

Investment Commentary

Summer 2010

The Economy

It appears that the economy is losing steam. The majority of the economic data recently released has been lackluster or downright disappointing. First quarter gross domestic product (GDP), initially estimated to have increased at an annual rate of 3.2%, was just revised downward to 2.7%. This represents a major slowdown from the 5.6% growth rate seen in the fourth quarter of 2009.

Consumer confidence unexpectedly fell sharply in May, from a reading of 62.7 in April to 52.9. This indicator bottomed at 25.3 in early 2009, but was above 100 throughout much of 2007. This is not good—worried consumers are less likely to spend. Other recent negative data include weak retail sales and housing numbers, which have decidedly worsened in the wake of expired federal tax credits designed to boost the housing industry.

The highly anticipated June jobs report was not inspiring. The economy lost 125,000 jobs in June. Backing out the lost temporary

census jobs, we see that 83,000 payrolls were created in the private sector. While the economy has created roughly 600,000 payrolls in the private sector year-to-date, this sub-par pace will not be enough to bring down the unemployment rate. In June the unemployment rate did come down to 9.5%, but this is misleading. Many workers have exited the workforce and are no longer counted as unemployed.

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Not all of the data is gloom and doom. Capacity utilization continues to improve and the Leading Economic Indicators remain positive. Both of the Institute for Supply Management readings indicate that the manufacturing and the service sectors continue to expand as well. History shows that much of the data will be erratic from month-to-month and will

Index	2nd Quarter 2010	Year-to-Date
S&P 500	-11.9%	-7.6%
DJIA	-10.0%	-6.3%
Nasdaq	-12.0%	-7.0%
Russell 2000	-10.2%	-2.5%

Reflects price changes only

continue to be so as the economic recovery unfolds.

Fixed-Income Markets

During the second quarter money flowed into the treasury market as we once again saw a “flight to quality.” U.S. Treasuries remain the world’s safe haven. Worries about ballooning deficits have taken a back seat for now. The 10-year treasury, yielding 4.01% in early April, finished the quarter yielding only 2.95%. Once we see signs of inflation or an increase in inflation expectations, yields will move higher. That may not happen, however, until we see a capacity utilization rate above 80% (currently it is at 74.7%) and a lower unemployment rate. In the meantime, it appears that the U.S. Federal Reserve will continue

to hold short-term interest rates low for the foreseeable future.

Equity Markets

Stocks experienced a horrible second quarter. There was no place to hide. Initially the European debt crisis provided the reason for the sell-off. But, after an 80% increase in stock prices from their March 2009 lows, the market was primed for a correction. Foreign stocks declined more than domestic stocks. Not a single S&P sector was positive. The worst performers included materials (-15.7%) and financials (-13.6%). The best performers were utilities (-4.8%) and telecom (-5.7%).

Outlook

We think the U.S. economy is resilient and will con-

tinue to see moderate growth throughout the year, with a GDP in the 2.0%–3.0% range. However, we are concerned about the level of debt—local, state, and national. The European debt crisis should serve as a wake-up call to all of us. Total U.S. public debt has continued to rise at an alarming pace. Currently, public debt as a percentage of GDP stands at 90%. Tough decisions will need to be made—either cut

spending, increase revenues, or some combination of the two.

Corporate earnings have continued to improve. In the first quarter, 80% of the S&P 500 companies reported better than expected earnings. These earnings were a result of better revenues, not cost cutting. All S&P sectors experienced revenue growth compared to first quarter 2009—with most sectors growing at

a double-digit pace. The focus now will be on second quarter earnings to see if this trend

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continues. In the long-run, higher earnings means higher stock prices. But, as we have

stated many times, fear and emotion can be the drivers. With the recent sell-off, equity valuations are better. Stocks now trade at a price-earnings ratio below their 20-year average.

The Fed will most likely remain on the sidelines and not raise the federal funds rate until 2011.