# MARKET OUTLOOK

***JULY 2010***

In the second quarter of 2010, stock markets in Europe, Asia, and the U.S. sold off sharply. The immediate catalyst was the euro-zone debt crisis which was precipitated by a sell-off in the debt of several of the weaker European nations. This was discussed in our June newsletter. Because of the crisis, the European nations collectively realized that severe austerity measures of less spending and higher taxes are needed to reduce the unsustainably growing levels of government debt. This caused many to conclude that future economic growth in the euro-zone would be lower than expected over the next few years which, in turn, could reduce U.S. and Asian growth and put into jeopardy the already fragile economic recovery.

As the quarter unfolded, the markets were confronted with additional news of less than robust growth from domestic housing, employment, manufacturing, and falling consumer confidence. Taken together, these events led some economists to raise the prospects of a double-dip recession in late 2010 or 2011. While an actual double-dip has occurred only once in the last century, the concerns over the possibility of a slowing economy and weaker corporate profits were enough to raise risk levels and lower stock prices. Specifically, the S&P 500 declined 11.4% for the quarter and 15.3% from its April peak. This sharp decline in stock prices this early in an economic recovery is a highly unusual event.

On the other hand, these same events led to a sharp reduction in interest rates and strong price gains in corporate, municipal, and especially U.S. government bonds. These low interest rates, coupled with the Federal Reserve's decision to keep short-term interest rates at zero for an extended period, should support economic growth. The declines in interest rates have fed into the mortgage market where thirty year mortgages are now at 4.6%, the lowest rate in forty years. Despite the recent mixed economic signals, the economy has grown for three consecutive quarters and corporate profits have been very solid with profit margins back at peak levels. This has resulted in very strong corporate balance sheets with high levels of cash which will provide the wherewithal to finance future growth in capital spending and increasing employment. In addition, banks have used this period of very low short-term rates to strengthen their balance sheets and are now better positioned to significantly expand lending if demand improves. Inflation is subdued and looks to be contained which will give the Federal Reserve much flexibility in using monetary policy to provide additional support to economic growth. Finally, stock prices, especially after the recent sell-off, are not expensive and price-earnings ratios are at moderate levels based upon historical experience.

Clearly, the markets are faced with very high levels of uncertainty. The consensus forecast calls for 3% GDP growth for the rest of 2010 and into 2011. While this is positive, it is below the average growth out of a recession and is probably not strong enough to result in a significant reduction in the rate of unemployment. The U.S. faces rising personal and corporate tax rates next year, the specifics of which are still not known. Federal government regulations in health care, the environment, and financial sectors are increasing but again are not defined and won't be for some time. State and local governments are facing their own fiscal stress and will be under pressure to reduce spending and raise revenues. All of these factors result in a very uncertain future environment which naturally causes both corporations and individuals to be more cautious in their spending plans. In this environment of elevated risk levels, we will continue to be careful in our approach to the management of assets by emphasizing quality, diversification, and balance through the use of both stocks and bonds. We will continue to put an emphasis on the preservation of principal while at the same time taking advantage of market dislocations to purchase securities at attractive prices.


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