

Market Review & Outlook

July 2010

After an explosive 13 month rally that saw stocks rise 80% from the March 2009 lows, investors were brought back to reality during the 2nd quarter, as all the major averages shed 10% or more and the market experienced its first full-fledged correction since the rally began. After reaching a 19 month high on April 23, the S&P 500 declined a full 15.4% through June 30 as the end of the quarter had a decidedly negative tone to it, with volatility increasing and the market declining 9 out of the last 10 trading days. For a more detailed look at how the stock and bond markets have performed so far this year, please refer to the following table:

Index	June 2010	2nd Qtr. Performance	YTD Performance	Description (what the index is comprised of)
S&P 500*	-5.4%	-11.9%	-7.6%	Large Cap Stocks
DJ Industrial Average*	-3.6%	-10.0%	-6.3%	Large Cap Stocks
NASDAQ Composite*	-6.6%	-12.0%	-7.0%	Large & Mid Cap Tech Stocks
Russell 1000 Growth	-5.5%	-11.7%	-7.7%	Large Cap Growth Stocks
Russell 1000 Value	-5.6%	-11.1%	-5.1%	Large Cap Value Stocks
Russell 2000 Growth	-6.7%	-9.2%	-2.3%	Small Cap Growth Stocks
Russell 2000 Value	-8.7%	-10.6%	-1.6%	Small Cap Value Stocks
MSCI EAFE	-1.0%	-14.1%	-12.9%	International Stocks
Lehman Aggregate Bond Index	1.6%	3.5%	5.3%	U.S. Government Bonds
Lehman High Yield	1.2%	-0.1%	4.5%	High Yield Corporate Bonds
3-month Treasury Bill	0.0%	0.1%	0.1%	

There were a host of factors that played into the market's decline over the past quarter – among them:

➤ **European sovereign debt concerns put the market on edge** and made investors realize that the global economy still has significant obstacles to overcome. Greece required a bailout to avoid a default on its debt and worries spread that other nations such as Portugal and Spain would also need assistance. The Euro has fallen to its lowest level in years versus other currencies as confidence has waned, and there are fears that Europe will soon fall into recession, especially with many of the austerity measures that are being implemented. Furthermore, investors are worried about what effects any slowdown would have on the US economy.

➤ **The May 6th “Flash Crash” damaged investor confidence**, as the market fell by nearly 10% within the span of 30 minutes. Although the market recovered much of the loss by the end of the day, the

fact that the market dropped hundreds of points in a matter of minutes caused many to question the integrity of the markets and whether or not existing rules and market structure are adequate. Even though there have been investigations into the cause, the episode remains largely unexplained. Many believe that high frequency traders – firms which buy and sell large volumes of securities to make a fraction of a cent per share – exacerbated the problem, and that this type of activity has a very negative influence on market volatility in general. Despite this, there has been no effort to curb the practice.

➤ **An explosion and fire on BP's Deepwater Horizon drilling rig killed eleven people and caused the largest oil spill in US history.** This occurred on April 20, just a few days before the market's recent

peak, something that may not be coincidence as investors realized the vast impact this crisis might have. The spill has resulted in a significant disruption of the lives and economies in the Gulf region, and over the two and a half months since it happened, estimates of the amount of the spill have increased dramatically. While it certainly caused the stock prices of many oil and oil services companies to fall, it has also had the effect of damaging investor and consumer sentiment.

➤ **The momentum of the economic recovery has shown signs of fading.** Both the May and the June employment reports indicated that job growth in the private sector was less than expected. Although the official unemployment rate fell to 9.5% in June from 9.7% in May, this was largely due to the workforce shrinking, as 652,000 people decided to stop looking for work, making it one of the largest such declines on record. While private sector employment has increased 593,000 since the

Market Review & Outlook

July 2010

beginning of the year, there has been an overall decline of 7.9 million jobs since the peak in December 2007, and it is estimated that the US economy needs to produce up to 150,000 jobs a month just to keep up with the growth of the labor force. The May retail sales and factory orders reports also came in at less than expected levels.

➤ **New regulations proposed in the financial reform bill moving through Congress caused uncertainty for many financial services companies and likely contributed to the weakness in stock prices.** While many commentators are questioning whether the “reforms” in the bill would have prevented the recent financial crisis (the causes of which the proposals are meant to address), it is certainly the case that some of the proposals, if enacted, would negatively affect the profitability of many financial services firms. There are also concerns about the new regulations discouraging lending and adding to the regulatory bureaucracy. With the financial sector still comprising the largest piece of the S&P 500 by market capitalization, a decline here can have outsized influence on performance of the major indices.

On balance, the data indicate that the economy is still recovering. The recent spate of negative reports confirms what was widely expected at the beginning of the year. That is, economic growth was expected to be positive, transitioning to a more sustainable recovery (one supported by an underlying expansion in consumer spending and business fixed investment rather than federal fiscal stimulus and a shift in inventories), but unlikely to be strong enough to push the unemployment rate down by much.

That being said, psychology is a hard thing to predict, and a “double dip” recession could become a self-fulfilling prophecy. While a distinct minority of professional forecasters are currently predicting that the economy falls back into recession, their numbers have been increasing, and many of those not predicting this outcome will admit that the probability is becoming

greater. The recent decline in stock prices not only reflects real negative developments, but also contributes to economic weakness through a feedback effect. This is because a decline in asset values causes a negative wealth effect as people change their behavior and spend less. Therefore, it’s not surprising that we got a negative surprise with the May retail sales report or that consumer sentiment dropped sharply from May to June. Though the US consumer has proven resilient over time, if overall negative sentiment becomes pervasive enough, consumers stop spending, firms stop hiring, and the “double dip” decline becomes a reality. Furthermore, the list of near-term economic headwinds is long:

➤ **Lingering problems in residential and commercial real estate:** Although the S&P/Case-Shiller Home Index rose 3.8% in April compared to April 2009, the number of buyers purchasing homes in May dropped to an all-time low (since numbers were first recorded in 1963) and down 30% from the prior month as the new homebuyer’s tax credit expired in April.

➤ **The contractionary consequences of tighter state and local budgets:** Many states are in the red and some, like California, are having to resort to drastic measures to curb spending. State employees have seen their earnings decline 14% this year due to forced furloughs, and Governor Arnold Schwarzenegger last week announced that 200,000 state employees’ pay would be cut to the federal minimum wage unless a budget impasse with the state legislature is reached. Other states are implementing similar austerity measures.

➤ **Expiration of stimulus:** One of Obama's first acts as president was to authorize a massive stimulus package that cost \$787 billion. It included a number of provisions that were intended to help jumpstart the economy. Some economists are concerned that the stimulus plan is the only thing driving GDP growth in the United States. "Absent fiscal and monetary stimulus, there's been no recovery; it's been at best an ['L-shaped'] recovery, not a ['V-shaped'] recovery, except for the sugar rush of stimulus." says Rob

Market Review & Outlook

July 2010

Arnott, chairman of Research Affiliates. Many economists argue that more fiscal stimulus is needed, but the public mood is against this idea and it's unlikely that anything significant could get through Congress at this point. While the desire to reduce the budget deficit is well-intentioned, in the short term many economists feel this is misguided.

➤ **The Bush tax cuts expire at the end of the year:** Taxes will be going up in 2011, and regardless of one's political opinion about whether tax rates should have been decreased in the first place, most economists would agree that raising taxes in the short term given our current situation is not the optimal fiscal policy. Academic research shows that a 3 to 1 ratio can be applied to how taxes affect economic growth. For example, if taxes go up by 1% of GDP, then GDP will fall by 3%. Estimates are that the lapse of the tax cuts will be a 2% increase in taxes as an overall percentage of GDP, meaning that all else held equal, GDP should decline by 6% next year.

➤ **Spending cuts and austerity measures:** At the recent G-20 summit of the industrialized nations, leaders from around the world pledged to begin cutting budget deficits. This, along with the recent austerity measures implemented in some European countries, is an admirable goal, but probably not the best time to implement such a program with fiscal stimulus currently one of the only things propping up economies.

There are other concerns, but you get the point – maintaining the current economic recovery will be difficult and uneven. That there is currently such a wide divergence of opinion about the prospects for the

economy and markets is not unusual. In fact, it is common in the early stages of a recovery and especially the past 2 “jobless” recoveries that we experienced in the wake of recessions in the early 1990's and early 2000's.

We are currently cautious about the market. Technically, stocks look fragile and last week, the S&P 500 experienced a so-called “death cross,” as its 50 day moving average (DMA) crossed below its 200 DMA, something generally thought to be negative for the market. While the predictive value of such an event has

been called into question with its occurrence, it's no surprise that the recent oversold short-term conditions were at least temporarily halted with a near 300 point rally in the Dow Jones Industrial Average on July 7. Whether this is the start of a meaningful move upward or a brief respite from the recent slide remains to be seen.

Indeed, the recent slide and increase in volatility brings back memories of the events of late 2008/early 2009. Was the recent

13 month rally the beginning of a longer-term “secular” bull market or just a cyclical bull market rally within a longer term “secular” bear market? While many analysts point to more reasonable current stock valuations, many of their comparisons

are against numbers from the past couple of decades, numbers which are arguably inflated by bubble conditions that we experienced during the tech and real estate booms of the past 20 years.

Whatever happens, diversification is the key to improving the risk/return characteristics of your portfolio, and we would be happy to help you in that regard. If you have a general question about your account, please contact our customer service at 800-535-4253 extension 152. If you need investment advice, please contact me or your firm's designated consultant. You can reach me at extension 178 (510-740-4178) or at john.w@wespac.net. John Williams, Manager of Advisory Services – WESPAC

