

Second Quarter 2011

Two years after the official end of the recession, economic recovery is still sputtering. The latest numbers released by the Bureau of Labor Statistics show that U.S. unemployment remained at 9.1% for May, and closed the quarter at 9.2% after a disappointing jobs report. The housing market and the current state of the economy remain in the forefront of people's mind. However, progress is often overshadowed by doomsday scenarios. On a positive note, the Federal Reserve's Beige Book indicates that progress is being made despite the very slow pace of recovery. According to the third estimate released by the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.9%, boosted by exports of goods and services. In May 2011, real disposable personal income increased 0.1%. Furthermore, economic activity in the manufacturing sector expanded in June according to the Institute for Supply Management's Report on Business.

### Stock Market

Hope is not a viable investment vehicle – this old-school axiom has been revived lately in light of less than stellar economic news. Volatility characterized the stock market in the second quarter of 2011 as investors paid close attention to “market moving” events. The global economic crisis, Europe's debt woes and the impact of the earthquake and tsunami in Japan weighed heavily in the balance. The highs and lows caused by global turmoil led investors to stay watchful on the sidelines. According to the Wall Street Journal, trading volumes on the New York Stock Exchange and Nasdaq were down more than 30% in the second quarter from 2010. The Dow Jones Industrial Average (DJIA) moved steadily downward for six weeks, but managed to reverse course by mid-June with blue chip stocks surging ahead. A visible shift in markets occurred as the Greek parliament passed the austerity measures needed for a bailout. For the week ending July 1, equities soared higher, closing out the second quarter and finishing with the best weekly gain of the past two years. Fixed income markets experienced mixed performance. Many analysts are concerned about future demand for U.S. Treasuries as the Federal Reserve retires its quantitative easing policy. The following table summarizes the average annual returns for various indices:

Index	1st Qtr	1 Year	5 Year	10 Year
S&P 500 (Composite Total Return)	0.10%	30.70%	2.94%	2.72%
Russell 2000	-1.61%	37.41%	4.08%	6.27%
MSCI EAFE (Net)	1.56%	30.36%	1.48%	5.66%
Barclays Aggregate Bond	2.22%	3.89%	6.51%	5.61%

*The S&P 500 is a commonly used measure of common stock total return performance, the Russell 2000 is a commonly used measure of small capitalization stocks, the MSCI EAFE is a commonly used measure of common stock total return performance of international markets, and the Barclay's Aggregate Bond Index is a commonly used measure of the bond market. All referenced indices are unmanaged and not available for direct investment.*

*Past performance is not a guarantee of future results.*

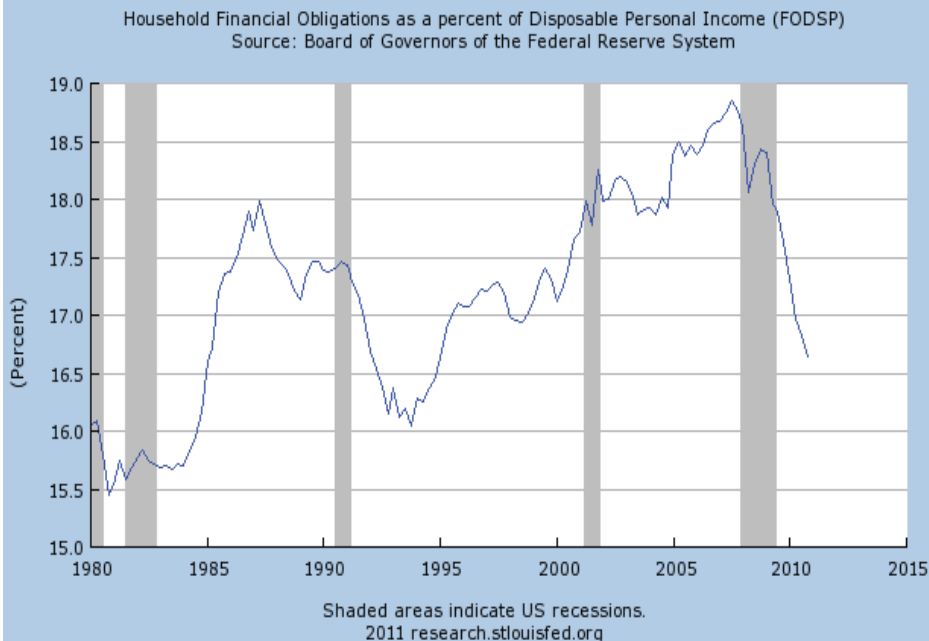
### Housing Market

The S&P/Case-Shiller Home Price Index data through April 2011, which tracks changes in the value of residential real estate, showed a monthly increase for the 10- and 20-city composites for the first time in eight months. While the index, which is published with a 2-month lag, remains below the same period one year ago, some economists see the recent bounce as a sign that price declines are moderating. Existing-home sales fell 3.8% in May, and are 15.3% below the pace of May 2010 when sales were surging to beat the deadline for the home buyer tax credit. Soaring gasoline prices and widespread severe weather conditions may have hindered an already ailing housing market. Another factor that could have an impact on the housing market is the recent qualified residential mortgage (QRM) proposal from banking regulators requiring lenders to retain 5% of the value of the loans they originate (for loans that are securitized, excluding Fannie Mae and Freddie Mac) unless the buyers put at least 20% down. If the 20% down-payment minimum is not met, buyers could be faced with higher financing charges. This proposal remains open for public comment until August 1, 2011. Despite all these factors, Lawrence Yun, chief economist at the National Association of Realtors expects that sales for the second half of this year will be stronger than the first half, and much stronger than the second half of the previous year.

## Consumer Spending

In theory, consumer spending is straightforward: people consume more and, consequently, the consumer spending index reflects an increase. As inflation puts upward pressure on the prices of goods and services, consumers might be spending more, but consume less, getting less “bang for their buck”. The latter seems to have been the trend in the second quarter. Soaring food and energy prices impacted other discretionary spending, and consumers pulled back nearly everywhere else. Spending numbers were up 0.5% in April (compared to March), but “real” spending, after inflation, gravitated around 0.1%. According to the Bureau of Labor Statistics, the all items consumer price index (including food and energy) rose 3.6% for the 12 months ending May 2011, the highest figure since October 2008. As of April, the overall energy index had risen 19% over the previous 12-month period, with the gasoline index up 33.1%.

The chart below, obtained from the Federal Reserve Bank of Saint-Louis, illustrates household financial obligations as a percent of disposable personal income (or “debt service ratio”) over the past 30 years. The household debt service ratio is an estimate of the ratio of debt payments (outstanding mortgage and consumer debt) to disposable personal income.



Consumers’ debt-to-income ratio is an indicator of their ability to repay debt. If the ratio is low, the likelihood of repaying debt is high, and vice-versa. The downward trend in the ratio since the end of the last recession seems to indicate that consumers are trying to lower their overall expenses. This has proved impactful on GDP results, as consumer spending accounts for a large portion of that number. GDP for the first quarter of 2011 increased at an annual rate of

1.9%, compared to 3.1% in the fourth quarter of 2010. According to the U.S. Bureau of Economic Analysis, a deceleration in personal consumption expenditures partially explains this slowdown.

## Parting with Cash

In corporate news, a glimmer of light is on the horizon. Companies are now starting to release their hold on cash reserves that they had previously been reluctant to spend. Increased acquisitions and capital expenditures could provide the economy with a much needed boost. In a quote from a press release regarding results of a liquidity survey conducted in May by the Association for Financial Professionals: “[...] financial executives continue to use an extremely conservative approach to cash investment. Nevertheless, [the survey] showed the biggest decline in companies building cash reserves in the history of the survey. While some of that decline was based upon lower operating cash flows as a result of the recession, the survey noted that a subset of companies have in fact begun to invest their cash in growth-oriented initiatives.”

## Conclusion

The uneven pace of the global economic recovery is difficult to ignore. According to a poll conducted by Gallup, U.S. economic confidence sharply deteriorated in early June amidst six weeks of stock market declines, a dismal jobs outlook and fears of Greece defaulting on its debt. The Federal Reserve on the other hand maintains that economic recovery is underway, albeit at a frustratingly slow pace. Only time will tell if the “new normal” is simply transitory or if it is here to stay.

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