

PMFA MARKET PERSPECTIVES

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FINANCIAL ADVISORS



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Executive Summary

- ❖ *The trajectory of U.S. economic growth has downshifted as the stimulus and cyclical inventory restocking appear to have largely run their course.*
- ❖ *Labor market weakness, excess industrial capacity, ongoing deleveraging, and a shrinking money supply are contributing to the disinflationary trend.*
- ❖ *With the risk of deflation growing, the Federal Reserve has little reason to raise interest rates and may need to consider whether additional quantitative easing is needed to reflate the economy.*
- ❖ *Equity valuations do not appear grossly excessive, and the backdrop of low interest rates and a growing economy should be supportive of risk assets.*
- ❖ *Elevated volatility is to be expected given the slow growth in the U.S. and abroad; a double-dip recession is possible, but not a foregone conclusion.*

Capital Markets

Risk Assets Trim Gains as Economy Downshifts

“Growing, but slowing.”

That seems to sum up in simple terms the current state of the U.S. economy. Collectively, the economy continues to expand, but aggregate growth and many other economic indicators have been easing of late. We want to be very clear on this point: despite all of the recent headlines and discussion about “double dips,” the economy is still growing at a pace expected to be near 3% for the second quarter. The only “double

dips” that appear imminent involve two scoops of classic vanilla, rocky road, or fudge ripple that is more than appropriate as thermometers close in on the century mark. If you’re buying, make mine strawberry.

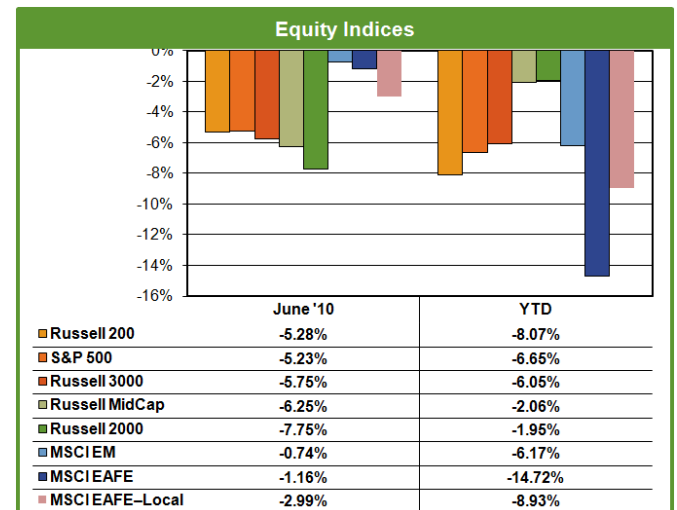
Our belief that a double-dip recession is not imminent should not be misconstrued to suggest that we don’t believe that one is possible in the quarters ahead. It certainly is, although we believe that most indicators today continue to suggest that we’re in the midst of slow growth, not contraction. That being said, there are two predominant competing theories about what we are seeing: the bearish view is that the U.S. (or even global economy) is poised for a double-dip recession. That possibility exists, although true double dips are not terribly common. We acknowledge that the most recent recession and its aftermath are not typical of a U.S. business cycle contraction either. Nonetheless, there are only two examples of double dips in the U.S. – one in 1937 and the second in 1981. Although we could debate whether or not the recession of 1937 was truly a double dip (and good arguments can be made either way), we will consider it such for the sake of discussion. Both were a direct result of governmental policy decisions rather than a pre-mature breakdown in business cycle fundamentals.

In 1937, the U.S. was still rebuilding from the rubble left by the Stock Market Crash of ‘29 and the Great Depression. Banks were accumulating capital, and the Federal Reserve raised reserve requirements, keeping that capital bottled up to ostensibly avoid an inflationary spike that the central bank feared could result from a surge in lending. To compound the issue, the Roosevelt administration cut federal spending and raised taxes in an effort to bring federal governmental deficits under control. The convergence of tighter fiscal and monetary policy on the back of an already fragile economy pushed the U.S. back into recession.

The more contemporary example occurred in 1981, during the nascent days of the Reagan administration. In this instance, it was a concerted effort by the Volcker Fed to break the back of inflation that was the impetus. The Fed knew that by raising interest rates to accomplish that goal, the economy would be pushed back into contraction. It was the “lesser of two evils,” so to speak, and recession was perceived to be an unwanted but necessary byproduct of the policy needed to bring prices under control. It worked.

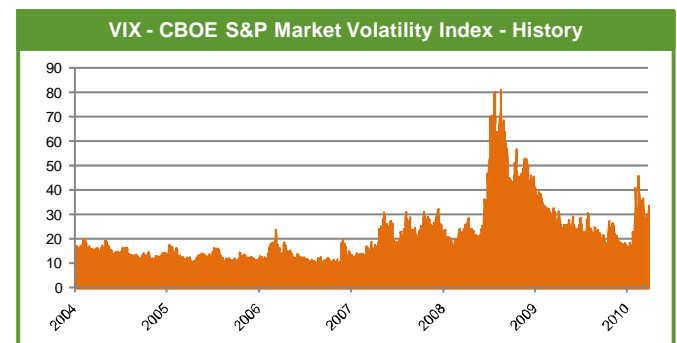
While the near-term outlook suggests that the economy has sufficient momentum to continue to grow, the potential exists that fiscal or monetary policy error, the

impact of deleveraging, another systemic shock, or other unexpected factors could truncate the current expansion. At a minimum, what we’re seeing is a slowdown in the pace of growth – the trajectory of the expansion is not as steep as it was in the latter half of 2009. Q1 GDP growth came in at 2.7%, less than half the brisk 5.7% pace of the prior quarter.



Source: PMFA

Rising nervousness about the potential for a double-dip recession rattled equity markets in June. Domestic equities were much harder hit than foreign markets, which had already posted higher losses through the first five months of the year. As we mark the midway point of 2010, major equity market indices are in the red year-to-date.

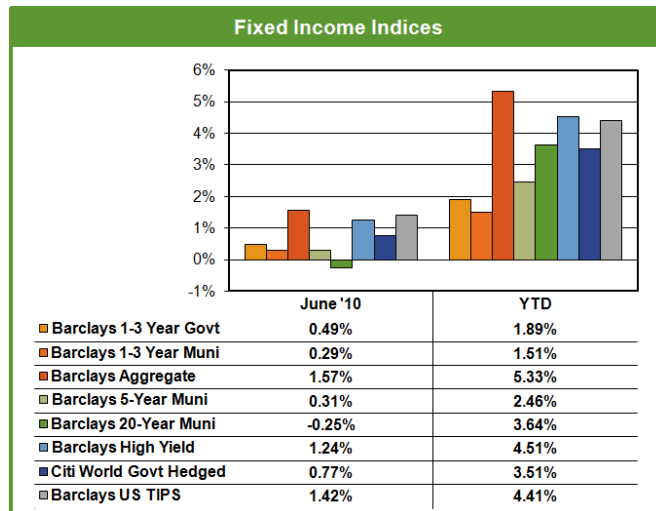


Source: PMFA

Our message for some time has been that we expect market volatility to remain heightened, and that has certainly been the case. The last time that we saw market volatility pushing higher and reaching current levels was in mid-September 2008. Of course, volatility moved much higher from there in the subsequent months as the credit crisis intensified; while a

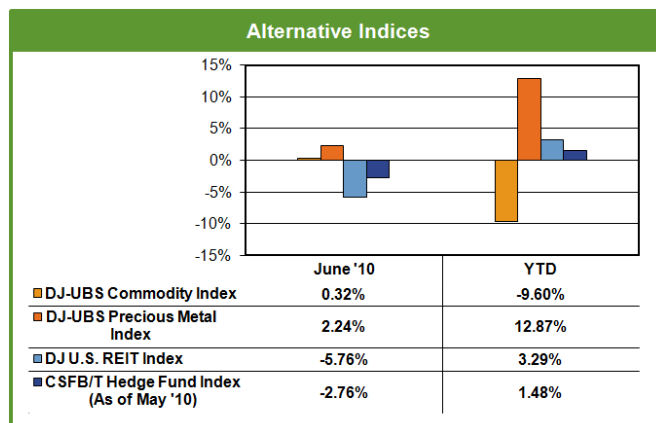
recurrence cannot be dismissed out of hand, we do not believe it to be the most likely outcome.

Not surprisingly, the corrective activity in stocks benefitted bonds. The Barclays Aggregate Index returned over 1.5% for the month as Treasuries rallied, driving the yield on the ten-year Bond down to below 3% for the first time since April 2009.



Source: PMFA

Returns on other risk-oriented assets were a mixed bag during June, reflective of the various factors that influence their respective performance. Commodities held steady, while precious metals were up again; gold remains a primary beneficiary of the fear that a global reckoning still awaits fiat currencies. Publicly traded Real Estate Investment Trusts (REITs) fell in concert with the broad stock market in June. While reporting of hedge fund results lag other indices with daily performance reporting, the CSFB Hedge Fund Index remained in positive territory year-to-date through May.



Source: PMFA

At this point, economists are projecting growth slightly less than 3.0% for the second half of the year. Earnings season is now underway and the preliminary results have been positive. With only a handful of companies reporting as we pen this missive, it is still too early to extrapolate early results to the broad market. While retail sales disappointed in May, declining for the first time in eight months, we anticipate that profit margins should generally hold their own as cautious companies continue to delay a ramp up in staffing. Whatever the outcome, actual Q2 corporate earnings results and, perhaps more importantly, revised corporate guidance regarding future earnings expectations is likely to play a major role in driving equity market performance in the near term.

From a practical perspective, what does this mean for investors? First, market volatility is likely here to stay for the foreseeable future. That may exhibit itself in the form of a meaningful correction as we've seen in recent months or as a nice rally that pushes stocks higher. Lack of clarity – whether stemming from an opaque economic outlook, geopolitical developments, regulatory change, fiscal and monetary policy challenges, or other factors – increases investor anxiety and creates intermittent periods of risk and opportunity. Many of the current sources of concern are not going to be solved in the short term, and in some cases are likely to take many years to address.

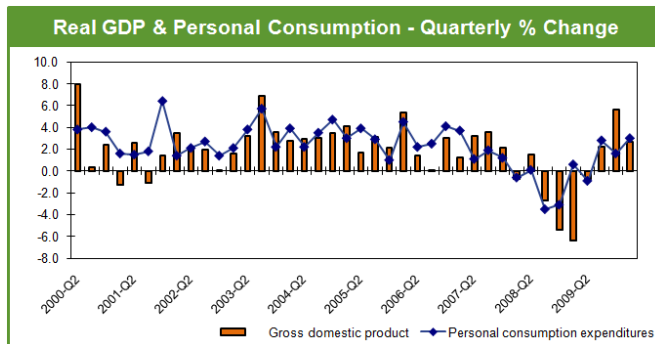
Second, a slower rate of economic growth also makes the economy more vulnerable. Even during expansions, the pace varies over the course of the cycle. In China, a 2-3% slowdown would certainly be noticed, but with high single-digit growth, the risk of an outright recession is more limited than in other regions where growth is much slower. With subpar growth already expected in the U.S., a further slowdown is more likely to be viewed as a red flag by investors. As we've seen in recent weeks, the economy need not be in a recession to cause investors to reduce their risk; often, mere speculation about such matters is sufficient. The frequency of such reactions could easily increase in a low-growth environment. That lower margin of error for the economy to absorb a temporary slowdown is also likely to contribute to volatility.

As always, investors should have a strategic plan for their portfolio that contemplates not only their target return, but acceptable volatility as well. Understanding what is possible should better enable the investor to react appropriately when the possible actually transpires. Meanwhile, we continue to monitor current conditions and fundamentals and remain focused on identifying opportunities to improve portfolio returns while managing portfolio risk.

Economy

GDP

After two downward revisions, the final estimate for GDP growth was 2.7% for the first quarter. This result is less than half the 5.7% increase in the fourth-quarter 2010, and is evidence that the expansion has shifted down a gear in recent months. The downward adjustment in personal consumption from an estimated 3.5% to 3.0% annualized rate was the primary driver behind the downward revision. As consumers remain focused on debt reduction and the challenging jobs market, they may not be able to provide the same degree of cyclical boost to spending as after other recent recessions. Moreover, if fears of a double-dip recession continue to take root, already bruised consumers may constrain spending further.



Source: PMFA, Bureau of Economic Analysis (BEA)

INFLATION

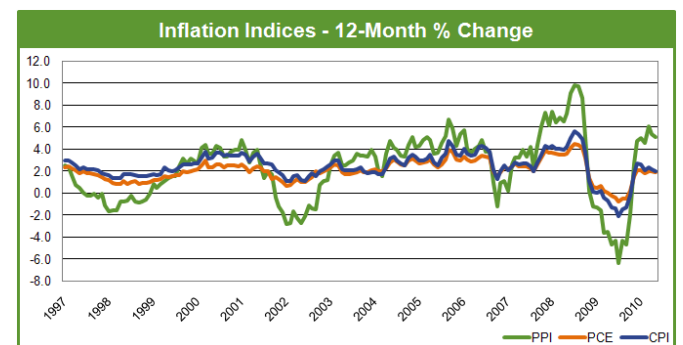
Perhaps we should retitle this section of our monthly commentary to “Disinflation,” as that would be much more accurate in light of current conditions. Deflation has become one of the concerns du jour, as weak labor markets, subpar growth, deleveraging, and a shrinking money supply are all contributing to downward pressure on price levels.

As inflation indicators continue to pull back, the results have potential to cause concern. On one hand, low inflation allows the Fed to maintain loose reins by continuing an accommodative monetary policy. On the other hand, if consumers continue to expect price deflation, it could lead to a downward spiral. Consumers delay spending, which causes companies to cut back production and staffing, and a reinforcing deflationary cycle begins. Currently, future inflation expectations remain moderate, and we anticipate the probability for this outcome is low.

Index	Period Ending May 2010	
	One-Month % Change	One-Year % Change
All Items		
CPI	0.1%	2.0%
PPI	-0.3%	5.1%
PCE	0.0%	1.9%
All Items Excluding Food and Energy		
Core CPI	0.0%	0.9%
Core PPI	0.2%	1.3%
Core PCE	0.2%	1.3%

Source: PMFA, BEA, Bureau of Labor Statistics (BLS)

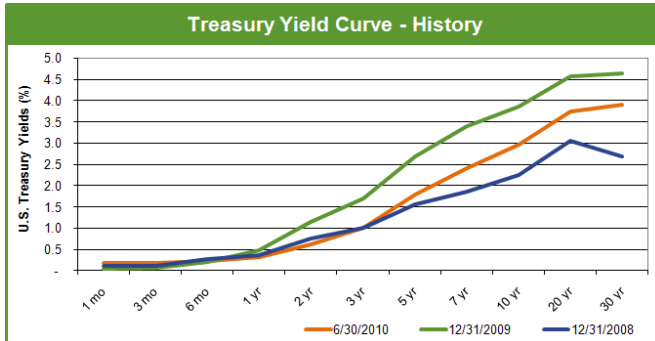
Changes in inflation during the month of May were mixed; however, the 12-month change was primarily downward for most indices. The CPI declined to 2.0% year-over-year, due largely to falling energy prices. When the more volatile food and energy prices are removed from the computation, core CPI remained flat at 0.9% on a year-over-year basis. Expectations are that the headline CPI rate should recede considerably in June, as the impact of an early summer spike in gas prices last year drops out of the data series.



Source: PMFA, BEA, BLS

INTEREST RATES

A year and a half has passed since the FOMC reduced the fed funds rate to its current target range of 0 - .25%. Market expectations for a rate increase continue to be extended and now suggest rates to remain unchanged at least into the first quarter 2011. The now boilerplate language in the June FOMC statement was little changed, although they acknowledged that “financial conditions have become less supportive of economic growth on balance.”

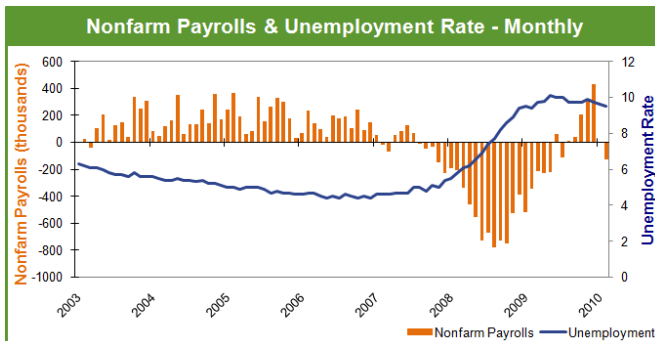


Source: PMFA, U.S. Treasury

Long-term Treasury yields continued to decline throughout June, as the 10-year Treasury fell .86% during June to end the month at 2.97%, its first trip below 3.0% in over a year. The fear driven flight to quality continued, as U.S. economic news disappointed expectations, and the significant fiscal problems in parts of Europe remain unresolved. Lower inflation expectations also contributed to declining yields. Short-term yields remain relatively range-bound with little room to move lower from current levels.

EMPLOYMENT

Nonfarm payrolls gave ground in June for the first time this year, predominantly as a result of government job cuts of temporary Census 2010 workers. Payrolls had been skewed in recent months with the inflow of the temporary Census workers, and the June reversal of that trend as 225,000 of those temporary jobs were eliminated was widely expected. Excluding the change in government payrolls, the private sector posted an increase of 83,000 new jobs, which was again below expectations. Private sector employers continue to be very cautious in managing the size of their workforce. Slow employment growth is expected to be a detriment to personal consumption in the near term.



Source: PMFA, BLS

The unemployment rate ticked downward to 9.5%, the lowest rate in nearly a year, but for the wrong reasons. Rather than improvement in the jobless rate resulting from job creation, the decline was attributable to nearly one million workers leaving the workforce in the last two months alone. With that as a backdrop, the slide in consumer confidence – which is heavily influenced by their collective evaluation of labor market conditions – should come as no surprise. Unfortunately, the correlation between confidence and consumer spending is very high. In addition to the existing emphasis on savings and debt reduction, the lackluster jobs environment appears highly unlikely to prompt a resurgence in consumer spending, further weighing on the economic recovery.

Gratuitously Unnecessary Statistic of the Month

Life, Liberty, and the Pursuit of Fireworks

Americans are a patriotic group of people—especially when it comes to celebrating our independence. Consider the following statistics:

- According to the National Retail Federation, 87.8 percent of all Americans were projected to take part in some type of Independence Day activity this year.
- The American Pyrotechnic Association further projected that consumers would spend more than \$600 million on fireworks over the July 4th weekend, two-thirds of which would go toward backyard celebrations.
- BIGresearch estimated that Fourth of July cookouts cost, on average, about \$54.62. With 36 million barbecues and picnics taking place across the country, that's about \$2 billion spent on cookouts alone!

This just goes to show that economic challenges can't dampen our patriotic spirit...or our abiding appetite to watch things explode!

Source:

<http://www.msnbc.msn.com/id/38004858/ns/business-forbescom/>

Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.

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