

# Monthly Investment Update

August 2010

## Highlights

With July in the books, it is important to note that the Dow Jones Industrial Average, on a price appreciation basis, is flat for the year. All of the major indices advanced in July with the Europe, Australasia, and the Far East (EAFE) index advancing +9.49%.<sup>1</sup> The rally came on the heels of an earnings season that continues to produce numbers exceeding analyst expectations, thus economists are looking for reasons to explain the “soft patch” that occurred in May and June. According to the Council of Economic Advisors, the impact of the stimulus has already peaked as it relates to consumer income and spending.<sup>2</sup> Second quarter US Gross Domestic Product (GDP) also came in lower than expected at +2.40% as government and trade provided a drag on the consumption and investment components of GDP.<sup>1</sup> Bonds continued their rally, with yields on the 10-year Treasury falling to 2.90% and credit spreads narrowing around 10 basis points.<sup>3</sup> This month also saw the most sweeping piece of financial reform signed into law. The Dodd-Frank Wall Street Reform and Consumer Protection Act created a new systematic regulatory body, a new process for ending the concept of too-big-to-fail, provisions to rein in the shadow banking system, and permanently raises the current standard FDIC deposit coverage amount to \$250,000.<sup>4</sup> ♦

Source: 1. Bloomberg, 2. Wolfe Trahan, 3. Morgan Keegan, 4. American Bankers Association

Asset Class	Index	7/31/10	Total Return 1 Month	Total Return 3 Month	Total Return YTD	Total Return 1 Year
Domestic Equities	Dow Jones Industrial Average	10,466	7.23%	-4.28%	1.87%	17.28%
	S&P 500	1,102	7.01%	-6.69%	-0.11%	13.84%
	S&P 400 Mid-Cap	760	6.91%	-7.29%	5.45%	22.82%
	Russell 2000	651	6.87%	-8.88%	4.81%	18.48%
International Equities	EAFE Index	1,475	9.49%	-3.83%	-4.57%	6.90%
Fixed Income	Barclays Capital Intermediate Gov/Cr	-	1.09%	3.20%	5.70%	7.99%
	Barclays Capital 7 Yr Muni	-	1.64%	2.95%	5.25%	7.59%

Source: Bloomberg, Barclays Capital Indices

## Market Update

**Equities.** Growth in U.S. retail sales bolstered the earnings season and results of European Bank stress tests allowed equity markets to regain some of the ground lost over last quarter.<sup>1</sup> Emerging markets are having a significant impact on the earnings we are receiving this quarter. Virtually all growth in sales and pickup in demand is coming from initiatives that focus on the emerging world; economies fueled by demographics, friendly business environments, and little to no sovereign debt.<sup>2</sup> The best performing sectors were materials (+12.83%), industrials (+10.43%), and energy (+8.37%). Lagging behind the S&P 500 average were health care (+1.31%), consumer staples (+5.80%), and financial (+6.52%).<sup>1</sup> Macroeconomic forces continue to influence 88% of equity returns, which is significantly above the average of 71%.<sup>3</sup> ♦

**Fixed Income.** The intermediate portion of the yield curve has begun to flatten, with the 10-year spread contracting 91 basis points since last quarter. Keeping with the improving global fiscal picture, sovereign debt had the best overall return posting a +2.98%. Corporate bonds had a 1.96% return. Tax-exempt debt continued its rally, with the Colorado bond index experiencing a +1.14% return, just shy of the overall Municipal Index return of +1.25%.<sup>4</sup> This is in light of a quarter that produced some of the most troubling headlines to date. While Colorado municipalities are in pretty good shape, other areas around the country aren't looking so rosy. Munis are facing two major headwinds, a slowing business cycle and state & local deficits.<sup>3</sup> However, supply and demand principals have been pulling yields in the opposite direction. U.S. Banks' municipal bond holdings have reached a 25-year high at \$216.2 billion.<sup>5</sup> Build America Bonds (BAB) are also taking tax-exempt supply off the table. Investors have found comfort in the 15 month BAB program as these taxable munis remain relatively attractive. BAB issuance accounted for 23.8% of muni issuance in July.<sup>6</sup> ♦

Source: 1. Bloomberg, 2. Knight Research, 3. Wolfe Trahan, 4. Barclays Capital Indices, 5. Bloomberg, 6. JP Morgan

## Bottom Line

Headwinds against the economy are economic releases that have turned weaker, contracting bank credit, high unemployment, and consumers spending less in favor of paying down debt and saving.<sup>1</sup> Growth, in light of the stimulus, has also been trending far weaker than analysts anticipated. Conversely, on a forward earnings basis, the markets are still relatively cheap with the S&P 500 trading at a 12-month forward P/E of 12.1x.<sup>2</sup> Commodities, which have remained far below their all-time highs, are providing the consumer with a stimulus similar to a tax break. Sugar, rice, and silver are 60-70 percent below their peak. Productivity, a function of labor, has soared to levels considered unsustainable, which will require more labor inputs (jobs).<sup>1</sup> Lastly, with Congressional bodies on vacation, the markets should be able to stabilize and prepare for a mid-term election that routinely signals positive equity returns. ♦

Source: 1. Brown Brothers Harriman 2. FactSet