

## Stock Market: Correction or Something Worse?

A resurgence in volatility and the first significant test to the market's 14 month uptrend arrived in the second quarter as the major indices suffered their greatest losses since the fourth quarter of 2008. After starting on a decent note in April, the markets rolled over at the beginning of May and the correction quickly garnered attention with the May 6<sup>th</sup> Flash Crash that saw stocks drop 6-7 percent and then rebound about the same amount in only 30-40 minutes time. Worries about sovereign debt in Europe, an economic double dip, and tightening fiscal support for world economies have combined to create heightened uncertainty at a time when valuation and complacency had reached elevated levels leaving the markets vulnerable to shocks in confidence.

Fundamental conditions have recently taken a turn for the worse as economic reports have started to disappoint relative to expectations—particularly in the labor and housing markets. The ongoing headwinds of deleveraging and weakened consumer strength will likely remain for some time. Finally, corporate earnings have continued to improve but expectations have reached levels that will make upside surprises tougher given a more challenging economic environment.

Large cap stocks fared worse for the quarter than their small cap counterparts while there was no significant difference in the performance of value and growth stocks. The materials, financials, and energy sectors were the downside leaders for the quarter while the defensive nature of utilities, consumer staples, and healthcare helped these sectors outperform. Two notable themes for the quarter were the strong shift toward quality after a number of challenging periods and the surge in stock correlations to levels seen at the worst of the bear market in 2008 and the 1987 crash.

With the market's first major correction underway since the March 2009 lows, the question arises whether this sell-off is just correcting a historic rally that will reach new highs or discounting a harsher economic environment and an ongoing bear market. For now, the sell-off is just a strong correction after a 14 month uptrend. However, the fact that the major indices are selling off so strongly from major resistance levels created by the most recent bear market has created uncertainty for the bullish argument. The fear gripping the markets about further recessionary conditions along with other ongoing macro concerns will likely keep the upside in check for the near future while creating the potential for stocks to discount further disappointments.

## The Economy: Recovery Meets Storm Clouds

In July, 1981, the Business Cycle Dating Committee concluded that the recession which began in January, 1980 lasted six months and an economic recovery had begun in July, 1980. Ironically, the very month this declaration was made is the beginning of a subsequent or double dip recession that proved deeper and, at 16 months, matched the longest contraction since the great depression. Nearly 30 years later, there continues to be a semantics debate over whether the

2 <sup>nd</sup> Quarter Scorecard		Table 1
Index	Quarter	1 Year
S&P 500	-11.4%	14.4%
Russell 1000	-11.5%	15.2%
Russell 2000	-9.9%	21.5%
Russell 3000	-11.3%	15.7%
Russell 3000 Growth	-11.6%	14.0%
Russell 3000 Value	-11.1%	17.6%
Barclays Capital US Aggregate	3.5%	9.5%
3 Month T-Bills	0.04%	0.16%

1980-82 experience was two recessions or one extended two year contraction. A more timely debate is whether the current environment will prove to be a replay of that painful experience.

For much of the past year, evidence has continued to build that the economy is emerging from the frightful crisis-like conditions of the prior 18 months. While no official proclamation has yet been made, there has been a general consensus that we have been in a recovery phase since the second half of 2009. Housing appears to have ended its free fall, labor market conditions have stabilized, consumer spending has picked up somewhat and credit market conditions have improved. This has all occurred in a policy environment that represents the most massive mix of monetary and fiscal stimulus ever.

More recently, however, attention has been focused on a number of storm clouds which may threaten the staying power of what has already been an anemic recovery. Specifically:

- European economies appear to be implementing significant budget austerity programs in the wake of their debt related stress
- Prospects of a slowdown in China have increased
- Following the expiration of tax credits, housing market conditions appear to be weakening
- Most recent economic data have been below expectations, especially those related to the labor market

While recent data has been disappointing, in our view, it is premature to suggest that the recovery has ended. Measures of consumer confidence and spending, while down

from their earlier levels, remain well above those consistent with a recession. Housing will remain troubled for the foreseeable future as excess inventories, negative equity issues, and the foreclosure pipeline continue to weigh that sector down. Nevertheless, after the “payback” adjustment to expiring tax credits, we expect sales to at least stabilize.

For the past several quarters, we have expressed the view that the recovery will be uneven and painfully slow. In fact, at times, it will indeed seem that either the recession has not ended or we have entered a new recession. While we acknowledge the possibility that conditions may well deteriorate further, we remain of the view that the recovery, as anemic as it is, will remain intact for the foreseeable future.

## Interest Rates & the Federal Reserve – How Low, How Long?

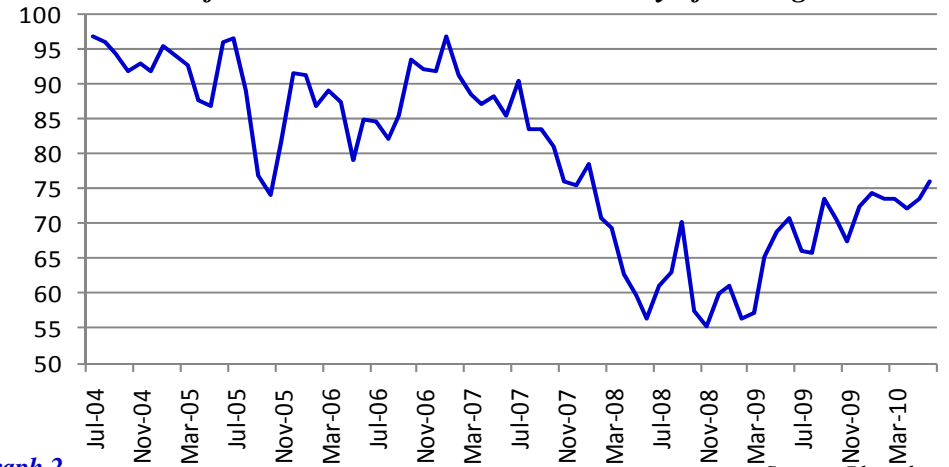
Interest rates fell during the third quarter as Europe’s debt problems, disappointing economic numbers and a total absence of inflation pressures have confirmed, at least for now, that Fed Policy will remain extremely accommodative for the foreseeable future (see Table #2). Yields on most maturities of U. S. Treasury securities fell by approximately three quarters of a percent during the quarter reflecting the investor interest in seeking “safe havens.” The Fed has now maintained its official zero-0.25 percent target range for Fed Funds for over eighteen months and is likely to hold there as long as economic measures remain weak. While credit spreads have widened somewhat, overall credit conditions remain fairly healthy. While interest rates may remain near current levels for a period of time, we continue to believe that the central tendency of over the next 6-12 months will be for rates to move higher.

## Interest Rate Summary

Table 2

	6/30/09	3/31/10	6/30/10	Qtr Change	12-Month Change
3 Month T-Bills	0.2	0.2	0.2	—	—
5 Year Treasury	2.6	2.6	1.8	-0.8	-0.8
10 Year Treasury	3.6	3.8	3.0	-0.8	-0.6
30 Year Treasury	4.3	4.7	3.9	-0.8	-0.4
5 Year Corporate (‘A’)	5.2	3.8	3.2	-0.6	-2.0
10 Year Corporate (‘A’)	6.3	5.3	4.7	-0.6	-1.6
30 Year Fixed Rate Mortg.	5.6	5.3	4.8	-0.5	-0.8

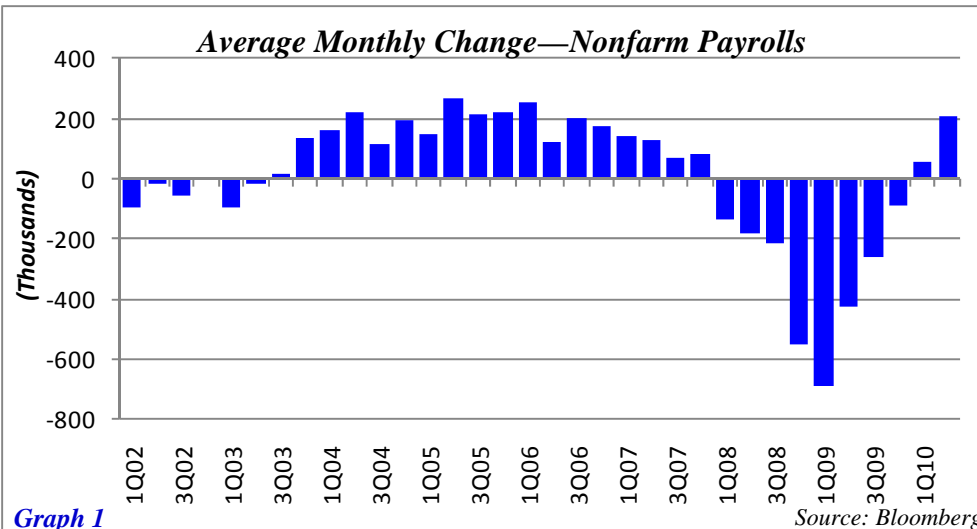
## Index of Consumer Sentiment—University of Michigan



Graph 2

Source: Bloomberg

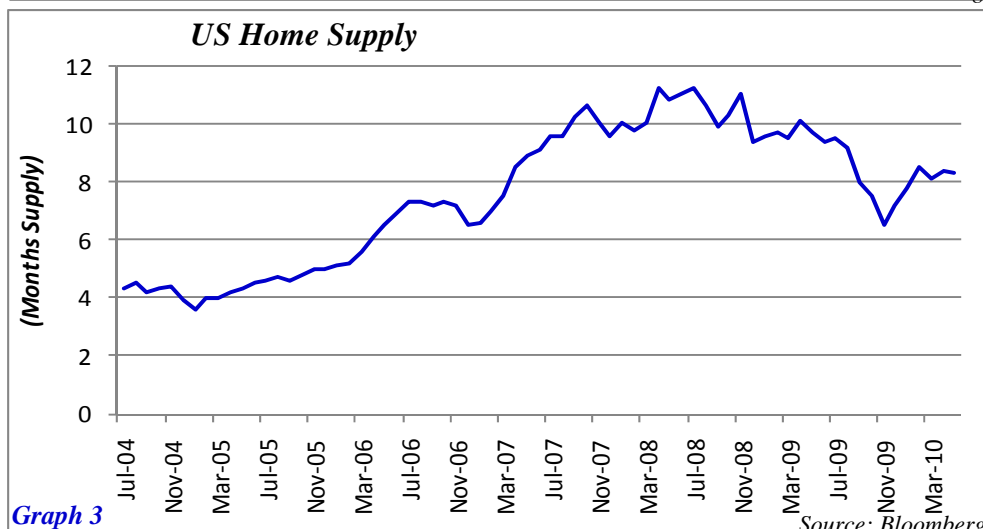
## Average Monthly Change—Nonfarm Payrolls



Graph 1

Source: Bloomberg

## US Home Supply



Graph 3

Source: Bloomberg