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market commentary

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An equity market rally based on signs of improving consumer spending and corporate profits gave way in the quarter to concerns over the sustainability of growth. After reaching a peak in the later part of April, the U.S. equity markets fell by approximately 15% in the last two and a half months of the quarter. Small and mid-capitalization stocks did somewhat better than the largest U.S. companies with the Russell 2000 down by 9.92% and the Russell Mid-Cap off by 9.88%. Large cap companies, as represented by the S&P 500, were off by 11.43 %. Internationally, developed markets declined by 14.19% and emerging markets were down by 8.37%. In response to the uncertainty about growth and the sovereign debt crisis in Europe Treasury, bonds rallied strongly in the quarter. The ten-year Treasury, which ended the first quarter at 3.84%, entered the July 4th weekend at 2.9%. As a sign of concern, the two-year Treasury, now at 0.65%, is below the level reached in December of 2008. Also, as a reflection of the debt problems facing the developed economies, gold rose by 11% in the quarter.

A slowdown in the economy's rate of growth after the initial surge off a recession bottom is not unusual. Such a slowdown is often accompanied by a negative market reaction. Recent examples would include 1994-1995 and 2004. In both of these cases, the market decline was precipitated by Federal Reserve tightening to slow growth and preempt inflation.

There is little risk today of the Fed tightening or of inflation. Rather, threats to growth are coming from a variety of sources. Domestically, employment growth is anemic. Employment is a lagging economic indicator, but in an environment where consumers are reducing debt, spending will have to come from income growth. This is particularly true as consumers are facing a major tax increase in 2011 when the Bush tax cuts expire.

The deficit and debt problems of Europe were a major story in the second quarter. Spending cuts and tax increases were expected as the only path to fiscal responsibility for much of southern Europe. What surprised the markets in May and June was Germany's decision to propose a restrictive budget as well. Widely seen as a beneficiary of the problems in Europe, German resolve to reduce their modest budget deficit, further impacting growth from Europe, caused concern globally about the recovery. Lastly, a slowdown in growth in China, the real engine of the global recovery since 2008, added to the concern that a normal slowdown would deteriorate into a slide back to recession.

The positives? Interest rates will remain low for an extended period of time. Corporate profits have been surprisingly good. Strong corporate balance sheets should fund growth in spending. Valuation is attractive and sustainable dividend yields are compelling when compared to the low level of interest rates. The market decline in the second quarter has discounted many of the problems facing growth.

We are in a different recovery. The key growth engine is not the U.S. but China, and we can not control that engine. Europe is reducing deficits when we still have a fragile recovery. Domestically, easy credit and massive deficits have been off-set by deleveraging by the consumer, uncertain tax policy and substantial regulatory changes. Uncertainty over the outcome, given these different inputs, has contributed to the recent decline. It need not end badly, but we need signs this summer that this different set of economic forces can produce a sustainable recovery.