prices have been putting additional money into household budgets as prices have fallen sharply from a peak of \$3.94 per gallon in early April to \$3.40 per gallon at June end.

Looming over the economic landscape is the current U.S. budget deficit. While the current problem would be partially addressed by the planned January 2014 tax increases, expectation are that this Fall Congress will temporarily extend the existing tax structure. By the end of this year, the Congressional Budget Office (CBO) projects that cumulative federal debt will reach 70% of gross domestic product, the highest level since the end of World War II. In comparison, and as recently as 2008, federal debt was around 40% of economic activity. Barring changes in current policies, federal debt would

reach 199% of GDP within the next 25 years. This represents a substantial fiscal worsening as last year the CBO projected debt in 25 years as being 187% of GDP.

To put these numbers in better perspective, Greece's current debt issues erupted when national debt hit 140% of economic activity. While the CBO estimate is just that, the continued degradation in these projections highlights the unsustainability of current entitlement commitments. The growth in spending on Medicare, Social Security and other entitlement programs for aging baby boomers comprise the vast majority of growth in debt from this year's 70% mark. Worsening the fiscal situation has been the Bush tax cuts and their sharp reduction in federal income tax collections.

The key issue at this stage is what will happen in the November

elections and whether Congress and the President will finally take action to short stop the CBO predicted financial disaster. Republicans and Democrats were achingly close to a solution last summer when immediate political concerns derailed the potential compromise. At this stage, both political parties are playing a game of chicken while hoping that the other will blink first. As shown by the rapid deterioration in Greece's finances, everything is o.k. until it isn't.

Adding to politicians complacency has been the sharp reduction in interest rates demanded for U.S. federal debt. All we are sure of at this stage is that decisive action is needed by both U.S. and European leaders. We wish that we were confident that this was going to be achieved before things get measurably worse.

Analyst Corner



Starting in the mid 1800s, telegraphs were the means of relaying critical information across the country. Leader among telegraph companies was Western Union (NYSE: WU). Since those early days, the company has evolved into a global provider of money transfer services. Emphasizing its core consumer to consumer cash transfer services, Western Union has an unparalleled agent network of almost 500,000 locations. With large economies of scale, the industry behemoth

has operating margins twice that of its competitors. Although having a higher level of debt due its leveraged takeover of almost a decade ago, the company produces strong levels of cash flow that have allowed it to consistently buy back stock while recently increasing its dividend by 25%. Depending upon an investor's goals, the company's attractive financial performance could provide a rewarding return in the coming years.

Market Comments

The strong investor enthusiasm to open the year lagged as we entered into the year's 2nd quarter. Europe's worsening debt crisis and the sharper than expected economic slowdown in China have weighed on stocks since early April as the U.S. stock market declined by almost 3%. The market's big laggard for the year remains the energy sector with losses of more than 2%. In the face of anemic global energy demand and sharp increases in oil/gas reserves due to new hydraulic fracking technology, energy prices have seen declines of 30% since March. Leading the market higher has been the little loved telecom sector with gains of more than 16% as investors have come to better appreciate the sector's stable and growing cash flows.

Amidst the continued European turmoil, investors have increasingly flocked to safe haven assets. With U.S. Treasury securities being the most liquid haven, 10-year yields were driven down by more than 1/2 percentage point during the quarter

to record low levels. Although possibly prudent in the near-term, these very same investors choose to ignore the 800 pound gorilla in the room - the rapidly escalating U.S. entitlement programs and the resulting sharp projected escalation of U.S. deficits and debt.

Despite this gloomy backdrop, American stocks have also proven the place to be in 2012 as Wall Street's 9.3% rise readily trounced the developing world's stock return of 2.3% and the developed world's 0.8% year to date return. Driving this recent out-performance has been the U.S. economy's relative stability. While not strong in absolute terms, American economic growth of 2% shines as compared to the grinding recession being realized in many parts of Europe.

Moreover, with American banks having successfully re-capitalized following the 2008 financial crisis and the signs of a bottoming in the housing market, investors have increasingly viewed the U.S. as a safe haven aided by the robust

balance sheets of American corporations.

Interestingly this year, markets have demonstrated manic/depressive symptoms with a risk on/risk off approach. On some days, safe haven assets, such as U.S. and German government bonds, are desired at all costs. On yet other days, investors flood back into risky assets such as commodities, equities and currencies. This unusual behavior has undermined the investing process as correlations of financial assets across classes and countries has sharply increased - further worsening overall portfolio volatility.

As we look forward, we anticipate a continuation of the recently challenging investing environment. We believe though that the current situation underscores the need for a well developed investing strategy and the fortitude to stick to the plan no matter the day to day tribulations of the financial markets.

Performance as of 6/30/12

| | <u>Close</u> | <u>Month</u> | <u>YTD</u> | <u>1 Year</u> |
|-----------------------------|--------------------------|-----------------------------|-------------------------|---------------|
| DJIA | 12,880.09 | 4.05% | 6.83% | 6.63% |
| S & P 500 | 1362.16 | 3.96% | 9.31% | 5.28% |
| NASDAQ Comp. | 2935.05 | 3.81% | 12.66% | 5.82% |
| | <u>Quarter end yield</u> | <u>Prior Year end yield</u> | <u>Yield 1 year ago</u> | |
| 10 yr. U.S. Treasury | 1.66% | 1.87% | 3.16% | |

Planning Thoughts

According to a recent government survey, the net worth of American families has stagnated over the last decade. For those individuals entering into their 60s, the absence of growth in their assets has sometimes forced a re-consideration of existing retirement plans. With the years leading into retirement often being the period of highest savings, and greatest net worth growth, many of these investors are faced with fewer financial resources than they had anticipated. To help address this retirement shortfall, a number of actions can be taken. Some courses of action are more obvious such as saving extra money and re-evaluating retirement cash needs. Another opportunity can be seized by downsizing housing; by doing so, home equity can be freed up for investing while also reducing recurring housing expenses. While not as attractive, delaying retirement by even two or three years can substantially improve the retirement picture as it allows for additional savings along with a shorter retirement during which investments are being consumed.

A final means of attacking this problem is by more directly managing longevity risk (i.e. the risk of outliving your money). With average life spans having continued to rise, this risk has increased. Two means of mitigating this concern are to delay drawing on Social Security which meaningfully increases the monthly benefit and/or buying a single premium income annuity which guaranties a monthly income starting at age 85 or older. If your own targeted time frame for retirement is growing close, we would be happy to sit down and help you navigate this potential minefield!!



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