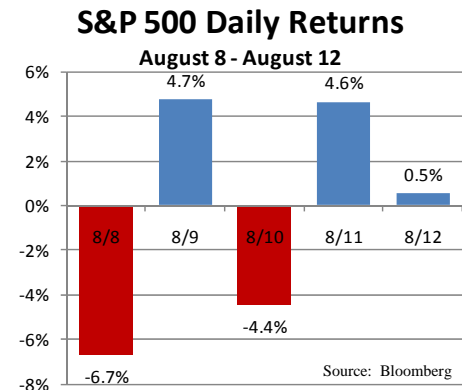


Volatility is High and Expected to Continue

August 2011

SUMMARY

In recent weeks, world financial markets experienced a rapid decline and significant increase in volatility. At its low, the S&P 500 was down almost 18% from its April peak, capped by last week's wild swings that included four consecutive days of over four percent moves in market indices (see right). Although the recent market correction is significant and unnerving, the S&P 500 is only down 4.2% for the year. The situation feels worse due to the prominent headlines and the pace of the decline. Concerns over the sovereign debt crisis in the Eurozone and an increasing probability of a double-dip recession are the key contributors to this volatile period. Additional factors such as the debt ceiling and the S&P downgrade of U.S. treasuries are of less importance but add to the uncertainty surrounding the outlook for global financial markets. The rapid decline in markets is concerning; however, comparisons to the market events in 2008 are too drastic, and we expect that markets are not too far from the worst we will see this year. Our actions to reduce equities in May put us at a “neutral” position; and although the stock market correction has been more severe than we expected, we are glad to have a portion of planned equity investments on the sidelines.



EUROZONE INSTABILITY

The Eurozone continues to be an unstable environment. This situation is similar to the 2008 financial crisis in the U.S., but the driver of the turmoil is government debt of the PIIGS nations (Portugal, Ireland, Italy, Greece and Spain) instead of U.S. investment banks. Although the ECB (European Central Bank) has taken steps to stabilize the situation, financial markets are not yet convinced that the magnitude of actions is sufficient. The ECB initially purchased government debt from Portugal and Ireland in an effort to reward those countries that had taken action to reduce spending; however, to restore confidence and stability, last week the ECB was forced to begin purchases of Italian and Spanish debt as well. In order for Germany and France to continue acting as a backstop for the rest of the Eurozone via the ECB, they will continue to require reduced spending from those less stable, high-debt countries. Until those negotiations are resolved, the market instability will continue.

The Eurozone debt crisis has the potential to create a credit crisis, which could push the US economy right back into a recession. Although we still think a double-dip recession is not the most likely outcome, the risk of that result has increased substantially in the last few weeks, and that increased risk is largely reflected in stock market values. If fears over European bank liquidity escalate, the ECB and EFST (European Financial Stability Facility) have the tools to address the problem (as the U.S. did in 2008); however, the negotiation between different European countries may take a while to conclude.

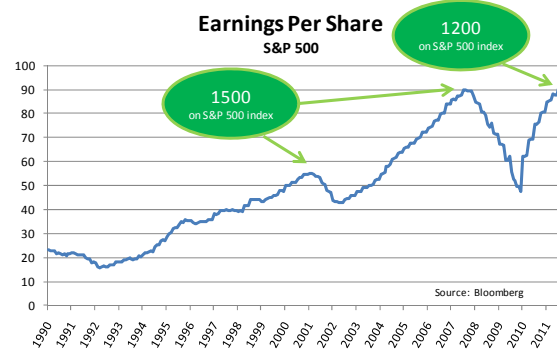
U.S. ECONOMIC ENVIRONMENT

The U.S. economy continues to generate mixed results. GDP growth has been below expectations, with the July report of second quarter growth at an annualized rate of 1.3% while the first quarter growth rate was revised downward from 1.9% to 0.4%. In contrast to general economic growth, corporate earnings continue to be strong. Second quarter earnings for the S&P 500 were up over 17%

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year-over-year, and it seems all but certain that the year will end with a record earnings per share. Despite the strong earnings data (see right) and the fact that the stock market is well below 2007 levels (S&P 500 now at 1200 versus 1500 in 2007) with the same earnings, concerns over expectations for future earnings are adding fuel to the fear of a double-dip recession.

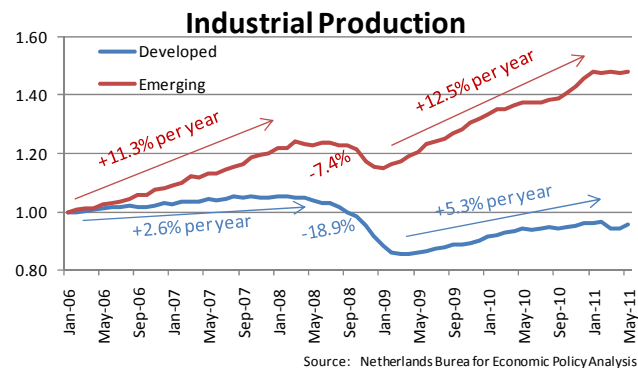


In the aftermath of the debt ceiling debate, political uncertainty will be high over the next 18 months, and the economy faces increasing headwinds on various fronts. In terms of government actions, there are numerous items that could infuse some confidence to markets in the short run. But given the polarized environment, it is becoming increasingly difficult to expect any good news from Washington that could help the stock market. On the horizon are the expiration of various stimulus efforts, including the payroll tax cuts, enhanced unemployment benefits, and bonus depreciation for capital spending. In addition, the 12-person spending committee created by the debt ceiling compromise must complete its recommendations by Thanksgiving, and Congress must revisit the Bush tax cuts sometime next year (in the middle of election season). As a result, we expect more political turmoil and “headline risk” in the future.

We do not expect a rapid recovery back to the April high water mark due to this economic and political uncertainty. The Federal Reserve (Fed) took modest action by committing to keep interest rates low into 2013, and even if the Fed initiates a third round of quantitative easing, the underlying economy must continue its positive trend for the stock market to recover its recent losses.

BIFURCATED ECONOMIC GROWTH

With the U.S. and European economies in question, the emerging market nations have continued to be a bright spot in the world economy. This is evidenced by growth rates in terms of industrial production (see right), which have strongly favored emerging nations before the financial crisis, during the recession, and in the resulting recovery. These nations are experiencing different problems than the developed world, as many emerging nations fear that rapid growth may lead to inflation. Both Brazil and China have taken actions to address inflationary concerns. Brazil, for example, has raised interest rates 8 times in 15 months to attempt to address the problem. It is likely that this bifurcated world – slower growth in developed nations and faster growth in emerging markets – will continue. If actions of emerging nations to combat inflation are too effective, those economies could realize a “hard landing,” and a reduction in the world’s only reliable growth engine could push a weak U.S. economy into recession.



VOLATILITY EXPECTED TO CONTINUE

After one of the most tumultuous weeks in stock market history, much uncertainty remains, and we expect the recent unpredictability to continue to be high, regardless of short-term actions from central banks or legislatures.

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We expect recent volatility to continue for a period measured in weeks or months, not days. Ned Davis Research conducted a study of panic selling (defined as 11-day declines of more than 15%) which shows that the market must go through a consolidation process after such “waterfall declines.” After the initial bounce off of the bottom, it may take 4-8 weeks for the market to resume a clear upward trend. Selling shortly after a waterfall decline typically destroys value since the market is up an average of 4.7% after three months and 10.2% after six months. We agree and think that although the market has recovered well from its low point, it would not be surprising for the market to retest the bottom realized last week.

Although volatility and stock market corrections are not pleasant, they are a normal part of investing. Michael Nairne illustrates that point through several facts in a recent *Advisor Perspectives*:

- Market corrections occur frequently. Since 1950, there have been 37 market declines of 10% or greater, a frequency of nearly one every twenty months.
- Most market corrections are not accompanied by recessions. In 27 of 37 corrections – nearly three quarters – no recession ensued. The stock market frequently forecasts economic downturns that do not occur.
- Many corrections occur quickly. Just over 40% of corrections played out in 75 days or less.
- Market corrections are always painful. The average decline for all 37 corrections was 19.7%.
- A strong recovery from market corrections is the norm. In 34 of 37 corrections, the market was up 12 months later by an average of 26.8%.

PORTFOLIO RECOMMENDATIONS

In terms of the economy, the bifurcated recovery continues. Headlines continue to capture the malaise about the economy – unemployment and housing continue with lackluster results while earnings are strong. Unemployment edged up in the latest report to 9.2% while home sales and prices remain soft. However, corporations are reporting record profits and continue to beat market expectations.

Our analysis of the current environment suggests that an increase in equity exposure could be warranted; however, the risk of another recession (and the fear of that event) has increased significantly. Given our dual objectives to both grow and preserve wealth, we do not find enough logic to change from our current neutral position. In the near term, we expect to gain more clarity on the stability of economic growth and expectations for stock market returns. As a reminder, we continuously monitor financial markets and investment positions; and, as always, we will either take action or notify you if investment changes are needed in your portfolio.

Please call if you want to discuss this commentary, your portfolio, and any other questions or concerns that you might have. We are available at 734-769-7727.



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