

June 2010

ECONOMIC OUTLOOK

Summary

The U.S. economy grew at a slightly slower pace in the first quarter than originally reported, with gross domestic product growth revised to 3.0 percent after initial estimates of 3.4 percent. Reduced spending by consumers and businesses alike contributed significantly to the downward revision. Nonetheless, economic statistics continue to show more positives than negatives since the end of the quarter. Even though the Institute for Supply Management (ISM) manufacturing index fell slightly in May, it came in higher than expected and still indicates growth in manufacturing.

The consumer remains the key to economic growth. While the unemployment rate remains stubbornly high, consumer confidence reached its highest level since March 2008 as measured by the Conference Board. Consumers are feeling more upbeat about job prospects, current economic conditions and the prospects for the economy going forward. This renewed confidence has led to greater spending levels for most of 2010, which should continue to benefit the economy.

There is some concern about the long-term impact on the U.S. economy of Europe's protracted financial problems. While there may be some repercussions for the U.S., troubled European countries represent a small percentage of our overall trade, which should limit any long-term impact.

The severe dislocations during the economic decline and the dynamics of the recovery indicate to us that this rebound may be weaker and uneven relative to historical norms. Due to the expiration of several stimulus programs and the absence of strong inventory numbers, we expect growth to gradually slow as we head into the second half of 2010. Nonetheless, we do not foresee a double-dip recession.

POSITIVES

- ❑ Consumer confidence continues to improve
- ❑ ISM manufacturing index remains firmly in growth territory
- ❑ Federal Reserve maintaining its low interest rate stance

NEGATIVES

- ❑ While job market appears to be stabilizing, unemployment rate remains high
- ❑ Expiration of tax credit to home buyers
- ❑ Index of U.S. leading economic indicators declined in April

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- ❑ Ultimate impact of European problems on the U.S. economy
- ❑ Impact of expired stimulus plans and anticipated tax increases

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EQUITY OUTLOOK

Summary

Fear seemed to be driving the market during the recent market pullback, while company fundamentals seemed irrelevant. Most of the fear was due to sovereign debt issues in Western Europe, which dominated the media on a daily basis and had a significant impact on equity markets. As a result, stocks with any foreign exposure generally underperformed stocks with primarily domestic revenues. Uncertainty surrounding domestic regulatory reform discussions also contributed to the market's negative sentiment. The oil spill in the Gulf of Mexico is still a concern, as its ultimate impact on the recovering U.S. economy remains unknown. As of May 31, the S&P 500 was down 7.9 percent for the month and down 1.5 percent for the year.

Not everything was gloom and doom last month, but the recent earnings season's reports of positive earnings and growing revenue were not enough to stabilize the market. There is evidence that the U.S. economy is still improving and earnings are on track. But until debt issues overseas are under control and volatility at home is reduced, this may not be enough to give equities a noteworthy boost. Despite the wall of worry currently facing equity investors, our longer-term view of the equity markets remains intact. An improving economy, low interest rates and stronger corporate balance sheets should be positives for stocks going forward.

POSITIVES

- ❑ Interest rates are still relatively low
- ❑ Economy is improving
- ❑ Earnings are improving

NEGATIVES

- ❑ Impact of sovereign debt issues in Western Europe
- ❑ High unemployment in the U.S. could last longer than anticipated
- ❑ Expectations of higher tax rates

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- ❑ Impact of government stimulus program reductions
- ❑ Economic response to European debt crisis

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Summary

The Barclays Capital Aggregate index returned 0.84 percent in May, bringing the rolling 12-month return to 8.42 percent. Within the index, U.S. Treasury notes returned 1.71 percent, followed by mortgage-backed securities and agency debt, returning a respective 1.12 percent and 0.76 percent.

Corporate bonds did not fare as well. The aggregate corporate bond market declined 0.55 percent, with a wide divergence between industrial companies (down 0.08 percent) and financials (down 1.37 percent). Two factors acted as a catalyst for market returns. First, there is no clear resolution to European sovereign debt problems. An almost trillion-dollar package intended to keep several European countries from defaulting on their debt did little to restore investor confidence. Instead, a massive flight to quality ensued, leading to strong demand for the perceived safety of U.S. Treasury notes. Next, analysts predict that financial regulation from Washington could potentially cause dramatic reductions in earnings, leading to lower-quality ratings for numerous financial institutions. However, the impact on financial bonds may be overblown, as earnings increased nicely and balance sheets showed considerable strength.

Economic recovery in the U.S. gains further momentum in some sectors, while other sectors continue to struggle. The Institute for Supply Management indexes for manufacturing and services both had solid expansionary readings for the month, and retail sales and industrial production both came in relatively strong. However, the employment landscape remains challenging, with initial jobless claims stubbornly elevated and private-sector hiring well below the level needed for a robust economy. By way of example, only approximately 7 percent of jobs lost during the recession have been recovered. While corporate America is doing well, other parts of the world economy still struggle. As such, we continue to favor high-quality intermediate corporate bonds, while maintaining a neutral-to-slightly-defensive interest rate position.

POSITIVES

- ❑ Core inflation remains low to nonexistent; commodity prices are declining
- ❑ Federal Open Market Committee continues to maintain language about keeping rates low for an extended period of time

NEGATIVES

- ❑ Weak private sector hiring
- ❑ Residential real estate market; end of home buyer tax credit

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- ❑ Government regulation of financial companies
- ❑ Resolution to the macroeconomic imbalances between euro zone countries