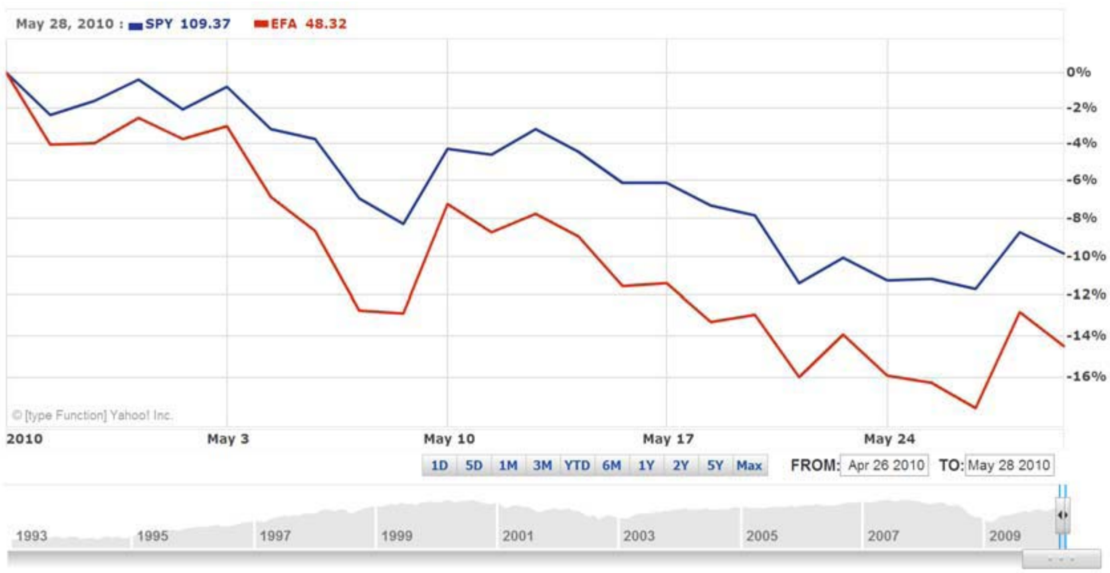
MARKET COMMENTARY - JUNE 2010

Ray Gadbois, CFP®
Index Financial Advisors LLC

May was a terrible month for equity markets in the United States and around the world. So this is a good time to take a step back, put this market into long term perspective, and review the state of our economy. Despite this recent downturn, we are still far from the depths of the financial crisis we experienced in March 2009. There are many risks and uncertainties to be worried about right now, but I believe the global economy will continue to recover in the months ahead. Read on for more details...

SHORT TERM MARKET CORRECTION

Since the most recent peak in the markets near the end of April, US stocks are down about 10% and international stocks are down more than 14%. See the chart below for SPY (S&P 500 Index) and EFA (Europe Pacific Stock Index). This downturn was fueled by fears about the sovereign debt crisis in Greece and its impact on the European financial system, currency and economic recovery. Money managers have been calling for a correction in the year-long bull market and used this opportunity to help make it happen. Hedge funds and other short term traders sold stocks (and the Euro), while most of the buyers stayed on the sidelines, especially after the "flash crash" (caused by computer based trading) made investors even more nervous.



Investors are right to be concerned about a wide range of issues. Taken together, they increase the risk that our economy could relapse into another worldwide recession.

- **Increasing levels of government debt will require tough austerity measures in the future**. Like Greece, governments around the developed world (including the US) have accumulated massive debts and unfunded liabilities for entitlement programs. The financial crisis and recession have required more deficit spending to repair the banking system, maintain the social safety net, and stimulate our domestic economy. In the future, balancing these budgets will likely result in higher taxes, reduced benefits and slower economic growth.

- **High unemployment and a weak housing market continue to weigh heavily on consumers.** The US unemployment rate remains high at close to 10%, not counting the underemployed or those who have given up trying to look for a job. Even the most optimistic forecasts for job growth predict a high rate of unemployment for several years. The risk is that persistent unemployment and depressed home prices will put a drag on consumer spending, retail sales, and the economic recovery.

- **Rapid growth in the emerging markets could lead to an asset bubble.** China and the other emerging markets have a very difficult balancing act to manage their economies. They want rapid economic growth, but they also need to avoid the creation of asset bubbles (e.g. in real estate prices) which can lead to serious problems when they burst. China has recently been tapping on the brakes to control the speed of their economy. But investors in the West are now concerned that these brakes may also slow down the global economic recovery.

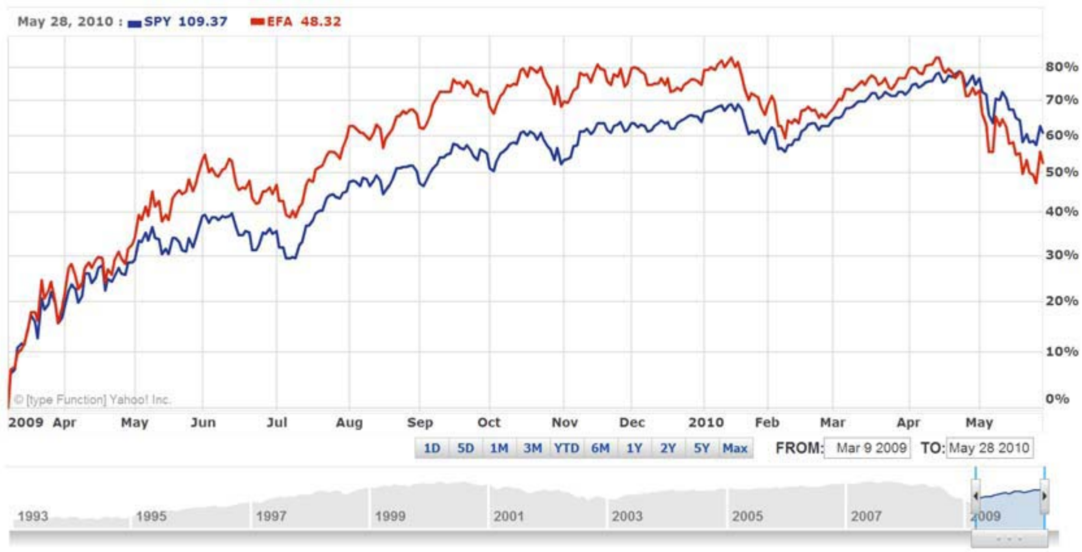
- **Regulatory risk creates uncertainty for business managers.** Financial regulatory reform is needed to reduce the risk of another financial crisis in the future. But uncertainty about the nature and extent of these reform measures can put a freeze on business decisions and scare away investors. The next item on the reform agenda is the energy markets, with proposed cap and trade legislation, and likely more regulation in the wake of the devastating oil spill in the Gulf of Mexico. The biggest risk to investors is the potential for a long period of political uncertainty until a final decision is made.

- **Geopolitical risk creates uncertainty for everyone.** As always, there is a long list of issues around the world that investors could be worried about. These include the wars in Iraq and Afghanistan, increased tensions between North and South Korea, violence in Thailand, Iran's nuclear ambitions, never ending problems in the Middle East, and the persistent threat of terrorism.

Yes, this list of issues can be downright depressing for the average investor. And it is easy to see why the markets have reacted to the recent turmoil in Europe as a threat to the global economic recovery. But history has been full of economic risks, political uncertainties, and global conflicts. Despite these issues, the long term historical trend for the economy and markets is one of persistent growth and positive returns.

LONG TERM ECONOMIC RECOVERY

If we step back and take a long term perspective on the markets, things don't look quite as bad. Since the bottom of the financial crisis back in March 2009, US stocks are still up about 60% while international stocks are up more than 50%, despite the recent correction. See the expanded chart for SPY and EFA below.



Looking forward, we have a long list of reasons to remain optimistic about a continuing recovery in the global economy and markets:

- **Economic growth continues around the world.** The US economy grew at an annual rate of 5.9% in the fourth quarter and 3.0% in the first quarter. Most economists predict similar rates of growth for the rest of this year and beyond. The global economy is also expected to grow this year, despite a potential slowdown in Europe. And the emerging markets are expected to continue their rapid growth at double digit rates.

- **US economic growth is creating new jobs.** So far in 2010, the US economy has added 573,000 jobs, including 483,000 jobs in the private sector. The employment data for May, to be announced on Friday, is expected to show another 500,000 jobs added last month. We need a lot more jobs to reduce the unemployment rate back to normal levels, but this is a good start.

- **Interest rates remain near historic lows.** The Federal Reserve is committed to maintaining short term interest rates at historically low levels. And the recent turmoil in Europe has actually reduced long term interest rates in the US. This includes a return to mortgage rates below 5%. These low interest rates should continue to stimulate economic growth in the months ahead.

- **The housing market has stabilized and begun to recover.** The most recent data on home sales, prices and inventories has been generally positive. This is due in part to the April expiration of the housing tax credit. But mostly because low prices and low mortgage rates have dramatically improved the affordability of home purchases. For example, the financial benefit from the recent decrease in mortgage rates is about twice the amount of the expired tax credit.

- **Consumer confidence and retail spending have improved.** Recent data on consumer confidence and retail sales continue to show modest improvement. In general, consumers are starting to feel a little better about their economic future and have started spending again.

- **Corporate profits and balance sheets are very strong.** Recent corporate earnings have been very strong and are beating estimates. A big factor has been aggressive cost cutting (i.e. layoffs) but sales have also started to increase. For the S&P 500, earnings in 2010 are expected to be close to $80, increasing to over $90 in 2011. This implies a forward P/E ratio of 14 for this year's earnings and less than 12 based on next year's earnings. These valuations are very attractive.

- **Inflation is not a near term risk in the developed economies.** Recent inflation data has been subdued and long term inflation expectations are moderate. Inflation is not likely to be a major threat as long as unemployment remains high and capacity utilization remains low. The recent drop in oil prices is also a big help.

So things are not all bad. And they are slowly getting better. I continue to be cautiously optimistic about the future of our economy and our investments.

THE BOTTOM LINE
As always, my recommendation is to continue to focus on your long term strategy with your long term investments. In other words, you should update and review your current asset allocation, and take this opportunity to rebalance your portfolio back to your long term asset allocation targets, which probably means adding to your equity investments now that stock prices are 10-15% lower.

I would strongly resist the urge to sell in the midst of this market correction, when sentiment is bearish and prices are low. If the market volatility and economic uncertainty is making you crazy and you want to lower your risk profile, I would encourage you to sell the next time markets are up, sentiment is bullish, and prices are high. I think it is always a good idea to take some money off the table when markets are good. At a minimum, this includes rebalancing back down to your strategic asset allocation, by selling some of your stock investments when prices are higher.

For my clients, I will be updating your portfolio, reviewing your asset allocation, and recommending rebalancing transactions if they are appropriate. In the meantime, please feel free to contact me anytime to discuss your specific financial situation and portfolio strategy. I look forward to talking with you soon…