

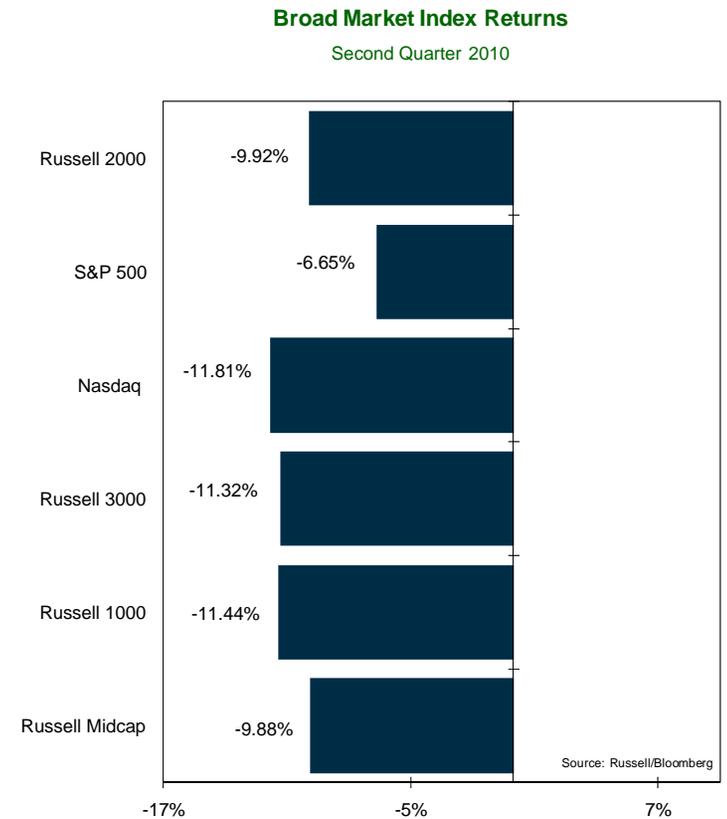


## Second Quarter 2010 Market Summary

### The Economy

The positive economic momentum experienced in the first quarter slowed appreciably in the second quarter of 2010. Indeed, not only did growth slow domestically, but concerns escalated globally over the sheer amount of outstanding sovereign debt, causing worry about defaults, and creating an extremely volatile market environment. At the forefront of the sovereign debt crisis was market participants' concern over the ability of certain countries to service their obligations, with the so-called "PIIGS" countries (Portugal, Italy, Ireland, Greece and Spain) being the most worrisome. The European Central Bank finally stepped in with bold measures to stand behind the debts of troubled nations.

But anxieties weren't confined only to continental Europe; the British Pound fell in relation to the dollar as speculation rose that the United Kingdom would soon suffer the same fate as Greece. However, the pound regained strength with the election of conservative leader David Cameron, who proposed a fiscally austere budget.



The current sovereign debt crisis can be traced to the coordinated efforts by world central banks to rescue the global financial system. But the massive fiscal stimulus employed in the past 18 months in an attempt to avert a financial system meltdown is not the only cause of the current situation. For several years, investors and financial institutions ignored deteriorating fundamentals, and borrowed at the prevailing low interest rates in order to invest in higher yielding investments.

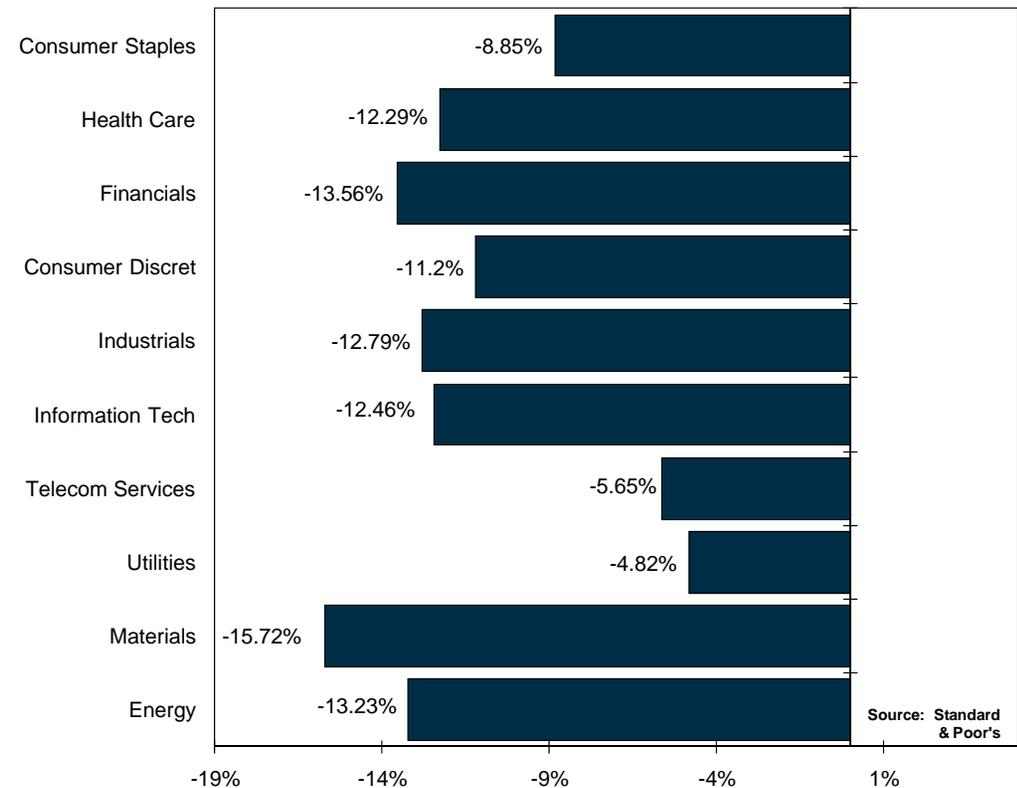
A global recovery seems to have taken hold, but is tenuous, as there are clouds on the horizon. At the recent G-20 meeting, most developed markets countries (with the notable exception of the United States) announced fiscal austerity plans, agreeing to bring down deficits materially in a three-year period. Such withdrawal of fiscal stimulus during a period when the economy is trying to regain its footing can be dangerous, particularly if the employment situation remains difficult.

## Highlights

### GDP

The Bureau of Economic Analysis released the third estimate of first quarter 2010 GDP, a downward-revised 2.7%. The previous estimate had been 3.0%. Many economists believe that this rate is barely enough to maintain pace with an expanding labor force, and not nearly enough to begin to recover the jobs lost in the Great Recession. The consensus believes that until economic and job growth accelerate, consumers will remain anxious, and the economy will continue to rely on government support.

**U.S. Equity Market Returns by Major Sector**  
(Securities in S&P 500, 2nd Quarter 2010)



## HOUSING

The housing market continued to undergo a significant correction from policy-induced levels. Existing home sales fell by 2.2% in May, with the Northeast leading the decline, dropping more than 18%. Some economists see the sharp retreat in housing data pessimistically, in that there are no underlying fundamentals to support the market, and the correction in housing will serve to bring about a double dip recession in the broader economy. Others, however, believe that the homebuyer tax credit simply shifted demand for housing forward, and that the underlying fundamentals have not changed. The optimists are supported by the fact that pending home sales data is improving. In addition, the sale prices of existing homes are up 2.7% from a year ago.

## EMPLOYMENT

Many economists believe that the economy will not be out of the woods until there is a meaningful pickup in employment. While the first two months of the second quarter hinted at a strengthening labor market, May's employment report was disappointing, and concerns about the prospects for a double dip recession heightened. The headline number in the report showed employment gains of 431,000 jobs in May, which about 411,000 of those were due to hiring by the Census Bureau; the private sector added only 41,000 jobs in the month. However, there were some positive trends that have continued, particularly gains in manufacturing jobs and the length of the workweek.

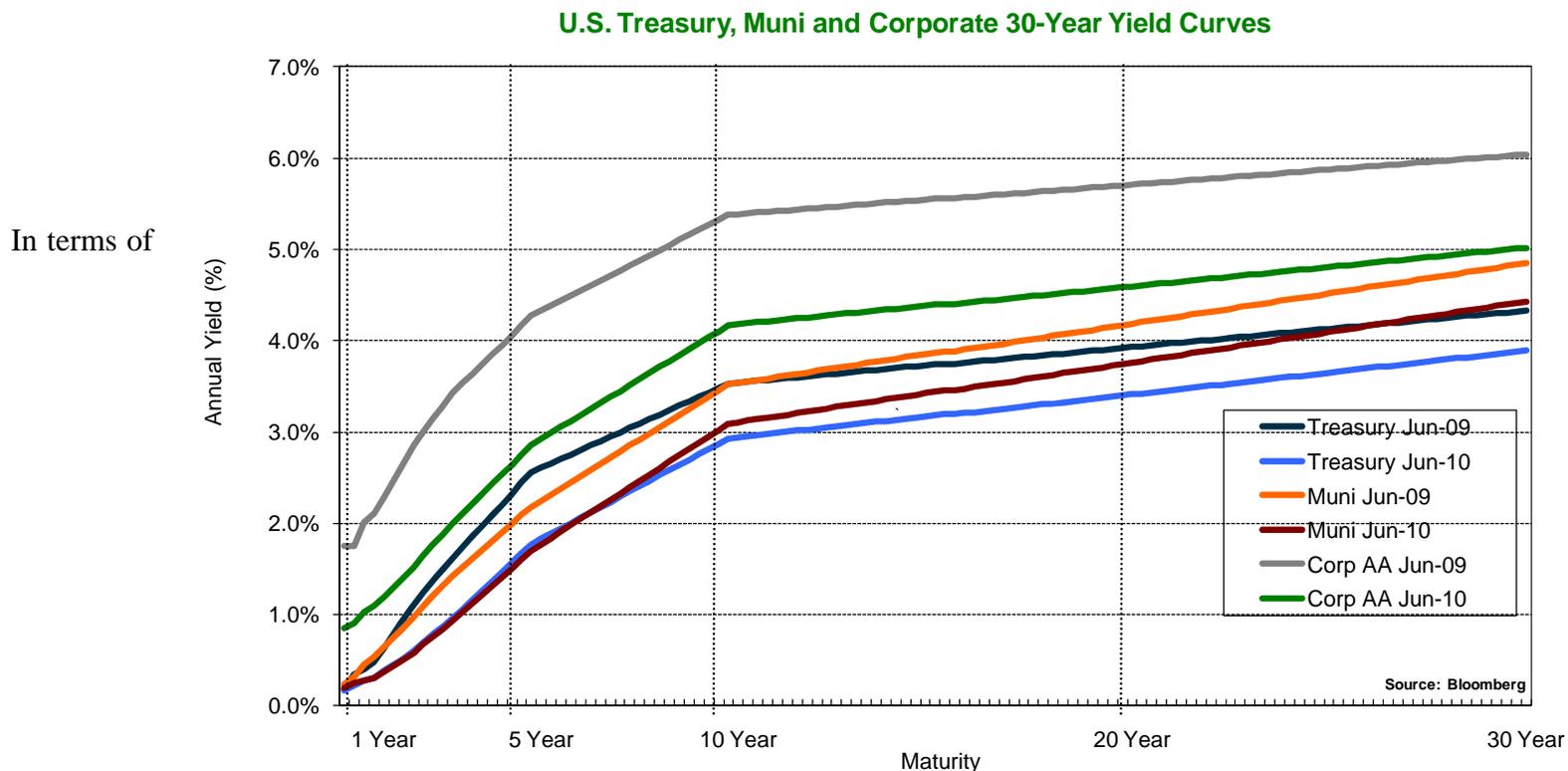
## FED POLICY

On June 23<sup>rd</sup>, the Federal Open Market Committee (FOMC) announced no change in interest rate policy. The FOMC said the fed funds rate target will remain in the 0% to 0.25% range. The FOMC statement said that the target is likely to remain "exceptionally low...for an extended period," wording that is unchanged from the committee's eight previous releases, going back to June 2009. What can be gleaned from the FOMC's inaction and statement is that the FOMC remains concerned about economic growth, and with little inflationary pressure on the horizon, it will maintain an aggressive monetary policy for some time. However, because the statement also referenced a "labor market [that is] gradually improving," it is apparent that the central bank is becoming more optimistic about the recovery.

Yet another indication the Fed believes the recovery has sustainability is the fact that it is allowing certain of its programs supporting liquidity in the financial markets, such as the Term Asset-Backed Securities Loan Facility, to expire. The Fed has also completed its purchases of Freddie Mac and Fannie Mae debt and mortgage-backed securities, and must now begin deciding what to do with the securities remaining on its balance sheet. It may allow some of the shorter-maturity issues to expire, but it must decide whether to sell or hold longer maturities. In any event, the Fed is expected to maintain its current low interest rate policy for some time.

## Interest Rates

Given the uncertain economic backdrop during the second quarter, interest rates generally ended the three months lower than where they began. In somewhat of a mirror image of the first quarter, the bond market began the second quarter with prices remaining stable, but as worries mounted over the twin concerns of the sovereign debt crisis and slackening domestic economic growth, a flight to quality took hold, and yields on government issues fell while credit spreads widened.



government securities, the yield curve flattened slightly during the quarter as the market digested the prospects that the Fed would maintain a low fed funds target for the foreseeable future. The yield on the 2-year U.S. Treasury declined 35 basis points, from 1.02% as of March 31<sup>st</sup> to 0.67% on June 30<sup>th</sup>. The yield on the 10-year Treasury fell by an even greater amount, 85 basis points, from 3.83%

on March 31<sup>st</sup> to 2.98% on June 30<sup>th</sup>. Longer term maturities also witnessed a decline in yields of about the same magnitude as the 10-year note. It seems that the market does not sense that inflation will be an issue to contend with in the short- to intermediate-term. Yields also declined in the face of the flood of new issuance coming to market in order to finance new government programs.

The credit segment of the fixed income market, while experiencing a drop in yield, did not fare as well as government securities in the second quarter. The yield on the Barclays Capital Corporate Bond Index declined from 4.49% on March 31<sup>st</sup> to 4.23% on June 30<sup>th</sup>. However, because of concerns over an economic slowdown, the yield on high yield securities actually rose during the quarter. The Barclays Capital U.S. Corporate High Yield Index witnessed a rise in yield from 8.66% on March 31<sup>st</sup> to 9.28% on June 30<sup>th</sup>. If economic concerns persist, the spread between government securities and high yield issues should be expected to continue to widen.

The municipal segment also witnessed a drop in yields, but not of the magnitude of the government sector. The Barclays Capital Municipal Bond Index posted a return of +2.03% for the three months ended June 30<sup>th</sup>. During the quarter the yield on the index dropped from 3.59% to 3.41%. States and municipalities continue to have budget difficulties with which legislatures are grappling.

## Equities

Equities had a difficult time during the second quarter, after low volatility marched higher in the first quarter. The Russell 1000 Index of large capitalization stocks declined -5.57% in the month of June, bringing its total return for the second quarter to -11.44%. Small capitalization stocks underperformed large cap stocks, as investors became concerned that the economic slowdown would have a greater impact on smaller companies. The Russell 2000 Index declined -7.75% in the month of June, and -9.92% for the quarter.

International stocks fared even worse during the second quarter, primarily as a result of the sovereign debt issues pervading European economies. The MSCI EAFE Index of developed market stocks declined -13.75% for the quarter, but was down only -0.97% in the month of June. Emerging market stocks fared somewhat better, as investors focused on those countries' stronger relative growth rates. The MSCI Emerging Markets Index declined -8.29% for the quarter, but only -0.72% in June.

**Non-U.S. Equity Market Returns**  
By Country (U.S.Dollars)  
2nd Quarter 2010

