

Quarterly Market Commentary – Q209

Presented by *Advisor Name*

Rally stalls as the quarter closes

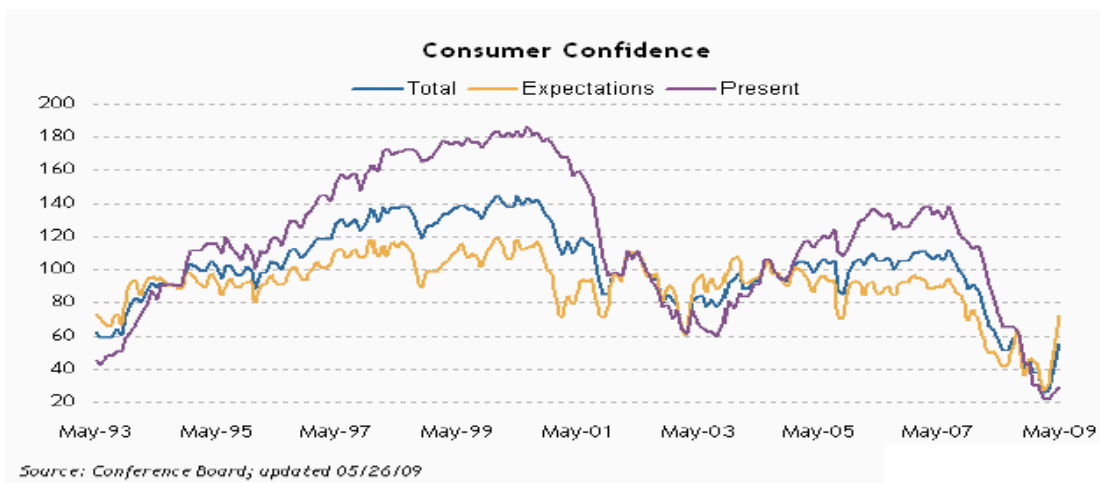
Equity markets experienced one of the sharpest rallies in recent history in the second quarter, following a sharp first-quarter decline. Despite the strong gains, U.S. equities are still mostly flat for the year. The Dow Jones Industrial Average returned 11.96 percent for the quarter, but it is still down 2.01 percent year-to-date. The S&P 500 Index is up 3.16 percent year-to-date, after a 15.93-percent gain for the quarter, its largest since 1998. Markets have taken a breather from their highs seen in mid-June, however, causing investors to ponder whether there's life left in the rally.

Green shoots and “better” data

A major catalyst for the recent rally has been the perception that the economy may not be as bad as it has been. In mid-March, Federal Reserve Chairman Ben Bernanke referred to these tentative signs of improvement as “green shoots.”

Most significantly, the employment picture does not appear to be as troubling as in months past; the U.S. shed 345,000 jobs in May. While this is a substantial number, it is well below the 504,000 and 652,000 jobs lost in April and March, respectively. The unemployment rate also increased to 9.4 percent in May, its highest level since July 1983, and it could rise above 10 percent if further job losses persist. But encouraging news from Washington has helped to alleviate some fears of job losses. President Obama has cited that, through the federal stimulus package, he has already “saved or created” 150,000 jobs and expects to save or create an additional 600,000 by this summer.

The economy may also be getting a boost from signs of increasing consumer confidence. In May, the Consumer Confidence Index moved up sharply to 54.9, from 40.8 in April. This is the highest level since last September, but it still falls short of the 58.1 level we saw a year ago. Clearly, we've got a long way to go before we return to normal, but higher confidence levels could help to bolster the ever important consumer spending, which has accounted for almost 70 percent of the U.S. gross domestic product. On another positive note, May's retail sales numbers were up 0.5 percent, after declining 0.2 percent in April. It remains to be seen whether these levels can hold, given the unemployment situation and weakening wage gains.



For sale: U.S. auto industry

The second quarter also saw a new round of business dislocation, this time with the beleaguered automakers. Chrysler filed for Chapter 11 bankruptcy on April 30, and, despite Italian automaker Fiat's bid for the firm, it was unable to avoid a bankruptcy proceeding. Following some legal hurdles, the company entered into a prepackaged bankruptcy agreement that was predominantly engineered by the federal government.

General Motors (GM) followed suit, announcing its move to seek Chapter 11 bankruptcy protection on June 1. The plan was again engineered by the White House, which sought to shrink GM and allow it to reemerge as a leaner, profitable company. It is the largest bankruptcy by an industrial company and the fourth largest in history. The resultant company will be 60-percent owned by the federal government as compensation for the \$50 billion in taxpayer money that has been used to keep the company afloat.

Better news on the banking front

Results of banks stress tests were announced in May; 10 out of 19 banks were shown to need additional capital. Of the \$74.6 billion of capital needed, Bank of America accounted for more than half of that amount. Recently, however, banks have been able to raise additional capital and convert debt and preferred stock to common shares, thus reducing the amount required by the stress tests.

Additionally, banks have been given the green light to repay Troubled Asset Relief Program (TARP) money, which would relieve them of the federal restrictions imposed on them by the program. Ten banks announced that they planned to repay TARP money; Goldman Sachs led the way, repaying the \$10 billion it owed the government on June 22. U.S. banks may be subject to increased regulations going forward, if President Obama's proposal to overhaul the entire financial regulatory system makes it through Congress.

Overseas investors enjoy a strong quarter

Domestic equity markets saw substantial gains for the quarter, but international and emerging markets were clear standouts. The broad international markets, as measured by the MSCI EAFE Index, gained 25.43 percent for the quarter, leaving the benchmark higher by 7.95 percent year-to-date. The MSCI Emerging Markets Index gained a whopping 33.57 percent for the quarter and 34.26 percent for the year. Global markets were boosted by optimism surrounding a global economic recovery; however, since the June 1 high in emerging markets, the index has turned lower in the wake of talks that a global recovery might be premature.

Fixed income bounces back

Fixed income markets had a tremendous quarter, supporting the notion that an allocation to bonds can indeed benefit investors. Credit spreads narrowed significantly during the quarter, resulting in strong gains for domestic corporate bonds and high-yield bonds in particular. High-yield spreads narrowed by more than 500 basis points (bps) to roughly 950 bps, and corporate spreads tightened from 500 bps to just under 300 bps. This is a dramatic move that has substantially reduced the borrowing costs for companies; spreads are the premium companies must pay, relative to U.S. Treasuries, in order to borrow money in the capital markets.

High-yield bonds gained 26.72 percent for the quarter and 30.43 percent for the year, as measured by the Barclays Capital High Yield Index. Corporate bonds were up 10.45 percent for the quarter and 8.32 percent for the year, as measured by the Barclays Capital U.S. Investment Grade Corporate Bond Index. Municipal bonds also gained during the quarter, as supply in tax-free bonds was squeezed by the issuance of the Build America Bonds. The Barclays Capital Municipal Bond Index returned 2.11 percent for the quarter, leaving it higher by 6.42 percent for the year.

Looking ahead

The economy has showed marginal signs of improvement, but it is still too early to say whether it is on the upswing. Fears of a slowing recovery hindered market gains over the last couple of weeks of the quarter. Many investors who have been on the sidelines are concerned that they have missed the rally—prompting them to consider reentering the markets at these higher levels. This reactionary posture can lead to the classic mistake most investors make—to sell at market lows and buy after markets move higher. Now, more than ever, it is critical to stay the course and continue to execute the investment policy you have developed to weather these still uncertain times.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. The Barclays Capital High Yield Index covers the universe of fixed-rate, non-investment-grade debt. Pay-in-kind bonds, Eurobonds, and debt issues from countries designated as emerging markets (e.g. Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in nonemerging market countries are included. The Barclays Capital U.S. Investment Grade Corporate Bond Index covers all publicly issued, fixed-rate, nonconvertible, investment-grade corporate debt. Issues are rated at least Baa by Moody's Investors Service or BBB by Standard & Poor's, if unrated by Moody's. The Barclays Capital Municipal Bond Index includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than \$50 million.*

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