Quarterly Review (2Q 2010)

The Capital ReCap

Closing Out 2Q 2010

Economic Activity

Just as we thought the economy was gaining steam, the economic train hit a wall during the second quarter.

- We started the quarter off well with a high initial GDP reading of 3.2% for the first quarter, which was later revised down, to what some believe as a meager 2.7%.
- General sentiment has become quite pessimistic, despite seeing the Michigan Sentiment survey jumping to its highest levels since early 2008.
    - We do have a conference board reading on consumer confidence that shows us at extreme pessimistic levels.
- The two data points that have been sparking the most interest lately have been in relation to employment and housing.
    - The unemployment rate stayed below 10% throughout the quarter and currently resides at 9.5%.
    - Initial claims continue to be range bound and seem to dictate the mood of the markets for Thursdays as it is released. The initial claims level was at 460K to begin the quarter and ended the quarter at 472K.
    - Employment data this quarter was skewed due to hirings related to the census.
    - On the housing front, we began to see the positive effects of the housing credit wear off.
        - As the credit expired in April, we didn't see the influence of the expiration until the end of the quarter.
        - This is when we saw existing home sales drop 2.2% and new home sales fall 32.7%.
- The ISM readings continue to suggest that the services and manufacturing sectors are in growth territory.
- Inflation continues to be of minimal concern as CPI and PPI stay low.
    - Deflation has now entered the realm of possibilities as the CPI and PPI readings have yet to show major movements upward.
    - The Fed continues to keep rates low and all signs point to this being the case for the rest of the year. Their outlook of the economy continues to be relatively positive.

Equity Activity

Corporations continued to impress in the second quarter as we continued to see both top and bottom lines grow. This news was overshadowed by the concerns revolving around the state of our economy domestically and globally.

- We saw United and Continental merge to form the largest airliner in the world.

- Apple continued its dominance, as they released another trendy product in the form of the IPad.
- BP took a major hit during the quarter as they were the face of the largest oil spill ever.
- Goldman Sachs saw their 'golden' image bruised during the quarter as criminal investigations and lawsuits were launched against the company in relation to its mortgage-backed securities. The company saw its stock slide close to 24% during the past three months.
- Performance for the quarter through 6-30-2010
    - Dow down 9.8%, S&P down 11.9%, Nasdaq down 11.5%
    - 10 year Treasury down 91bps to 2.95%
    - GLD up 11.5% and OIL down 16.5%

What Lies Ahead?

This past quarter was a tough one for the equity markets as they got pounded on poor news coming from all angles.

It began with the SEC suing the golden boy of Wall Street, Goldman Sachs. This brought the fear back to the street that we may not be through the worst just yet. Then we saw one of the most unbelievable days that Wall Street has ever seen in the form of the flash crash on May 6th. Markets fell 1,000 points midday, before closing down only 300 points and we saw company prices reach the lows of a penny a share. The bailout of Greece lifted markets briefly before the continued worries regarding the EU put the markets in a tailspin from mid-May until the end of the quarter.

Along the way, we have seen the markets trade below the 10,000 mark and we currently have a 10 year Treasury yield that is below 3%. Oh, and we almost forgot the largest oil spill EVER is still ongoing in the Gulf of Mexico.

With all of these current events, pessimism has again gained popularity within the marketplace. Analysts and traders alike are having a difficult time finding ways for the U.S. equity markets to buck the current negative trends. The pessimism can be seen by looking at three major areas of the economy and the general market consensus regarding them: with regards to employment, the consensus is a worsened picture; regarding growth, the expectation is slowed second half growth; and regarding earnings, the outlook is that companies won't increase their outlooks this upcoming quarter.

Coming into the second quarter, the mood surrounding the markets was positive and then we had some negative surprises that caught the markets off guard. Yes, Greece was an issue we all knew about, but markets were caught off guard with the extent of the contagion that actually occurred. Markets continued to be caught off guard with regards to the Goldman Sachs issues, the flash crash along with the major oil spill in the Gulf. So, just as we saw negative surprises arise within the second quarter so quickly the same can be true with regards to positive surprises going forward.

The CIA Investment Committee foresaw a correction in the markets to occur during the middle of the year. We didn't know what would be the catalyst for the correction, but it seems that the concerns across the pond were the ultimate catalyst.

What we can assume to see in the upcoming months is a watered down financial reform bill to hit the President's desk, along with a bleak employment outlook and likely slowed economic growth. If we are to see a surprise in regards to economic growth, it will have to come from the business sector. As our theme of businesses, businesses, businesses will have to provide the positive spark in order to lead to a positive surprise within this economic data point.

The surprises relating to the employment picture will have to come from corporations finally hitting a peak in their productivity and needing to add to their lean payrolls. Although, we may look at the areas that could end up being surprises, we cannot predict the surprises, but one thing we do know is that markets tend to perform well in pessimistic environments.

A Longer Term Perspective

We still could see the equity markets face some pressures in the near term as there is a tornado of worries still swirling around the markets. The CIA Investment Committee continues to be in the camp that OPPOSES a double dip recession.

The Investment Committee sees the current state of the markets to still be in the correction stage that we foresaw at the beginning of the year. And we continue to believe that the markets have potential for a late year rally. Whether that rally comes from the results of the mid-year elections or positive surprises from economic data, we feel that the markets are poised to rise towards the end of the year.

With all of these doomsday type outlooks that have been described above, where do we want to position our portfolios? The Investment Committee continues to allocate portfolios to larger cap, more proven companies that pay healthy dividends. We continue to feel that dividend payers are going to be the outperformers over time.

With rates continuing to get to extreme low levels, we want to continue to invest our bond allocations to shorter duration and floating rate bonds. One thing to continue to monitor is whether or not the yield curve begins to flatten (short-term rates rising as long-term rates stay steady). If we see this come to fruition, then it may end up being more beneficial to shift some of the bond allocation to longer duration bonds.

Lastly, the Investment Committee continues to stay diversified. Despite the high correlations that we currently see between sectors within the equity markets, we are seeing asset allocation working. This can be seen by looking at the performance of IVV (the S&P 500 ETF) and BND (the total bond market ETF) over the past quarter. As IVV was down 10.7% for the quarter, BND was up a modest 2.7%. What this tells us is that we are again seeing that as investors become risk averse they are moving to the safety found in bonds, instead of moving out of the markets totally and into cash… as we saw in 2008.

In conclusion, the Investment Committee continues to stress to our clients to not become overly influenced by the current day-to-day changes in economic and equity data and to try to steer away from focusing on expectations. Rather, we need to focus on reality. And the reality right now is that the equity markets, the economy and corporations are in a better position today then they were prior to this whole "Great Recession."