

Our Thoughts on Recent Market Volatility

After a year marked by little volatility in the stock market, stock indices across the world have sharply declined over the past month. The 14% decline since late April experienced by major stock indices (through August 9), both domestically and abroad, has wiped out the past twelve months' gain. Such declines, while unpleasant, are not without precedent. In fact, from April to July 2010, concerns about economic growth and the European financial system drove stocks 16% lower. The reasons for recent volatility have been well chronicled by the media but ultimately are tied to fiscal problems for the governments of developed economies and much weaker than anticipated economic data, raising recessionary fears.

- **Debt and deficits:** For too long, the United States and many European nations have run deficits that led to mounting debt burdens. We have reached the point where continuing to increase such debt levels is no longer easy or desirable, as evidenced by the recent political drama in the U.S. that essentially "kicked the can" down the road without convincing the public that the longer term fiscal imbalances in the U.S. are being addressed. These imbalances led to Standard & Poor's downgrading the debt of the United States on August 5, exacerbating already diminished confidence in the U.S. government. European governments face crushing debt loads and currently lack the authority, institutions and political will necessary to address their problems. As the European Central Bank and the governments of Germany and France publicly debate what can and should be done, conflicting signals are being sent to the marketplace, adding volatility to an already unsettled climate.
- **Continued economic concerns:** U.S. Gross Domestic Product (GDP) growth has come in well below consensus in 2011, with second quarter GDP estimated at an anemic 1.3% annualized return after a .4% first quarter figure. Given the severity and duration of the recent recession, such numbers are quite poor and reflect the continued reduction in consumer spending as they work down excess debt accumulated over the past decade. Since consumers represent nearly 70% of our GDP, this weakness is a significant concern. Unemployment remains stubbornly high, with little hope of improving dramatically in the near term, and housing prices remain weak. While economists expect US GDP to accelerate in the second half and beyond, the recent stock market downturn increases the odds that weakened consumer confidence will further curtail spending at a point when the economy is already teetering. The European sovereign debt crisis, along with a slowing of emerging market economies, contributes to growing concerns about a global recession.

Johnson Investment Counsel has been concerned about the economic and fiscal issues mentioned above for quite some time. It is always important to have the right mix of assets in a portfolio, especially in times of stress like now. Our incorporation of alternative and real assets into client portfolios, in addition to owning cash and high quality bonds where appropriate, has helped cushion the blow during this downturn, along with having significant exposure to high quality companies. Unlike many governments and consumers, most of the companies we own are in remarkably good shape, with manageable debt levels, high levels of cash on hand, and record high profit margins and profits. The companies in the S&P 500 are projected to earn over \$25 per share this quarter, which, if continued, would mean the Index is trading near 11 times earnings—not a level associated with significant declines, and well below historic averages. While it's impossible to time the market in the short run, history is not kind to those that sell in the midst of a sharp downturn. One of the best attributes of successful investors is not joining the crowd during manias or panics, and we will stick to our discipline of properly diversifying client portfolios to meet long term goals. Having a good base of cash, fixed income, alternative assets and real assets typically provides significant benefits during periods of stock market volatility, and this recent occurrence has been no exception.

We will continue to closely monitor the news in the U.S. and abroad and adjust our portfolio strategy as necessary. Please do not hesitate to contact your Portfolio Manager to discuss your unique situation and any questions or concerns you have. Thank you for your continued confidence in Johnson Investment Counsel.

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