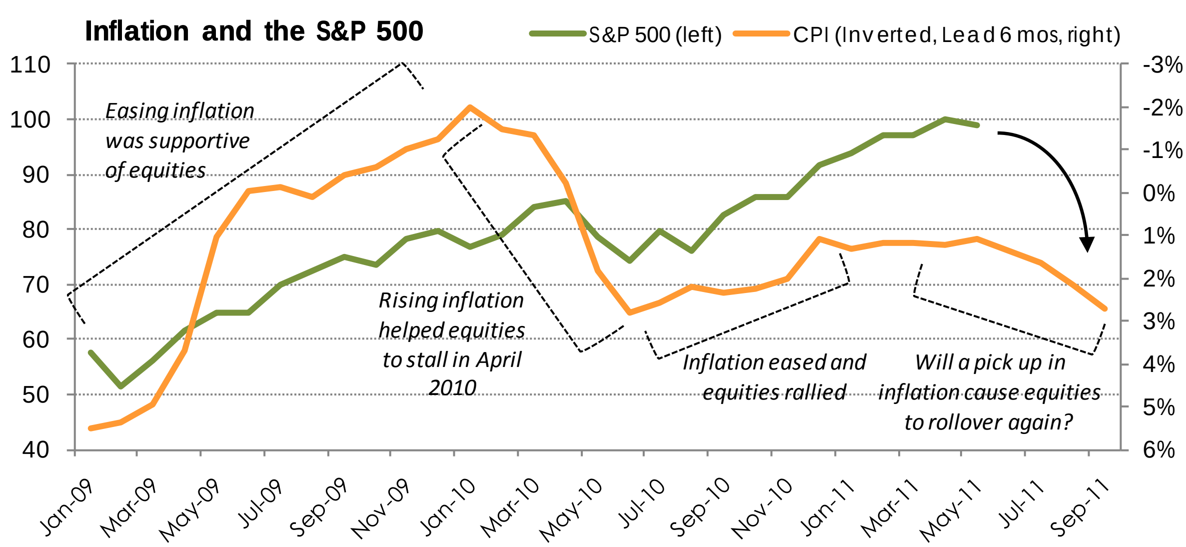
In some ways the behavior of the equity market in 2011 has been eerily reminiscent of the first half of 2010: a strong start to the year with weakness setting in around late spring. After a lackluster summer last year, the stock market rallied in the fall after Fed Chairman Bernanke announced that the Federal Reserve would undertake a second round of quantitative easing (QE2). Additional stimulus was just one piece of the puzzle though. The fact that gets little attention is that the inflation backdrop at that time was actually quite influential for the improving trend in equities as well.

After a bout of deflation during the recession in 2009, headline prices began to bounce off of their lows in the fall of '09. Inflationary pressures take time to filter through the supply chain and impact the end-consumer, which means that the dampening effects of higher prices usually hit the economy with a lag of roughly six months. Not coincidentally, equities peaked in April 2010 about six months after the Consumer Price Index (CPI) posted its first positive annual growth rate since the recession. In the several months that followed, equities struggled as inflation took its toll on growth. The negative impact of inflationary trends then started to ease again in the late-summer - not coincidentally around the August 2010 bottom in equities and the Fed's announcement of QE2.

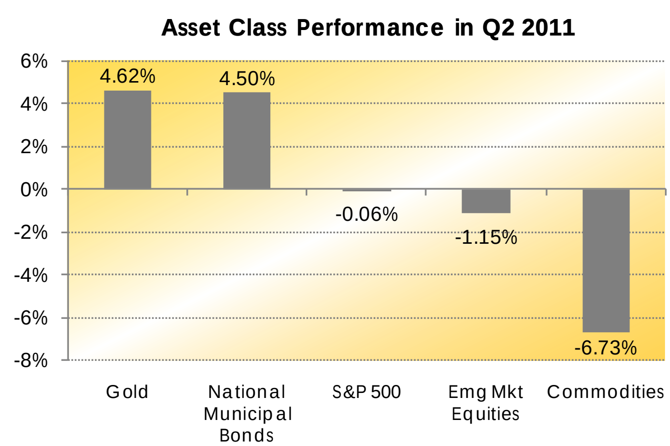


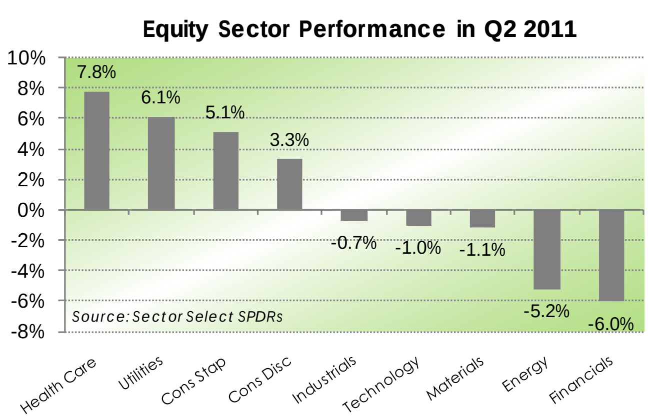
We rehash the 2010 episode not as a history lesson, but to contrast it with the current backdrop. Stocks continued their late-2010 rally into the beginning of the new year as inflationary pressures had eased six months earlier, and this favorable backdrop happened to coincide with additional monetary stimulus. The high from round two of quantitative easing did not last for long, however, as the QE2-weakened dollar pushed up oil and food prices. High commodity prices gradually flowed through the supply chain and began impacting U.S. consumers both directly through food and gas, as well as indirectly through the prices of imports. The lagged effects of these pricing pressures hit the headline CPI numbers toward the end of 2010, resulting in the lagged effect hitting consumers around June of this year - again, coincident with equities taking another breather. With lagged inflation trends accelerating through at least the fall, the backdrop today looks much less supportive for equities than it did a year ago; and today additional stimulus is unlikely.

Nothing New is Bad News

The news here is nothing new. In other words, for the last several years the movements in equities have been driven largely by the macro backdrop, even when investors think otherwise. This should come as no surprise for several reasons. First, more than 70% of U.S. economic growth is tied to the consumer. When prices are higher, especially for food and gas, consumers have less discretionary income to go around. A weak dollar may be good for the American export industry, but at about 12% of GDP, the segment is not large enough to keep the ship afloat. Conversely, the weak dollar makes imports and many commodities more expensive for American consumers forcing them to make discretionary spending choices. Second, the bursting of the housing and credit bubble left consumers with no major income sources other than employment. The "house as ATM" and free credit days are gone. If prices are rising, jobs are scarce, houses are under water, and credit is unavailable, then consumer spending power is limited. Corporate America may be in great shape, but unless it is sharing the wealth through hiring, Main Street America will continue to be whipsawed by the prices imposed upon them. A weak consumer is a drag on equities.

These trends have translated into a very straightforward cyclical approach to investing. An improving (low) inflation and growth backdrop has benefitted more aggressive, cyclical areas of the markets while the opposite backdrop has been supportive of defensive assets. As economic conditions deteriorated in the second quarter, municipal bonds became one of the best performing asset classes in our portfolios. Meanwhile, growth-sensitive areas like emerging market equities have lagged behind. The chart above right shows the performance of several major asset classes in the second quarter of 2011. Within U.S. equities the same pattern has emerged: defensive sectors have outperformed cyclical sectors. The chart above left shows the sector performance breakdown year to date.





Actively Indexing

Macro-driven swings in the markets have provided us the chance to make some beneficial changes in our portfolios. We acted on the opportunity to benefit from weak-dollar-induced commodity inflation through purchases of the Agribusiness ETF (MOO) and the iShares Canada ETF (EWC) in late 2010. As commodities spiraled upward in April, we sold these positions to lock in gains before the investment-related benefits of inflation began to be damaged by slowing growth. In anticipation of a turn toward defensive names and higher volatility, we replaced these holdings with the Consumer Staples sector ETF (VDC) and the Mid-Term Vix Futures Fund (VXZ) in mid-May. Although volatility has not yet reemerged in a significant way, the equity market has positioned itself to benefit defensive sectors, as shown in the chart earlier. Consumer Staples was among the top performing sectors in the second quarter with a 5% return versus the broad S&P 500 index which was slightly underwater.

We also made changes to allocations we viewed as long-term strategic holdings. Broad commodity indices have been in our portfolios since inception. We viewed these positions as “alternatives” that were designed to have a low correlation to equities and bonds, and therefore provide diversification. As commodities ran into bubble territory, we reevaluated this thinking. Instead of providing diversification, commodities had become highly correlated with equities because of the dollar. In other words, a weaker dollar meant higher commodity prices, but a weaker dollar would also drive equities higher as part of the “risk on/off” trade. Instead of providing diversification, commodities were providing leverage in a sense. We decided to sell our core commodity holdings and replace them with other non-correlated alternative holdings.

Municipal bonds have boosted many of our clients’ portfolio performances, despite investors’ expectations for trouble in that area. Comments about impending muni defaults roiled the markets in late 2010, but we believed that those fears were overdone. We have written extensively on why we thought that high quality muni bonds were in little danger of default, and how they proved to be relatively-safe investments even through tumultuous times such as the Great Depression. From a strategic viewpoint, we believed that the weak economic recovery would support bonds, and the U.S. would retain its safe have position relative to Europe and help keep yields down. The markets have proven us correct. In fact, yields have fallen since the beginning of the year. The National Municipal Bond index is up 4.9% year to date, while California municipals have gained 6.3%.

Keeping Perspective

As our clients know, we view a big part of our job to be communicating with and educating our investors. This may not seem important when markets are rising, but when the outlook is murky it is vital. **One of the challenges investors face is separating their risk tolerance from their market outlook.** It’s easy to be aggressive when markets are up and conservative when they are down, but if one follows that approach the risk of being whipsawed by market movements is high. Identifying with a certain risk profile means weathering both the ups and the downs associated with that allocation. At Miracle Mile Advisors, we believe that over time investment discipline is more important than being “right” 100% of the time. In these uncertain times, our goal remains the same: minimizing losses for our clients while still capturing upside, regardless of risk tolerance level.

June 30, 2011

Katherine Krantz

Katherine Krantz
Chief Economic Strategist

Brock E. Moseley

Brock E. Moseley
Chief Investment Officer

Miracle Mile Advisors, LLC | 201 North Robertson Blvd, Suite 208, Beverly Hills, CA 90211 | tel 310.246.1243
www.MiracleMileAdvisors.com l info@MiracleMileAdvisors.com

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