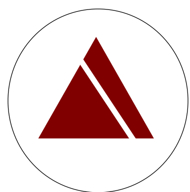

INVESTMENT PARTNERS, LTD

June 2010 Market Commentary

Presented by Investment Partners, LTD

Volatility returns to markets

The second quarter brought renewed volatility, as markets continued to trade on fears of a global slowdown and worries over the worsening European debt situation. Markets ended the quarter to the downside, with major U.S. indices trading sharply lower on the last two days of the quarter. European markets were hardest hit, and there were ripple effects across global markets.

The MSCI EAFE lost 13.97 percent for the quarter, and it has lost 13.23 percent for the year. The broad U.S. market, as measured by the S&P 500 Index, lost 11.43 percent for the quarter and is now down 6.65 percent year-to-date. The Dow Jones Industrial Average lost 9.36 percent for the quarter and is off 5 percent for the year. We have now broken below the S&P 500's February lows and are back to the levels seen in October of last year.

Bonds are a bright spot . . . Again

Bonds made strong gains during the quarter, helped in large part by a significant reduction in interest rates. The yield on the 10-year bond moved from 3.83 percent at the beginning of the quarter to 2.95 percent at the end of the quarter. This sizeable move pushed bond prices higher, as investors sought protection in U.S. bonds in the face of the Greek credit problems. The Barclays Capital Aggregate Bond Index gained 3.49 percent for the quarter and is higher by 5.33 percent for the year.

The returns for the Aggregate Index have told two stories. At the beginning of the year, spreads narrowed and credit-sensitive bonds, such as corporate and high-yield, saw strong gains. During the recent quarter, spreads began to widen on perceived fears of a larger debt contagion, while gains were seen in interest rate-sensitive investments, particularly U.S. Treasuries.

Greece and the other "PIIGS"

Greece took center stage on the global news front as the severity of its debt crisis came to light. The nation had reached the end of its borrowing capabilities and was threatening to default on its outstanding debt. While Greece took most of the heat, other "PIIGS" nations—namely, Portugal, Italy, Ireland, and Spain—also began to raise the alert over difficulties in refinancing their own debt. This prompted the European Union, led by German Chancellor Angela Merkel,

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to provide a comprehensive aid package. The end result was a bailout of roughly $1 trillion in order to avoid widespread default.

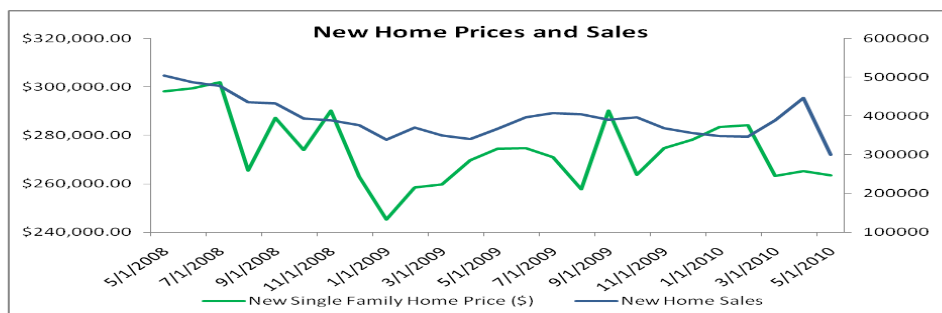
This bailout, however, did not come without cost. Significant austerity measures were imposed upon Greece in an effort to help prevent further problems caused by perceived fiscal imprudence. The resultant cuts in budgets, benefits, and public services led to widespread unrest across the country. While Greece has been the most significant concern for markets, there could be a larger crisis looming. The outstanding debt of Greece is roughly $285 billion, while the total combined debt of the PIIGS nations is $4 trillion. Roughly $3 trillion of this debt is held by European banks, and ongoing concerns over this huge liability have helped pushed many of these bank stocks sharply lower. Global markets have continued to be cautious over the potential for further fallout from the debt crisis, which could add to volatility in the coming months.

The recovery continues, but how strong will it be?

The market's dramatic move higher through most of 2009 was fueled by anticipation of an improving economy—and this thesis did indeed prove correct. We began to see an inventory rebuilding cycle, as companies realized that their low inventory levels were not sufficient for their ongoing business needs. This was evident in the robust manufacturing numbers. Evidence also suggests that companies will continue to build inventories and fuel growth in the near term. Industrial production has ticked higher for the past three months—it was up 1.20 percent in May after a 0.70-percent increase in April. This has also prompted strength in factory orders, a sign that the economy continues to improve for the time being.

This recovery, however, is showing signs that it is not as strong as past recoveries, particularly given the depth of the recent recession. Recent remarks by the Federal Reserve help to support this notion; the Fed has continued to cite high unemployment, modest income growth, and tight credit as a caution to growth prospects, saying, "Financial conditions have become less supportive of economic growth on balance." Because the Fed's outlook can be interpreted as being less optimistic, we believe this continues to support the argument that interest rates will remain low. We may even see short-term rates at or near zero percent through 2011.

There are also signs that the housing market is turning down again after recent strength in the first half of the year. Following the expiration of the $8,000 tax credit, we have seen home sales slide considerably. While this was to be expected, the level of only 300,000 new homes sold in May was far below the 446,000 level sold in April. In fact, this is the lowest level of new home sales since the Census Bureau began recordkeeping in 1963. Existing home sales also fell to 5.66 million units in May, from 5.79 million units in April. This will no doubt continue to put downward pressure on house prices, as inventories remain persistently high.



Source: Bloomberg

Many economists also point to a less followed metric from the Economic Cycle Research Institute for some insight into the future health and direction of the economy. The readings for the Weekly Leading Index have been pushing lower recently, down 6.90 percent for the week ending June 18, following a 5.80-percent decline the week before. Market analysts argue that these readings signal the impending slowdown of the economic recovery.

The gross domestic product (GDP) numbers also show signs that the recovery is slowing. First-quarter GDP estimates were lowered to a 2.70-percent annualized growth rate, from the initial reported estimate of 3 percent. And it is quite possible that we will see lower GDP figures for the second half of 2010.

Investing in this "new normal"

Equity markets have definitely become more volatile recently, amid concerns about the European debt situation and the slowing economic recovery. This is an environment in which investors need to be vigilant about risk, positioning portfolios to take advantage of the potential for a slower growth environment. Investors may want to seek market returns as well as income to help cushion some of the volatility and preserve capital. Income-producing stocks with strong fundamentals may make sense for investors, as could diversification within fixed income to help provide an ongoing income stream. Also, with the current turmoil in Europe, a focus on domestic holdings could prove to be more beneficial in the near term.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.*

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