MARYLAND CAPITAL ADVISORS INC

WEALTH MANAGEMENT • RISK-BALANCED PORTFOLIOS

INVESTMENT COMMENT **August 7, 2011**

Recent events

Global capital markets had been "treading water" in the current quarter until July 27 when Risk investments (stocks, Real Estate Investment Trusts) began to move lower and Low Risk (government and investment-grade bonds) began to rally to new low yields in reaction to a confluence of events:

- European sovereign debt concerns
- US political crisis that raised the specter of a previously-unthinkable default on obligation
- Economic impact of the Budget Control Act of 2011, executed on August 2

The most recent event, S&P's decision to lower US Treasury debt rating from AAA to AA+, occurred after all markets had closed for the weekend. What follows is some perspective on capital market reactions to-date, thoughts on the ratings downgrade, and comments on our asset allocation process during this volatile period.

Selected Asset Classes August 5, 2011	Since July 26	YTD Return
SELECTED RISK ASSET CLASSES		
US Large Cap Core	**-10.5%**	**-4.1%**
US Large Cap Value	**-10.6%**	**-5.8%**
US Small Cap Core	**-13.5%**	**-8.4%**
US Small Cap Value	**-12.5%**	**-9.6%**
Intl Large Cap Core	**-10.7%**	**-5.9%**
Emerging Markets	**-10.8%**	**-9.7%**
International Real Estate	**-9.0%**	**-4.9%**
US Real Estate Investment Trusts	**-13.8%**	**-2.5%**
SELECTED LOW RISK ASSET CLASSES		
US Treasury 1-3yr Notes	**+0.3%**	**+1.2%**
US Treasury 7-10yr Notes	**+2.8%**	**+8.4%**
US Treasury 20-30yr Bonds	**+7.3%**	**+11.5%**
US Treasury Inflation-Protected	**+1.9%**	**+9.6%**
Inv Grade Short Duration	**+0.2%**	**+2.1%**
Inv Grade Intermediate Duration	**+1.2%**	**+6.0%**
Inv Grade Long Duration	**+4.4%**	**+10.4%**
Mortgage-Backed Securities	**+1.0%**	**+4.9%**
International (Non-US Dollar)	**-0.4%**	**+6.8%**
EQUITY INDICES		
MSCI All-Country World Index	**-10.8%**	**-5.5%**
S&P 500 Index	**-9.9%**	**-3.6%**
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	**-5.9%**	**-0.4%**
DFA 60/40 Fund	**-6.9%**	**-1.8%**
DFA 25/75 Fund	**-2.4%**	**+1.3%**

Source: Bloomberg Professional
Note: Returns include reinvested dividends.

MID-QUARTER CAPITAL MARKETS UPDATE

Following the past 8 trading days, Risk investments have now generated negative year-to-date returns. Portfolios with balanced exposures to Risk and Low Risk investments are on either side of zero, depending on their specific construction[1]. This past week has provided yet another reminder of the need to maintain risk-balanced portfolios.

So, what is the meaning of these recent capital market gyrations? Bond and stock markets are signaling the same message: there is an increased likelihood of recession. The recessionary impact of cutting government spending is simple math, but the Act also increased uncertainty about what segments of the economy would be most impacted. Essentially, the Act eliminated the uncertainty of a government default (a catastrophic event that markets generally discounted as unlikely). However, the "trigger" provision of automatic, across-the-board spending cuts (if the Congressional joint "super committee" fails to agree to specific debt reduction) seems likely and has introduced a new dimension of uncertainty.

[1] We have updated our clients on their portfolio returns through Friday, August 5.

On August 2 we had two fundamental events for the stock market to digest. In addition to the recessionary impact of government spending cuts, fears were further stoked with the release of the latest monthly data on Personal Consumption that showed a marked decline[2] in consumer spending. From Introductory Economics we may recall that GDP = C + I + G + Net Exports.

Economic Activity		Personal Consumption Expenditures		Residential and Nonresidential Fixed Investment and Inventories		Government Consumption Expenditures		Net Exports
Gross Domestic Product (GDP)	=	C	+	I	+	G	+	NetEx
Current % of GDP		71%				20%		
Economic "news" on August 2		⇩				⇩		

Since the release of this latest consumer spending data, several economist forecasts for GDP growth have, not surprisingly, declined for 2011-2012. Stock markets are a valuation mechanism where the Present Value equals the expected future cash flows (earnings) discounted by the market's required return on Risk. This past week's information reduced earnings prospects and caused a flight-from-Risk to Low Risk investments. It is important to note that financial markets have been functioning in an orderly fashion and are simply adjusting to a more uncertain future – these latest movements are not due to a "Flash Crash"[3] or similar market dislocation.

S&P'S DOWNGRADE OF US TREASURY DEBT FROM AAA TO AA+

Although markets had been well-warned by rating agencies, S&P surprised many market participants by announcing a downgrade on Friday night. As we noted in our quick-read note to clients shortly after the release, their rationale was largely reliant upon their qualitative assessment of the polarized and economically disruptive policy-making process recently evident in the U.S. A cynic may cite their previous failures at quantitative evaluation of risk (i.e. their terribly mistaken analyses surrounding sub-prime mortgages, CDOs, etc) as the reason why they now focused on qualitative analysis. In fact, there has been bipartisan criticism of S&P, particularly since their underlying data analysis of US debt reduction projections included an acknowledged $2 trillion error!

There is an important message for global policy-makers embedded in S&P's decision: Political discourse and tactics matter. S&P is essentially saying that the U.S. remains highly capable of paying its debts, but there is a slight, but dangerous increase in domestic political willingness to default on obligations. To the degree that this new, qualitative aspect of ratings criteria enforces more serious dialogue on policy matters, rather than hyperbolic rhetoric to excite constituents for the next election, S&P's action may be helpful. *It is clearly a new paradigm in sovereign risk ratings criteria.*

The fact remains that US debt outstanding is projected[4] to grow substantially under the burden of an aging population that will increase demand for Medicare and Medicaid. Tinkering with government spending over the course of the next few years is a distraction from resolving the long-term

[2] The mean of economist forecasts had been +0.1% increase in June vs. May, but data showed a -0.2% *decline*.
[3] See our May 6, 2010 Comment "Some Perspective on a Tumultuous Day"
[4] Non-partisan Congressional Budget Office (CBO)'s "alternative scenario" projects US Net Public Debt will reach 101% of GDP by 2021

imbalances that exist and have been recognized for some time[5]. We can only hope that S&P's ratings action brings policy-makers closer to an honest process of realigning entitlement program spending with tax revenue[6].

What does S&P's ratings downgrade mean in the near term?

- *Contrary to news reports in several media outlets this weekend, this action is unlikely to lead to higher interest-rates.* Several reports cited that "consumer loan rates, credit cards, savings deposit rates" would rise. While we may, in fact, see some increased volatility in the bond market, the notion that this action would lead to a protracted increase in interest-rates is illogical. US Treasury debt will very likely retain its role as a "safe haven" investment during uncertain times – and we are likely to have continued uncertainty throughout 2011.
- *Lesson from experience*. There is precedent for highly-rated developed country sovereign ratings being downgraded: Canada in 1994 and 1995, Japan in 2000, 2001, 2002, and 2009. *Such downgrades have historically had little impact on yields*[7].
- *Continued elevated levels of Risk volatility*. The primary issue for Risk investments will continue to be the assessment of a recession, but S&P's action will increase near-term uncertainty.

OUR ASSET ALLOCATION STRATEGY

Each client portfolio has targeted exposures to overall Risk and sub-components of Risk investments. During market environments such as last week (typically referred to as "Risk-Off" markets), the various types of Risk move lower more-or-less in unison (correlations approach 1.0). The extent of this recent adjustment was not sufficient to cause us to consider rebalancing client portfolios by selling Low Risk and purchasing Risk investments. However, as always, we are continually monitoring each client's portfolio actual vs. targeted exposures and may find an opportunity to rebalance as markets find their equilibrium level.

Two particular Low Risk asset classes, US Treasury Inflation-Protected securities and Collateralized Mortgage Obligations (CMOs), have been important contributors to portfolio returns year-to-date. Despite Friday's downgrade of US Treasury debt and tomorrow's likely announcement of a similar S&P downgrade of agency-backed CMOs, these holdings are secure elements of our overall portfolio management strategy.

As we have noted before, it is best to fight the urge to "do something" during the height of market confusion and, instead, adhere to a well-designed, risk-balanced strategy. Rather than attempting to predict which asset classes may outperform in the future, the better long-term approach is to readjust to pre-determined targets. Please feel free to call us with any questions or concerns.

Michael Damas

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[5] See, for example, "U.S. Heading for Financial Trouble", 60 Minutes interview with David Walker, former Comptroller General, March 1, 2007, http://www.cbsnews.com/stories/2007/03/01/60minutes/main2528226.shtml

[6] For an excellent analysis of the causes of the changes in debt projections from 2001-2011, see "The Great Debt Shift", Pew Fiscal Analysis Initiative, April 2011.

[7] See "When 'Risk-Free' Isn't Risk Free: The Impact of a US Treasury Downgrade", Ivan Rudolph-Shabinksy, AllianceBernstein, June 2011