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BLOATED WORLDWIDE SOVEREIGN DEBT THREATENS RECOVERY

GLOBAL AUSTERITY PROGRAMS ARE WEIGHING ON FUTURE GROWTH

The U.S. industrial sector is showing continued growth. Industrial production (measuring the output of factories, utilities, and mines) rose 1.2% in May as compared to April. Global demand for a wide range of American products is being driven by emerging markets such as China, India, and Brazil. Corporations have enjoyed a string of solid quarterly earnings and are now well positioned after investing in new equipment and restocking inventories. Many corporations are flush with cash. Nonfinancial companies accumulated \$1.84 trillion in cash and other liquid assets as of the end of March, an increase of 26% from a year earlier and the largest ever increase since record keeping began in 1952. The Fed will probably maintain current interest rates into 2011 in the face of high unemployment and low inflation. Consumer spending has an upward trend, and while unemployment remains very high, those who are employed do not seem to be as worried about getting laid off as they were a year ago. Household net worth - the net value of houses, stocks, and other investments minus debts - has risen for four straight quarters and now stands at \$54.6 trillion. The Federal Reserve data also shows Americans are making progress in bringing down their debt. The first quarter data shows debt fell at a 2.5% annual rate.

U.S. Corporations Have Enjoyed A String Of Solid Quarterly Earnings

This is not to say the economy is not facing headwinds. The European debt crisis not only erased much of this year's market gains but has highlighted the fragility of the global recovery. While the odds of a double dip recession remain low, they have increased in the face of the debt crisis. Small businesses are still having problems obtaining credit as banks adhere to prudent lending standards. Foreclosures remain at record levels and housing sales are anemic and may even be trending downward. There is still deflationary pressure with so much underutilized capital and labor, high unemployment, and excess manufacturing capacity.

The European Debt Crisis Has Highlighted The Fragility Of The Global Recovery

Commodities Gold prices continue to discover reasons to climb. Investors seem to no longer be purchasing gold simply as a hedge against inflation, but rather as an insurance policy against paper currencies. Gold purchases appear to not be driven so much by greed as by fear – fear that paper currencies can not be trusted. The European debt crisis and the depreciation of the euro have helped drive the price of gold higher. An economist recently observed that investors do not seem to be speculating in gold but rather they are

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simply buying it and holding it due to all the uncertainty. One analyst said with no hint of inflation, every time he sees gold prices hit a new high he views the higher price as further proof of eroding global confidence in paper money.

IN A SEA OF UNCERTAINTY, GOLD BUYING CONTINUES, AS UNCERTAINTY RISES



Employment Many an economist predicted early in this recession that a good percentage of the jobs being lost would never come back due to a systemic shift in the American economy. The latest unemployment data seems to validate the economist's prediction that many of these jobs have in fact permanently disappeared. Millions of Americans are joining the ranks of the long term unemployed. Over 46% of all the unemployed have been out of work for more than 6 months, and the trend indicates that many of these jobless workers will never find new employment in the same field. Many recent studies have exposed the lifelong damage done to people who are unemployed for extended periods of time. Not only do the long term unemployed suffer the financial trauma of burning through their savings, often including their IRAs or 401(k)s, running up credit card debt, and even possibly losing their homes, but the vast majority of the long term unemployed will be hired back into the workforce at a wage that is far lower than their previous employment. Economists claim a displaced worker often never recovers from the terrible financial losses he or she incurred during a lengthy span of unemployment - even if they remain employed for the rest of their life.

OVER 46% OF THE UNEMPLOYED HAVE BEEN OUT OF WORK FOR MORE THAN SIX MONTHS

Job growth remains excruciatingly anemic. The overall unemployment rate has been marooned near 10% for months. The private sector is not hiring. Of 431,000 jobs added in May, 411,000 were temporary Census positions. The most recent weekly jobless claims have actually been climbing. In some regions where employment has picked-up slightly, economists report people are accepting jobs at much lower wages, fewer hours, and often without the benefits they previously enjoyed. With the exception of those working in the health care field and other highly trained technical workers - the job market is terrible. For those seeking low skilled employment, the situation is near depression levels. It would seem that as the economy moves deeper and deeper into the technology era, there are few if any opportunities for the lowest skilled worker.

A good number of the long term unemployed are beginning to fall off the rolls altogether after exhausting their 99 weeks of benefits and are now referred to as "99ers" in certain state agencies. Numerous states report a surge in people seeking emergency aid for food stamps and other basic services now that their unemployment benefits have expired. And unfortunately for the unemployed, future employment surveys of both labor experts and business leaders are quite dour. Most believe the economy shows no signs of mass hiring in the near future and the unemployment rate will probably remain high as we tread water well into 2011 and possibly later.

UNEMPLOYMENT WILL PROBABLY REMAIN HIGH WELL INTO 2011, AND POSSIBLY LATER

Housing The troubled housing sector continues to struggle. The Commerce Department reported May construction starts of single-family homes fell 17.2% to an annual rate of 468,000, which is the lowest level in a year. New home sales plunged 32.7% in May and existing home sales fell 2.2% in the same month. Also, applications for building permits, a gauge of future building activity, fell sharply. One month of data does not make a trend, but the indicators are worrisome. Analysts are fearful that without the help of the expired government home-buying tax credit, the housing sector is much weaker than previously thought. The foreclosure process continues to drag down the housing market and probably will not be worked out until sometime in 2012 or 2013.

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WITHOUT THE HOME BUYER TAX CREDIT, HOUSING APPEARS TO BE TRENDING DOWNWARD



Virtually all the mortgage modification programs enacted thus far have been an utter failure. The latest government data regarding the HAMP (Home Affordable Modification Program) reports the grim fact that 65% - 75% of those already completed modifications are slipping back into default within 12 months. Surveys indicate more and more people who are employed but severely underwater in their homes are voluntarily turning the keys to their homes over to the banks and simply walking away from their loan obligations. A recent analysis in *The N.Y. Times* of Fannie Mae and Freddie Mac offers the following disturbing data – Fannie and Freddie took over a foreclosed property every 90 seconds through the entire first quarter of 2010. The nation's two largest landlords owned 163,828 houses as of the end of March - more houses than in the city of Seattle. The CBO predicts that the final bill for the American taxpayer from Fannie and Freddie could reach \$389 billion – more than the bailout of both the banking and automobile industries combined. Experts tend to believe that housing prices are not going to collapse, but housing is not going to recover for nearly another 18 to 24 months. One realtor probably summed it up best - the volume of homes involved in this mortgage mess is overwhelming. It is going to take a very long time to move all of these properties and get back to something that looks like a normal housing market.

FANNIE MAE & FREDDIE MAC LOSSES COULD COST AMERICAN TAXPAYERS \$389 BILLION



European Debt Crisis European woes have cast a shadow over American markets since April. A rift has developed between the U.S. and European nations on whether or not this is the proper time for drastic deficit reduction plans. Despite protests from the Obama administration, Britain and Germany have pressed ahead with their own comprehensive austerity programs, and France is likely to follow soon with their own belt-tightening plans. There is a fear, as seen by the Americans, that these extensive cuts in government spending will impede both the U.S. and global economic recoveries.

THE FALLING EURO WILL AFFECT U.S. EXPORTS, THE ONLY QUESTION IS HOW BIG AN IMPACT

Britain and German officials have rejected American concerns and insist growing deficits must be addressed at this time and can not wait until the global economy fully recovers. Administration officials fear deep European government spending cuts, amid a still struggling economy, would make Europe more vulnerable to falling back into a recession or at the very least put a severe crimp in their demand for U.S. exports. Slow growth in Europe is also expected to place further pressure on the euro. A falling euro automatically makes U.S. products more expensive in the 16 nations that use the euro and it also makes it harder to sell in those other countries where U.S. exporters vie with their European competitors.

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A weak euro also causes U.S. companies to earn less from their European operations when they convert their profits from the euro to the dollar. Nearly half of S&P 500 profits come from abroad. The crisis in Europe will have a negative effect on U.S. economic growth - the only question is how great an impact.

The more bearish analysts foresee not so much the probability of a double-dip recession as the possibility of very anemic growth in the second half of 2010. Many of these same analysts see growth in the last two quarters of this year as ranging from 1.25% to 1.75%. If the bears are correct and we see 1.5% growth later this year, the economy will not technically be in a recession - but it sure will feel like we are.



SUMMARY



- **Long-term (5-6 years) U.S. equities could double**
 - **Deflation, not inflation, is the dominant force in the economy**
- **Significant, short-term correction possible in U.S. stock market due to concern about U.S. deficits and European sovereign debt**
 - **Underweight European equities**
 - **Maintain target weighting in U.S. equities**
 - **Overweight investment grade corporate bonds**
 - **Target weight high yield bonds**
 - **Continue to build position in real estate**
- **Long-term U.S. Treasuries attractive for hedging against economic slowdown**
- **Agriculture commodities remain attractive. Energy, base metals and precious metals have limited upside but still provide diversification**
 - **Emerging market currencies should appreciate relative to the U.S. dollar**
 - **Euro should stabilize before further weakening relative to U.S. dollar**
- **Global financial crisis abated but economic growth will be modest in coming year**
 - **Greatest risk to investors in coming months is global government debt and instability in the currency market**

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