Commentary

Equity markets continued their slump in June, with the major stock indices posting significant declines for the month. In the major averages, we witnessed the second worst quarter since 1962, as the continuing impacts of the oil spill in the Gulf of Mexico, the European sovereign debt problems, and continuing signs of sluggish global economic growth drove market weakness.

In addition to the larger headlines, U.S. economic news was mixed. While reported manufacturing, auto sales, and consumer spending showed increases from May, retail sales and housing starts were down. The Federal Reserve indicated that short term rates would remain near zero for an extended period, albeit primarily as a result of low expectations for economic growth. Commodity prices were lower, and the price of oil was off by 20 percent in May alone. Employment continues to slump, and persistently high figures for long-term unemployment suggest that those workers who have not had jobs for more than a year are still not re-gaining employment in significant numbers. Evidence indicates that the private sector is generally not hiring and that government jobs are not being shifted to the private sector.

First quarter earnings, reported in the second quarter, were robust, with more than 80 percent of reporting companies surpassing their estimates. We see this earnings trend continuing into the second quarter, although we note that the market will be looking closely at guidance for future earnings. We believe that the market is currently oversold, as the market is valued at approximately eleven times the S&P earnings. While household spending is increasing, it remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software has also risen significantly. However, investment in nonresidential structures continues to be weak, and employers still appear reluctant to add to payrolls.

Our portfolios contain stocks that perform best when the economy is growing, so we did suffer quarterly losses while the recovery languished. However, we see the selloff occurring during this period as a temporary event, not as the beginning of a second, “double-dip” into recession. Rather, we believe that we are in the second year of the economic recovery, and we are preparing for a second rally to occur sometime late this year or in early 2011.

Moving forward into the second half of 2010, we will be reviewing companies we currently own to determine if they will perform in the current market environment. There will be some rotation in our portfolios, with certain companies being cycled out and certain others, better able to perform in the expected environment, cycled in.

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