

# Quarterly Review



## July 2010: Second Quarter

### PRICE CHANGES FOR LAST 3 MONTHS AND YTD

VALUE	BLEND	GROWTH	
-11.6%	-11.9%	-12.1%	LARGE
<b>-6.2%</b>	<b>-7.3%</b>	<b>-8.4%</b>	
-10.0%	-10.2%	-10.4%	MEDIUM
<b>-1.9%</b>	<b>-2.8%</b>	<b>-3.8%</b>	
-11.0%	-10.2%	-9.3%	SMALL
<b>-2.5%</b>	<b>-2.5%</b>	<b>-2.6%</b>	

Twelve months ago analysts were expecting the shape of the economic recovery to look like the letter “U,” described as a slow, modest expansion. In late 2009 and early 2010, with corporate profits exceeding investor expectations and surprisingly strong reports from the manufacturing and housing sectors, market pundits began to discuss past periods where deep pullbacks in the economy were followed by sharp upturns, hence a “V-shaped” recovery. Currently, news on the economy suggests the recovery may be decelerating. A weak jobs report and a slowdown in manufacturing and retail sales have some analysts looking for a double dip – a “W-shaped” recovery marked by an economy that slips back into a recession. We believe the fear of shifting from the “V” to a “W” in describing our economy is behind the second quarter’s correction in the stock market. Stock prices were down near double-digit levels across all the segments.

We certainly can understand the “W” camp’s thinking. Europe is slowing in response to the need to shrink its municipal budget deficits. In the U.S., municipal budgets are also hemorrhaging red ink, requiring major program cuts. Balancing these budgets means reducing employment costs – cutting wages, benefits and even the numbers of municipal employees – exacerbating already weak job markets. And, policy-makers in China, the world’s growth engine, have been trying to gently apply the brakes to its economy in an effort to rein in inflation expectations, particularly in the housing market. It’s no wonder investors are beginning to wonder if our economy can muddle through.

We believe the answer as to shape of the economic recovery is in the hands of the U.S. consumer. Personal consumption expenditures represent 71% of our real gross domestic product (GDP). Business and spending by various governmental bodies make up the rest. These sectors cannot move the economy forward if the consumer sector is going backward. The problem, of course, is that U.S. consumers are tired. At a minimum, if they are fortunate and their jobs are secure, they’ve seen their retirement assets and home values shrink. They may also have seen their incomes decline, yet their annual expenses rise. There are over 15 million consumers that are seeking employment and certainly millions more whose jobs are at risk if the economy falters.

Over the last decade our consumption mentality fueled a worldwide economic expansion. We imported consumer goods made in China. In turn, China employed their citizenry, hoping to grow a middle class society, and promoted growth in other nations by importing production materials from everywhere else. While the growing middle classes in the developing economies offer the prospect of future growth for the developed societies looking to serve them, these consumers thus far have been reluctant to spend. The path to long-term, global prosperity is to build a bridge from a short-term slowdown in U.S. consumer consumption to a long-term pickup in consumer demand from the developing middle classes.

Bridging the gap from then to now will not be easy. We need the administrators of our cash-strapped government to implement policies that promote growth. We need our cash-rich companies to start replacing some of the labor they let go when our troubles began. And, we need our cash-poor consumers to keep our economy afloat in the meantime. These tall orders cause us to maintain a conservative posture towards the stock market. Generally reasonable valuation measures and modest interest rates, however, are a good balance to our economic challenges.

We expect the stock market to be range-bound until the path to global prosperity appears more assured. In the meantime we will continue to look for opportunities when prices appear unusually weak and take some profits when the market responds to some positive progress. On the bond front, we are balancing some high-quality, short-term (2-4 year term) investments with some select medium-quality, medium-term (3-6 year term) corporate issues. Although we expect interest rates to ultimately rise in response to a resumption of economic growth, yields may stay low for the next 12 months.