

Q2 2010

Investors learned in the second quarter that the roller coaster stock market ride of the last three years was not quite ready to pull to a stop at the station. The period from April to June was dominated by “event risk” as a parade of high profile crises came in one after another, dominating headlines and causing skittish investors to flee back to the safety of cash and U.S. Treasury bonds. The S&P500 declined 11.43% for the three months ended June 30th, marking the worst quarter for the broad U.S. stock market since the freefall that followed the collapse of Lemman Brothers in September 2008.

The downgrade of Greece’s national debt on April 27th to junk bond status triggered a wave of selling due to sovereign credit risk concerns. The potential for a cascade of defaults throughout the Eurozone “peripherals” of Portugal, Italy, Ireland, Greece & Spain rekindled memories of the U.S. financial crisis. Of primary concern was the effect these risky debts would have on the solvency of major European banks in France and Germany which owned billions of dollars worth of exposure on their balance sheets. Ultimately, the IMF and European Union were forced to announce their own bailout plan which provided over \$1 trillion in loans and asset facilities to stabilize European markets and stem the freefall in the Euro. More importantly, investors worldwide were forced to re-assess the prospects for the global economic recovery as Eurozone contributions to growth are likely to be muted by the effects of reduced credit and austerity measures.

Index	Q2-2010	YTD 2010
S&P500	-11.43%	-6.65%
NASDAQ Composite	-11.83%	-6.63%
Russell 3000	-11.32%	-6.05%
Russell 2000	-9.92%	-1.95%
MSCI EAFE (US\$)	-13.97%	-13.23%
MSCI Emg Mkts (US\$)	-8.29%	-6.04%
Barclays Municipal-5 yr	1.68%	2.46%
Barclays Agg Bond	3.49%	5.33%

Adding to the uncertainty was the BP Gulf oil disaster which continued to linger, creating uncertainty about the economic impact as well as adding to a political backlash that questions whether government leadership will be able to navigate the country back to health. Regardless of political affiliation, the effect of this growing pessimism on financial markets cannot be understated as many disillusioned investors have simply resigned themselves to waiting to see the light at the end of the tunnel before recommitting assets to the global capital markets.

The 2nd quarter also saw signs of weakening U.S. economic data, which had previously been uniformly green lights on the path to economic recovery. Both weekly and monthly jobs data began to backtrack after steady improvement throughout much of 2009 and early 2010. Housing market data similarly fell off precipitously following the end of the Federal Home Buyer Tax Credit on April 30th. For the moment, the only arrow left in the Bull’s quiver is the phenomenal growth of corporate profits. Aided by slashed expenses and increased worker productivity, corporate America is flush with cash from the resulting healthy profit margins. This conservative approach by America’s CEO’s is largely viewed as a means of self-insuring against the dreaded double-dip recession scenario. The unfortunate consequence of this “safety-first” mindset is that it will stall improvements in the job market, thereby constraining consumer confidence and ultimately slowing the very economic growth that corporate America is waiting for to begin re-investing in jobs, equipment and new projects. All things being equal, this new found financial prudence by both corporations and individuals is likely to be a good thing in the long term as the era of negative savings rates and ballooning credit balances was unsustainable.

The focus for the second half of the year will be squarely on the pace of the U.S. economic recovery to see if we’ve simply paused at Alan Greenspan’s “invisible wall” or whether the current expansion is sputtering to a stop. Either way, stock market volatility is likely to remain elevated, leaving many of us to wonder when this roller coaster is going to level out.