"Risk Never Goes Away"
Market Commentary – June 2010

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. increased at an annual rate of 3.0% in the first quarter of 2010. The second estimate was revised slightly lower from the advance estimate of 3.2%. According to *The Economist*, 2010 GDP is projected to be 3.1% and 2011 GDP is forecast at 2.8%. On a positive note, American consumers are spending and consumer confidence has been rising in recent months. However, the economic recovery is a function of fiscal and monetary stimulus, coupled with businesses rebuilding inventories. These are temporary factors that will lose their punch over time. Moreover, economic troubles internationally are creating headwinds for the global economy as a whole.

European governments are learning a new word, austerity, as they struggle with leveraged balance sheets and budget deficits. Portugal, Italy, Ireland, Greece, and Spain, affectionately known as the "PIIGS", are at the heart of the trouble in the European Union. Greece saw the yield on its government debt skyrocket as investors lost confidence in the country. With Greece essentially cut off from funding, the European Union and International Monetary Fund were forced to issue a bailout loan to prevent Greece from defaulting. In turn, Greece has promised politically-challenging tax hikes, wage and pension cuts, and a hiring freeze. While Europe struggles, investors have fled to the relative safety of the U.S. dollar and U.S. Treasuries, driving U.S. interest rates lower. However, the U.S. is not a role model for financial responsibility. If the U.S. continues on its current fiscal path, financial markets will eventually vote that higher interest rates are required to justify the risk associated with U.S. Treasury debt. Higher interest rates, coupled with a mountain of debt, would not bode well for the U.S. economy. The debt bubble has transferred from the private sector to governments around the world. It will take time for this debt to be digested through a process of spending less than what is coming in (or defaulting).

Fear has returned to the financial markets, reminding market participants that risk never goes away. On May 6, the Dow Jones Industrials Average plummeted nearly 1,000 points (9%), falling 700 points in a matter of minutes, turning a down day into a panic. Curiously, the market rebounded minutes later, closing down only 3.2%. The cause of the "Flash Crash", as it has been dubbed, is still unclear. Regardless, that day switched investors' mentality from the sugar high of prior months to the reality that risk is everywhere. Indeed, it is prudent for investors to always remember this fact.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $84.30, which implies a price-to-earnings (P/E) ratio of 12.9 with the S&P 500 at 1089. The earnings yield (E/P) is 7.74%, representing attractive value with the 10-year U.S. Treasury note at 3.30%. Since stock prices are not at bubble levels, fundamentals will provide an increasing degree of support should prices fall further.

Momentum in the stock market continues to be to the downside. Following the negative divergence observed last month, our market breadth indicator turned negative on May 13 and has pressed deep into negative territory. It will take some time to create a positive divergence, which would indicate a change in character to suggest a rally.

The latest pullback in stock prices, although volatile, is healthy overall. Trending financial markets tempt investors to make decisions that deviate from their risk profile. A fluctuating market is a check-and-balance on an investor's perception of risk and reward. Now that the short-term overbought situation has been alleviated, we can focus on our medium-term outlook that there is more potential upside with this cyclical bull market. Our updated research on our universe and the individual stocks that we own shows that there are some outstanding values in the market.