



Quarterly Economic Update for 2Q 2010

The quarter in brief

The second quarter of 2010 brought a significant correction in the bull market and questions about the pace and strength of the global economic recovery. Few analysts were seeing a bear market ahead, but stocks did retreat – 2Q 2010 was the first down quarter for stocks since 1Q 2009, with the S&P 500 losing 11.86%. At the end of the quarter, we had new concerns emerged about the real estate market, a bill poised to become law that would bring great reforms to the financial world, and worries about foreign economies that stole the headlines from corporate earnings and domestic indicators.

Domestic economic health

Consumer spending (the ultimate driver behind any U.S. economic recovery) increased by 0.2% in May after a flat April. This was after month-to-month increases of 0.2%, 0.5% and 0.6% in 1Q 2010. As for consumer prices, they fell 0.2% in May following a 0.1% slip in April. Producer prices, too, headed south – down 0.1% in April and 0.3% in May.

Unemployment may have peaked in April. It was 9.9% then, 9.7% in May and 9.5% for June. However, just 83,000 net jobs were added to the economy in June, and Bureau of Labor Statistics data indicated that the main reason the jobless rate declined was because 625,000 job seekers stopped looking for work.

We saw sustained growth in manufacturing, another big cog in the economy. However, the PMI number got smaller as the quarter proceeded. The Institute for Supply Management's manufacturing index read 60.4 in April, 59.7 in May and 56.2 in June. How about the service sector? Well, across the quarter, ISM's non-manufacturing index posted a 55.4 in both April and May, so we were seeing growth.

Industrial output was up 0.7% in April and 1.2% for May, the Federal Reserve noted. Yet while durable goods orders were up 1.0% for April, we had an unforeseen 1.4% May decline announced at the Commerce Department.

The Fed did not hike the benchmark interest rate, and there were clear hints that it would not be doing so in the near future. Congress settled on a huge financial reform bill destined for President Obama's signature in July, which would create a Bureau of Consumer Financial Protection and an Office of Credit Ratings to regulate agencies like Standard & Poor's and Moody's. In the biggest victory for Wall Street, the bill permitted banks to continue foreign exchange dealing and interest-rate swaps.

Global economic health

After years of not exactly minding the store, several

European countries were looking at massive sovereign debt problems. When the crisis went full-blown in the media in May, Greece, Ireland, Italy, Portugal and Spain held debts ranging from \$236 billion to \$1.4 trillion – and not only that, these countries owed tens of billions worth of debts to each other.² An austerity plan and a bailout was rolled out, which the healthier economies of the EU (notably Germany) had trouble stomaching. As the quarter ended, the sense was that a massive credit and banking crisis had been averted ... at least for the short run.

In Asia, something interesting was happening with PMI indices: by the end of the quarter, the pace of manufacturing in some notable emerging markets was slowing, another development that hurt U.S. equities. China's PMI was 52.1 in June, down from 53.9 in May and the second straight month of decline. PMI indices in India, Taiwan, South Korea and Australia all showed growth, but at a slower pace than in preceding months.

World financial markets

We had it rough here in America, but other stock markets had an even tougher time of it in 2Q 2010. France's CAC 40 was down 13.36% for the quarter, and Brazil's Bovespa fell 13.41%. The Nikkei 225 dropped 15.40% and the Shanghai Composite took the biggest hit of any overseas benchmark, losing 22.86%. Even England's FTSE 100 fell 13.43%. However, there were some gains. In South Korea, the KOSPI gained 0.32% on the quarter. India's Sensex gained 0.99%. Chile's IPGA climbed 8.03%. As for the MSCI World and MSCI Emerging Markets Indices, they respectively lost 13.26% and 9.14% in the quarter.

Housing & interest rates

With federal tax credits set to expire, the second quarter was a test for the real estate market. What grade did it earn? How about a D? The month-to-month pace of new home sales, according to the Commerce Department, went from +26.9% (March) to +14.8 (April) to a record low drop of -32.7% (May). Correspondingly, pending home sales fell 30.0% for May. Existing home sales were up 8.0% for April, but down 2.2% for May. Fortunately, in early July President Obama put the tax credits back in place through September 30.

If the home sales numbers of months past appeared more than a little aided by the government stimulus, another kind of low was getting some very positive attention. Mortgage rates were setting all-time lows. On June 30, Freddie Mac's Primary Mortgage Market Survey had rates on 30-year FRMs averaging 4.58%, 5/1-year ARMs averaging 3.79% and rates on 1-year ARMs



averaging 3.80%. Could rates on the refiner's favorite, the 15-year FRM, fall below 4%? As June concluded, that almost happened: nationwide, they averaged 4.04%.

Looking forward

As we get into the third quarter, the wide belief is that the recovery is still progressing – just not as quickly or as robustly as we would like. It certainly is not thrilling Wall Street. Fears about overseas debt did rock the market in May and June, but we had a series of underwhelming domestic indicators that didn't help. We seem to have hit a soft spot, particularly in terms of consumer confidence. And what builds up consumer confidence come from?

Employment. Home sales. The sense that the pace of growth in the U.S. economy is accelerating rather than decelerating. So July may be the most important month of 2010 on Wall Street. We will almost certainly see major volatility. Yet as Standard & Poor's chief strategist Sam Stovall told AOL's Daily Finance, "The market is like a rubber band. Stretch it too far, and it's likely to snap back." Stovall noted that since the early 1920s, Wall Street has seen 41 quarters with declines of worse than 5%, including 2Q 2010. The good news: 29 of the 41 quarters that followed those pullbacks brought gains. Let's hope history repeats.

Looking back

So how did the market do last quarter? Well, here are the numbers. For the record, it was the poorest second quarter for the S&P, DJIA and NASDAQ since 2002.¹

<i>% Change</i>	2Q 2010	1Q 2010	Y-T-D
DJIA	-9.97	+4.11	-6.27
NASDAQ	-12.04	+5.68	-7.05
S&P 500	-11.86	+4.87	-7.57
10YrTIPS Yield	-28.13	+8.11	-22.30

QUOTE OF THE QUARTER

"Sing like no one's listening, love like you've never been hurt, dance like nobody's watching, and live like it's heaven on earth." – Mark Twain

(Source: CNBC.com, ustreas.gov, 7/1/10)

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