



# Investment Overview

July 2010 • Volume 19, Issue 3

## Economic and Markets Summary

by William S. Eastwood CFA, Senior Vice President-Union Investment Management Group

### Second Quarter 2010

#### The Economy

The economic recovery that began in the third quarter of 2009 has continued through the first and second quarters of 2010. The first quarter grew at a 2.7% rate, down from the 5.6% pace recorded for the fourth quarter of 2009. For the quarter just ended, Gross Domestic Product should be a bit stronger than the first quarter of 2010 but not strong enough to be near or exceed the fourth quarter of 2009.

A moderate, but not strong, economic recovery and expansion is about as good as it is going to get in the view of many economists. However, near the end of the second quarter fears regarding the sustainability of the recovery again surfaced. Throughout most of the first half of 2010 the majority of the economic indicators were very upbeat.

This led to a positive outlook for the economy according to a panel of economists released in a survey in mid-May. The 46 economists surveyed by the National Association for Business Economics predicted GDP would expand by 3.2% in 2010 and 2011. The NABE president, Lynn Reaser, said, "Growth prospects are stronger, unemployment and inflation are lower and domestic financial headwinds have diminished." The economists surveyed expect unemployment to fall to 9.4% at the end of 2010 and to 8.5% by the end of 2011.

Business investment and spending has been stronger than past cycles would suggest and should continue according to the survey with spending on equipment and software supported by higher profits. The panelists expect inflation to remain low and project fed funds to be only at 0.5% at the end of 2010.

**"A moderate, but not strong, economic recovery and expansion is about as good as it is going to get..."**

This positive outlook was overshadowed by several negatives that captured the attention of economists and investors for much of the second quarter after this report was released. The primary negative had to do with the sovereign debt crisis that began in Greece and threatened to extend to a number of other countries in Europe. The level of government debt in relation to GDP is uncomfortably high after years of deficit spending for countries such as Portugal, Italy, Ireland, Spain and Greece. The proposed cutbacks in spending, government employment and salaries, pensions and other benefits sent protesters to the streets. The demonstrations and rioting captured by news organizations had a shocking effect on investors and the stock and bond markets throughout the world.

There are no easy or business-as-usual solutions to this problem as additional borrowing in the face of too much existing debt probably is not the answer. The flaws in a single Euro currency being supported by a number of European countries, each with individual economic strengths, weaknesses, and fiscal policies, will take much time and effort to resolve. If indeed there is a solution out there, it was not apparent as the second quarter of 2010 ended.

Needless to say, with all of this turmoil in Europe and the Euro currency, the U.S. dollar on world markets was in great demand during the quarter. Investors around the globe gravitated to the safest, most liquid currency in the world, the U.S. dollar. U.S. Treasury securities benefitted from this demand as yields dropped significantly over the course of the quarter.

Another negative occurring late in the quarter was domestic in nature. The employment report released on June 4 was perceived negatively with job growth, after adjustment for the addition of temporary census workers, much less than forecast. This report brought renewed fears of the dreaded "double dip" to an economy that could start to weaken again. Even though consumer confidence had been very positive in its readings, again there was the fear that consumer and investor confidence would begin to turn negative. The pounding the stock market took in May added to the sense of angst and uncertainty regarding an economy that seemed solid as the quarter began but was perceived by some as questionable as the quarter ended.

### Interest Rates

Despite the turmoil radiating from Europe, the domestic economy near the end of the quarter seemed to be on an upward trajectory. The Federal Reserve's "Beige Book" report released in mid-June showed the U.S. economy improving, albeit at a modest rate. The anecdotal reports gathered by the 12 regional Fed Banks reflected strengthening in consumer spending, although consumers were buying necessities rather than big ticket discretionary items.

Tourism activity improved except for cancellations in the gulf coast areas affected by the BP oil spill. The job market is improving, particularly in manufacturing. In addition to production, services outside of finance and transportation continued to gradually improve, the Fed said. However, it was reported that commercial real estate activity remained weak.

A separate report released at the same time by a group of outside economists said that developed nations needed to pay more attention to deficits. Fiscal issues of a number of countries are the number one risk to recovery and expansion. This risk of spreading contagion from Europe led the forecasters to push back until February 2011 the time at which they expect the Fed to raise interest rates.

The Federal Open Market Committee of the Federal Reserve had two meetings on their schedule during the second quarter of 2010. The first meeting concluded on

April 28. Again the FOMC left rates unchanged with a range of 0-.25% maintained. Post-meeting comments contained little new verbiage compared with previous meetings. The Fed reiterated that policy called for an exceptionally low Fed Funds rate for an extended period. They very slightly upgraded their growth assessment, but made no change to their inflation outlook. "Inflation is likely to be subdued for some time."

The second meeting of the FOMC in the second quarter concluded June 23. The group continued to leave rates unchanged at the 0-.25% range. Post meeting comments varied little from previous meetings. However one new thought was added. "Financial conditions are less supportive of economic growth largely due to conditions abroad."

As mentioned, U.S. Government bonds have been the primary beneficiary of the recent flight from risk, with 10-year U.S. Treasury yields falling to the lower end of recent trading ranges. This movement downward in intermediate and long rates can be compared with relatively stable short rates at low levels thanks to Fed Policy.

The movement of interest rates and the change in the yield curve can be seen in the table below, which shows various rates at the end of the first quarter of 2010 and the end of the second quarter.

%	Treasury Bill		Treasury Notes & Bonds			FED Funds
	3 mo.	1 yr.	5 yr.	10 yr.	30 yr.	
03/31/10	0.15	0.38	2.56	3.83	4.72	0-.25
06/30/10	0.17	0.22	1.79	2.94	3.89	0-.25

Yield spreads began to widen from very narrow levels near the end of the quarter, primarily due to the higher level of uncertainty brought on by the European sovereign debt crisis. However, bond funds continued to attract huge inflows of funds from nervous investors throughout the world. For example, the biggest of all bond funds, Pimco Total Return fund grew to approximately \$228 billion in size at the end of May. Its size on December 31, 2008 was \$132 billion. The supply of new corporate bonds did not keep pace with the tremendous demand for these securities resulting in favorable yields for corporate issuers and disappointing yields for investors.

The movement in interest rates created generally positive returns for various bond fund categories during the second quarter of 2010. On the next page are some examples of different bond fund returns according to the *Wall Street Journal*.



### Year-to-Date Percentage Returns (as of 06/30/10)

Barclays US Aggregate	+5.30	Investment Grade - Short	+2.84
U.S. Gov't	+6.05	High Yield Taxable	-2.13
GNMA	+5.18	Municipal Bond Index (7-12 yr)	+4.03

### The Stock Market

The stock market began the second quarter on a relatively quiet note, adding to the tremendous gains recorded over the past year after the March 9, 2009 bottom of 6547 for the Dow Jones Industrials. The Standard & Poor's 500 Index gained another 1.5% in April, helped primarily by the very favorable earnings reports released during the month. Over 75% of the companies in the S & P 500 reported earnings in excess of Wall Street estimates. That provided the motivation for the buying interest for stocks. Near zero interest rates for Treasury Bills, money market funds and other cash equivalents provided the liquidity for the stock market advance.

As May got underway, investor sentiment abruptly shifted toward risk reduction brought on by intensified concern over the sovereign debt crisis in Greece and a feared domino effect heading toward other European countries with a high debt-to-GDP relationship. Also adding to equity investors' rising fears were a few "not so favorable" economic reports released in May. The negative turn of events was topped off by the British Petroleum oil leak that became worse as the month progressed and continued to defy solution for the balance of the second quarter.

The above factors motivated investors to seek shelters from riskier investments in May. The stock market suffered its worst May in half a century. The S & P 500 plunged 8%, and the NASDAQ dropped 8.3%. With the continued spotlight on the negative news from Europe the international EAFE index cratered to turn in a loss of approximately 12% in that one month period.

The month of June saw stocks trying to stabilize and recover from the May downdraft. Some relief in the international arena came in June when sentiment improved regarding the European Union's political and financial response to the sovereign debt crisis. The constructive tone came about after a series of successful sovereign debt auctions. All in the same week Portugal, Spain, Ireland and Italy had each issued new public debt in auctions that attracted better-than-expected demand. For the month of June the S & P 500 lost 5.23%, as stocks sold off sharply the last few days of the month.

For the second quarter of 2010 the DJIA closed at 9774 amounting to a loss of -11.12%. The S & P 500 ended at 1031 for a decline of -11.43% on a total return basis. The NASDAQ stood at 2109 on June 30 and recorded a loss of -11.83% for the quarter. International indices again continued to underperform. The EAFE international stock index declined -13.69% during the second quarter of 2010.

Below is a table showing percentage returns year to date for various equity sectors and investment styles as computed by Lipper Inc., and featured in the *Wall Street Journal* on a daily basis.



### Stock Fund Indices

As of 06/30/10

Large-Cap Growth	-8.68
Large-Cap Core	-7.65
Large-Cap Value	-7.13
Multi-Cap Growth	-5.98
Multi-Cap Core	-5.68
Multi-Cap Value	-6.50
Mid-Cap Growth	-3.28
Mid-Cap Core	-3.43
Mid-Cap Value	-3.20
Small-Cap Growth	-3.10
Small-Cap Core	-2.09
Small-Cap Value	-1.26
Equity Income Fund	-6.43
Science & Tech Fund	-7.52
International Fund	-10.89
Balanced Fund	-2.66

Regarding the domestic stock market, below is a chart of industry sectors ranked by percentage change by Bloomberg Research for the second quarter.



### Percentage Gain by Stock Sector

2nd Qtr.

1. Utilities	-4.82
2. Telecommunications	-5.65
3. Consumer Staples	-8.85
4. Consumer Discretionary	-11.20
5. Health Care	-12.29
6. Technology	-12.46
7. Industrials	-12.79
8. Energy	-13.23
9. Financials	-13.56
10. Basic Industry	-15.72

# Fund Results as of June 30, 2010

## Equity Funds

	Quarter Return	12-Month Return
Allianz NFJ Large Cap Value .....	-10.92	+13.86
Allianz RCM Mid Cap .....	-11.03	+20.93
Fidelity Adv Eqy Income .....	-12.88	+13.52
Goldman Sachs Mid Cap Value .....	-10.95	+22.50
Janus Adv Intl Growth .....	-10.98	+21.43
JP Morgan Mkt Exp Idx Select .....	-10.45	+23.50
Lazard Emerging Markets .....	-8.95	+25.02
Stratus Growth Portfolio .....	-12.08	+10.62
Templeton Inst Foreign Equity .....	-11.47	+8.22
Thornburg Int'l Value .....	-9.18	+11.10
Vanguard 500 Index .....	-11.45	+14.33
Vanguard Morgan Growth .....	-11.07	+15.34
Vanguard Small Cap Index .....	-10.05	+25.06
Vanguard Strategic Equity .....	-10.51	+22.03
Idx: S & P 500 .....	-11.43	+14.43
Idx: Russell 2000 .....	-9.92	+21.49
Idx: EAFE .....	-13.69	+6.56
Idx: NASDAQ Composite .....	-11.83	+16.04

## Fixed Income Funds

	Fixed Income Funds	Fixed Income Funds
PIMCO Total Return Fund (Inst.) .....	+2.75	+13.31
Stratus Gov't Secs .....	+2.76	+5.88
Templeton Global Bond .....	-2.47	+14.34
Vanguard GNMA .....	+3.43	+8.31
Vanguard Infl-Prot Secs .....	+3.90	+9.51
Vanguard Total Bond Idx .....	+3.58	+9.28
Idx: M.L. Int Term Bond .....	+2.32	+4.57

*Past performance is no guarantee of future results.*



The Investment Overview newsletter is published quarterly by the Union Investment Management Group of Union Bank & Trust Company. Please address correspondence to Union Bank & Trust Company, Union Investment Management Group, P. O. Box 82535, Lincoln, NE 68501-2535.

*Investment products: Not FDIC Insured - No Bank Guarantee - May Lose Value.*