The Markets: <u>2nd QUARTER</u>

2012

Market Commentary by
The Archer Funds

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2nd Quarter 2012

After an impressive start to the year, volatility returned to the equity markets in force during the second quarter. The Standard & Poor's 500 index fell 3.3% for the quarter as a late June rally eased some of the pain from May's 6% decline. International stocks, small company stocks and commodities all underperformed the benchmark S&P 500 as renewed concerns about Euro-area debt and global growth weighed on investor risk appetite. In a reversal from the first quarter, historically defensive sectors outperformed as telecommunications stocks (+12.6%) and utilities (+5.5%) were the best performers while financial, technology, and energy companies declined 6-7% during the quarter.

The sharp decline in May was initially sparked by the first Greek election and renewed investor fears of an imminent break-up of the European Monetary Union. Sentiment received a boost to end the quarter as European leaders agreed on a number of measures which would lay the groundwork for bank re-capitalizations and a more centralized banking regulator.

U.S. economic sentiment seemed to turn on a dime as manufacturing surveys turned negative and a number of high profile companies notified investors of poorer growth outlooks. Tight austerity programs in Europe have very likely resulted in recession in a number of countries and the weak manufacturing and persistently soft jobs market have reignited talk of a U.S. recession.

Bond yields continued to decline as the benchmark 10-year U.S. Treasury closed the quarter yielding approximately 1.6%. Domestic bond prices climbed nearly across the board (bond prices and yields move inversely). Government bonds rallied as many investors sought out the relative safety of the U.S. Treasury market and lower rated corporate bonds gained as other investors stretched for income.

At the close of the quarter, sentiment can best be described as cautiously optimistic. European leaders provided some hope that they will be able to contain their debt crisis. Likewise, some positives began to emerge domestically. Lower commodity prices and an improving housing market are providing some relief to consumers. "Homeowner's equity grew at its fastest pace in fifty years, eliminating the previous drag from the negative wealth effect" according to BCA Research.

Overall, we would count ourselves as being in the cautiously optimistic camp. The U.S. economy continues to recover, albeit at a painfully slow pace. It appears to us that the leaders across the pond are finally beginning to take the necessary steps to contain their debt crises and allow the European financial sector to heal. While we believe that many of the aforementioned concerns are largely priced into the market, we are well aware that in the current environment the market will be more susceptible to outside shocks and "headline risk." The impending elections, the well publicized fiscal cliff, and the situation in Europe will likely continue to add to volatility until the resolution of each becomes clearer. Reasonable stock valuations, extremely accommodative monetary policy around the globe and relatively balanced sentiment are supportive.

As investors with a long term focus, we continue to invest in companies with sound balance sheets, strong cash flow, attractive business outlooks and inexpensive valuations. Within the fixed income markets we remain selective and take advantage of opportunities when they present themselves by focusing on both the return *of* and the return *on* principal. Based on current valuations, we continue to view equities as relatively more attractive than bonds for a long-term investor, but we believe it is prudent for investors to take a balanced approach given the uncertain climate.

We welcome your comments or questions and thank you for your continued confidence.

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