Schaper, Benz & Wise
INVESTMENT COUNSEL, INC.

Economic and Market Summary
July 2011

After gaining momentum in the latter part of 2010, U.S. GDP for the first half of 2011 is projected to be just shy of 2%. Factors that detracted from growth include higher food and gasoline prices, unfavorable weather conditions, supply chain problems resulting from the Japanese earthquake, and continued weakness in housing. Historically, housing has led economic recoveries. This time around, we have tight mortgage underwriting standards and an oversupply of existing homes. Structural unemployment is higher because underwater mortgages have reduced worker mobility. While payrolls expanded by an average of 182,000 for the first four months of the year, growth slowed considerably in May and June. We estimate that payroll gains in excess of 200,000 per month are needed to reduce the unemployment rate. The elevated jobless rate is also a reflection of our global competitive position. Relatively high corporate taxes and a greater regulatory burden make investment in this country less attractive. While there has been discussion about overhauling the corporate tax code, the regulatory environment is becoming even more onerous. We note that the latest crisis erupted from the financial sector – one of the most regulated portions of our economy. We must remove impediments to investment and job creation.

While 2% to 3% growth is less than ideal, well financed companies with a strong market presence can do quite well in a slower growth environment. The primary risk we see is a government that may feel compelled to “do something” if this slowdown lingers. Monetary policy is already extraordinarily accommodative. Currently, the appetite for another asset purchase program is low due to a burgeoning Federal Reserve balance sheet and rising inflation. However, if times get tough, the cries for help will undoubtedly resurface. With the level of accommodation already unprecedented, we worry about unintended consequences arising from the misallocation of capital.

Investors have been preoccupied with “fat tail” risk which includes a Greek default spurring financial contagion and the U.S. government refusing to raise its debt ceiling and being unable to pay its bills. In both cases, resolution is sorely needed to reduce market uncertainty. With the latest Greek austerity package, the European banks have been granted time to become better capitalized so a default is less likely to destabilize the world economy. In our own country, the change in the discussion on government spending from “whether to cut” to “where and how much to cut” is very encouraging. The 2012 elections are shaping up to be a referendum on our nation’s fiscal priorities.

We expect economic growth to pick up in the second half of this year. Prices of oil and other key commodities appear to have peaked, providing relief to consumers and businesses alike. Japan is quickly recovering from its earthquake-induced downturn. Auto production will provide a meaningful lift in the quarters ahead. We acknowledge that our economy is still vulnerable to even modest shocks caused by aggressive monetary policies, unstable public debts, global economic imbalances, and elevated geopolitical risks. While this will make economic growth uneven at times, we do not believe the recovery has derailed. The market has been quite resilient in the face of negative news. Corporate profits remain healthy, and more capital is being returned to shareholders via dividends and share buybacks. The S&P 500 index is trading at 13x 12-month forward earnings, a level we have not seen since May 2009. In our universe of companies, we see especially attractive value in stocks that combine good growth prospects with strong free cash flow.

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To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address below.

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