VAUGHAN NELSON

INVESTMENT *perspective*

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The investment environment continued to be driven by major macroeconomic factors during the second quarter, a trend that has been in place off and on since the start of the Great Recession. With much of the euro zone either in recession or entering recession, the sovereign debt issues that were previously isolated to the peripheral countries have begun to impact the core of Europe. Spanish and Italian sovereign yields reached unsustainable levels, a situation exacerbated by problems in their banking sectors. Forced to deal with this, European officials have signaled they will separate a banking system bailout from the sovereign debt crisis. This is an important first step in breaking the negative, self-reinforcing cycle that exists between the banks and the sovereign debt crisis. Adding to the headwinds the Chinese and Indian economies continue to slow.

As for the United States, we suggested in our previous commentary that economic statistics in early 2012 would tend to overstate the economy's health and data points later in the year would confirm economic weakness. It now appears that growth in the U.S. is barely advancing as consumers continue deleveraging and company managements remain concerned about end markets and public policy. Combined with the weak international outlook, equity markets broadly retreated during the quarter.

Our equity strategy is based on the expectation that there is insufficient trendline growth in the developed world to allow both the consumer and the public sector to reduce leverage. We continue to expect domestic and international policy makers to struggle with this realization forcing global monetary authorities to rely on unconventional policy measures to support asset prices and economic growth as fiscal structural reforms are reluctantly and belatedly implemented. Against this backdrop, we think U.S. equity markets are likely to outperform foreign markets. We continue to focus on companies that can grow earnings and cash flows in what is a weak environment.

We do not strongly favor one sector over another; however, we think that commodities, particularly oil and gas, are no longer a secular investment and should be evaluated as cyclical industries. Weakening global oil demand coupled with increased domestic supply and higher oil production from Saudi Arabia could pressure oil prices below $75 per barrel within the next few quarters. We believe the longer term price will remain in the $80 – $90 range. Despite the challenges facing global economies we are able to find attractive investment opportunities across multiple industries. We expect equity markets to remain volatile as recurring market crises will likely be required to force policy makers to implement meaningful structural reform. Patient investors should be rewarded over time as they are able to exploit the fear within equity markets.

In the fixed income market, the flight to safety by bond investors around the globe has kept Treasuries expensive. Yields across the curve have touched record lows with the ten-year bond recently trading below 1.5%. We think corporate deleveraging and stagnant economic growth make high grade corporate bonds particularly attractive by comparison. We expect this to remain the case unless there is either a sudden, sharp hike in inflationary expectations or, conversely, a deep recession, neither of which we see as likely.

For taxable investors, concerns that there could be wholesale defaults by states and municipalities appear to be overblown. State tax receipts have increased for nine straight quarters despite a very weak economic recovery and spending has been reined in to balance budgets. Tax-equivalent yields on AA-rated state general obligation bonds are superior to either Treasuries or AA-rated corporate bonds. Given our outlook for very modest economic growth and a focus on return of capital, not just returns on capital, we favor bonds with maturities in the 3-year to 9-year range.