



June 1, 2010

The oil spill in the Gulf of Mexico. The still unexplained “Flash Crash” on May 6. Simmering tensions in the Koreas. The financial overhaul bill. Increasingly grim news about the state of the European economy.

Given that long list of nerve-jangling headlines, it’s little wonder that the stock market became far more volatile in May. How volatile? The Dow had swings of 100 or more points on fourteen of the twenty trading days last month (with nine of those days down and five up). As a result, though they were up or only slightly off for the week, the three major indexes all tumbled during May, with the Dow down 7.92% (its worst month since 1940 when it fell 21.70%), the S&P 500 8.20%, and the NASDAQ 8.29%. Now the question is whether the correction is over with or will June bring more of the same?

But first, the news from the home front, where on Monday the National Association of Realtors Sales announced that sales of existing homes in April, boosted by the homebuyers’ tax credit, rose a healthy 7.6%, following a revised uptick of 7% in March, and that sales were up 22% from a year ago. The Commerce Department followed up with the news that sales of new single family homes improved 14.8% in April and 47.8% year-to-year. The Standard & Poor’s/Case-Shiller 20-city home price index, however, fell 0.5% in March from February, the sixth straight drop, though the index was up 2.3% from last March.

	Key Market Data		
	Week ending...		
	5/28/10	5/21/10	Change
Dow Jones Industrial Average Index	10,136.63	10,193.39	-0.56%
S&P 500 Index	1,089.41	1,087.69	+0.16%
NASDAQ Composite Index	2,257.04	2,229.04	+1.26%
10-Year Treasury Note Rate	3.300%	3.202%	+0.098 pct. pts.
NYMEX Crude Future (Barrel)	\$73.97	\$70.04	+5.61%
Euro/U.S. Dollar	\$1.2270	\$1.2574	-\$0.0304

Later in the week, the Commerce Department said that orders for durable goods increased 2.9% in April, more than twice the forecast. And the Conference Board reported that its consumer confidence index rose to 63.3 in May from a revised 57.7 in April, fed by growing confidence about jobs. The outlook of consumers for the next six months jumped to 85.3 from 77.4, its highest point since before the recession began.

At week’s end, the Commerce Department revised first quarter gross domestic product (GDP) growth – down from 3.2% to 3.0% because of lower consumer spending and a bigger trade gap. Adding to concern about a slowdown in spending, the linchpin to GDP growth, on Friday the Commerce Department said that consumer spending was flat in April, rising just \$4 billion, despite the fact that personal income was up 0.4% or \$54.4 billion. It was the first time in six months that consumer spending did not improve. The savings rate was up to 3.6% from 3.1% in March.

With the House and Senate trying to reconcile the two financial overhaul bills, Benjamin Bernanke, chairman of the Federal Reserve, again spoke against the House measure that would increase oversight of the Fed's actions, saying, "Political interference in monetary policy can generate undesirable boom-bust cycles that ultimately lead to both a less stable economy and higher inflation." Addressing the House's rationale for the proposed new legislation, its penchant for secrecy, he added, "The Fed is committed to exploring new ways to enhance transparency."

The broader view

Treasury Secretary Timothy Geithner toured Europe last week, and, with the United States economy on the mend, he was in a position to offer some paternalistic advice: "The basic lesson of financial crises," he said, "is that you have to come in and act quickly and with force." Geithner's messages were that he wanted the European Union to speed up its rescue of debt-laden members and also to be less vague about the details of any rescue plan.

In addition, he wants the Europeans to act in concert so that the stock market is not caught off guard as it was by Germany's recent announcement to prohibit naked short-selling (effectively banned here in 2005, naked short-selling is, in essence, a bet that a stock's value will fall and is made by people who don't actually own shares of that stock). The meeting with Wolfgang Schäuble, Germany's finance minister, was cordial, but Schäuble did not give ground, saying, "We have done our homework. We have to keep moving forward."

Meanwhile, the spotlight turned to Spain, which acted to save or merge banks on the verge of going under while also passing a new austerity measure to cut spending and reduce its deficit. However, that bill passed with only one vote to spare and there's growing concern that Spain's Prime Minister José Luis Rodríguez Zapatero is on

the way out, with calls for a general election increasing. The International Monetary Fund also weighed in, encouraging Spain to take "bold" action though pointing out that Spain, compared to Greece, has less public-sector debt and has not misled EU members with dubious accounting.

In Spain as well as Greece and Portugal, investors and analysts are beginning to wonder whether those countries, saddled with debt, can rebound economically if they continue to cut spending. And the fact that Fitch cut Spain's credit rating (though to a still second-best AA+) on Friday did not help instill confidence going into the holiday weekend.

Lastly, it should be noted that the debt crisis in Europe, though it has made American exports pricier in the wake of weaker euro, does have its upside. Because of worries about Europe, investors have been diving into the safe haven of U.S. Treasuries, driving the yield down and pushing 30-year mortgage rates back to where they were last year, below 5%. In fact, last week the U. S. government sold \$42 billion in two-year notes at the lowest yield ever, 0.769%. That's great news for us because it reduces the cost of servicing our debt at a time when our deficit is swelling and it makes refinancing an attractive option for those who haven't already done so, perhaps giving the housing market another boost.

A look ahead

In a holiday-shortened week, the most important releases will not come until Friday when the Labor Department will report on non-farm payrolls and the unemployment rate for May, which is expected to fall to 9.8% from 9.9% in April. Finance ministers from the Group of 20 will be meeting in South Korea to prepare for the late-June meeting in Toronto, including the continued debate over a proposal to make banks pay for the cost of bailouts (members agree on the idea, just not the details). And there will be releases on manufacturing and factory

orders, nonfarm productivity, construction spending, pending home sales and vehicle sales.

That said, most investors will be trying to decide whether or not the recent correction has run its course. We believe that, before the summer is over, the stock market will bounce back, if not quite to the highs of 2010, at least into positive territory for the year. And the reasons are twofold: an overreaction to the crisis in Europe and improving fundamentals almost everywhere else.

Yes, there's plenty to be concerned about in Europe and there may yet be debt restructuring in the cards for Greece and Spain. But the news from Europe has begun to feed on itself – witness the selling frenzy last week after it was rumored that China was going to sell off its European assets, which its central bank promptly refuted. And despite the debt dramas, euro-zone GDP is expected to be up for 2010 (see below), a far cry from what happened during the recession. Furthermore, though subject to fits and starts, the American economy is clearly on the mend, as are the economies in emerging countries and in China, where the appetite for raw materials continues to spur world growth.

That's why the Organization of Economic Cooperation and Development (OECD) said last week that, even though there were concerns about Europe and the overheated economies of Asia, "the global recovery is taking root." In its twice annual report, the



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OECD predicted that GDP growth for its 31 member countries (the majority of the world's advanced economies) would rise 2.7% this year and 2.8% next year (in November, the forecast was 1.9% and 2.5%). Real GDP growth in the U.S. was estimated at 3.2% in 2010 (up from 2.5% in November) and the U.S. jobless rate was predicted to fall from 9.7% this year to 8.9% next year. Better still, GDP growth in the 16-country euro zone – and yes, that includes Greece, Spain, and Portugal – was put at 1.2% this year and 1.8% in 2011 (up from 0.9% and 1.7%), and global GDP growth, including that of the non-member China, was put at 4.6% in 2010 and 4.5% in 2011 (compared to 3.4% and 3.7%, respectively, in November). Angel Gurría, the OECD's secretary general, said, "There's objective reason to be positive about the outlook. World growth is picking up – it's quite better than it was even a few months ago," though he cautioned, "Now more than ever, we need to maintain cooperation at an international level."

Along with the generally good news about the American economy, that's enough to make us think that, while 2010 will not be 2009 all over again, it will not turn into another 2008 either.

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Standard and Poor's 500 Index[®] (S&P 500[®]) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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