

# INVESTMENT COMMENTARY

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## The Markets

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity</u>						
S&P 500	-11.42	-6.65	14.44	-9.81	-0.79	-1.59
Russell 1000 (Large Cap)	-11.44	-6.40	15.24	-9.54	-0.56	-1.22
Russell MidCap	-9.88	-2.06	25.13	-8.19	1.22	4.24
Russell 2000 (Small Cap)	-9.92	-1.95	21.48	-8.60	0.37	3.00
<u>International Equity</u>						
MSCI World ex US (Developed)	-13.63	-12.47	7.03	-12.61	1.48	0.58
MSCI Emerging Markets	-8.29	-6.04	23.48	-2.22	13.07	10.34
<u>Real Estate</u>						
FTSE/Nareit Equity REITs (public)	-4.06	5.56	55.98	-10.31	2.24	10.71
<u>Domestic Fixed Income</u>						
Barclays U.S. Aggregate	3.49	5.33	9.50	7.55	5.54	6.47
Barclays U.S. TIPS	3.82	4.41	9.52	7.62	4.99	7.35
Barclays Municipal	2.68	4.11	10.78	6.98	5.13	5.93
Barclays High Yield	-0.11	4.50	26.77	6.54	7.17	7.32
Citigroup 3-Month T-Bill	0.04	0.07	0.12	1.09	2.51	2.50
<u>International Fixed Income</u>						
Citigroup Non-\$ World Gov't Bond	-1.26	-3.33	1.53	7.66	4.99	6.44
<u>Commodities</u>						
UBS/Dow Jones Commodity Index	-4.84	-9.65	2.62	-9.50	-3.83	1.84

Uncertainty. Fear. Volatility. These three words encapsulate the second quarter of 2010. Over the course of the quarter, fearful investors sold equities, including REITs and commodities, and bought U.S. Treasuries and gold.

Just three months ago, the end of the first quarter of 2010 marked a time when investors were still uneasy

about the sustainability of the recovery; however, there was a subtle sense of security that the government's capital injections were working and that the U.S. economy would recover, although slowly. That belief in a global economic recovery was challenged in the second quarter.

In April, news of the SEC charging Goldman Sachs with fraud hit the wires. Although dramatic in content, it was not enough to stop the market's rise. However, the already known debt problem in Greece took center stage in May. Once it became frightfully apparent that Greece could possibly default on her debt, leaving other European Union countries, along with the IMF, to bail her out, fear began to seep into the markets. Investors realized that it was not only Greece who had a large debt balance, high unemployment and a perceived out-of-control spending policy, but other developed nations as well. Exacerbating the problem, on May 6<sup>th</sup>, with the market already selling off on news from Greece, the Dow Jones Industrial Average fell 700 points in a matter of minutes, likely caused by an electronic trading program. The "Flash Crash" as it was coined added to investors' uneasiness.

More recently in June, a group of 20 nations (G-20) gathered in Toronto, Canada, to discuss such things as country budget deficits and the sovereign debt issues in the Euro-zone. The group could not come to a consensus on how to solve the problems, and there was definitely two different sides being argued. Representing the U.S., President Obama, spoke of concerns of what austerity plans (cutting budgets and raising taxes) could do to the already fragile global economic recovery. Led by German Chancellor, Angela Merkel, there was another group who felt strongly about the critical need to reduce the massive budget deficits that resulted from countries spending to stimulate their economies during the financial crisis. Although appearing a bit contradictory, as the summit concluded, the group agreed to cut each of its deficits in half by 2013, while at the same time being mindful of economic growth. Investors almost immediately

reacted negatively. Fear that growth would indeed be stunted by government austerity plans helped drive stock markets down around the globe. Investor confidence faltered as fear of a "double dip" recession in the developed countries outweighed any optimism of a sustained global economic recovery.

### Equities

Whatever confidence in an economic recovery that the market was reflecting at the end of the first quarter has not only been erased, but investors continued to sell equities and run for the safety of U.S. Treasuries and gold. After finishing the first quarter up over 5%, the S&P 500 Index fell 11.4% in the second quarter, bringing the year to date return down to -6.6%.

In the Russell 3000 Index, down 11.3% in the quarter, not one sector delivered positive performance. The largest sector moves were seen in materials, down 15.1% and in energy, down 12.7%. If the economy slows as investors are predicting, then the demand for raw materials will fall as will certain commodity prices. That would, in turn, negatively impact companies' earnings in those two sectors. Due to their larger relative weight in the benchmark, information technology, 18.6% of the benchmark, and financial stocks, 16.2% of the benchmark, were the biggest negative contributors to the index's performance during the quarter.

We believe the U.S. equity market will remain volatile. Much of what is ailing the markets will not be solved overnight. Investors will be keeping an eye on the happenings in Europe and on governments' fiscal and monetary policy changes. We do, however, continue to prefer the U.S. equity market to the developed international markets, especially in light of the recent strength in the U.S. Dollar versus the Euro.

Entering the second quarter, REITs, measured by the NAREIT Equity Index, were up over 10% year-to-date. Investors were poised and ready for a

rebound in commercial real estate. However, as investor uncertainty in the sustainability of the economic recovery increases, excitement over a rebound in commercial real estate wanes. This is not to say it will not happen. At this juncture, it is a timing issue. If the economy stalls, a commercial real estate recovery is pushed further into the future. Economic road blocks to recovery, such as a high unemployment rate, 9.5% through June, continue to stand in its way. REITs fell 4.1% in the second quarter. Although, negative, the group did relatively well, falling less than half that of the broad equity market. This is likely due to the fact that many public REITs have healthy balance sheets, and as commercial real estate recovers, are in the best position to take advantage of any potential opportunities.

Industry specific, apartment REIT performance was positive in the quarter. Supply and demand outlooks bode well for this group. As many former homeowners, who have lost their homes for various reasons, seek to rent apartments, demand increases. On the supply side, with less friendly financing conditions than in previous years, new construction has slowed significantly, lowering the number of new apartment complexes. As a whole, REITs are still up year-to-date, and we do believe that when the economy stabilizes, there will be interesting opportunities in commercial real estate.

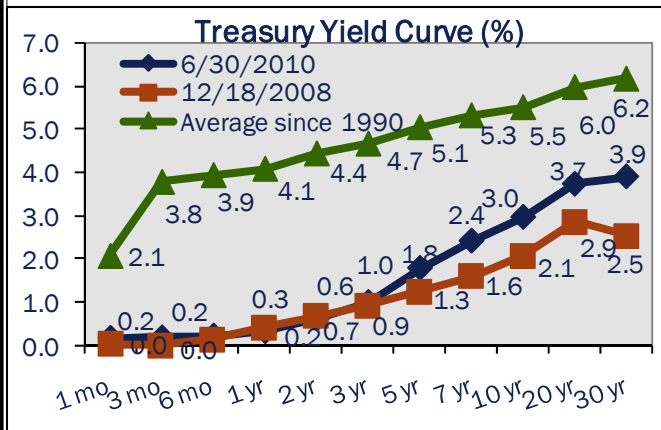
The MSCI World, ex U.S. Index was down 13.6% during the second quarter (-10.7% in local currencies). As the spotlight shone on the sovereign debt issues in the Euro-zone, namely in Greece and Spain, it is not all that surprising that developed world markets fell so dramatically. With the austerity measures being employed in Europe, it is almost guaranteed that growth will slow as a result. Budgets will be cut. Whether or not taxes are increased will vary by country. Overall, the likely result will be lower deficits at the expense of economic growth. Thus, international markets will likely remain volatile. For U.S. investors, if the U.S. Dollar continues to strengthen against the Euro, it will be a headwind to investing internationally.

Emerging markets were not immune to investors' change in sentiment; however, falling only about half that of developed markets. The MSCI Emerging Market Index was down 8.3% (-5.5% in local currencies). There is concern over the potential for economies to slow in the developed nations, as many are important export markets for emerging countries. Investors are also worried about China's economy slowing. It is perceived to be the world's future growth engine. We believe it is important to keep this point in perspective. Although the economy may be slowing, the country's year over year GDP growth rate is 11.9%. If the economic growth rate drops to 8% or 9%, that is still a healthy and much more sustainable growth number. It is imperative that the Chinese slow their growth, especially in light of an overheating real estate market. The Chinese are working to insure that the stimulus pumped into their economy during the financial crisis does not equal future inflation problems. Even in light of the troubles in Europe, the Chinese government decided to remove the Yuan's peg to the U.S. Dollar, which is being viewed as a vote of confidence. For the first time since July 2008, the Yuan appreciated against the U.S. Dollar. Other emerging economies that rely on world commodity demand, such as for oil, could suffer as well if slowing growth in the developed world equals less demand. Long-term, we still believe the emerging countries, with low levels of debt and continued urbanization, offer good investment opportunities, although with relatively high risk.

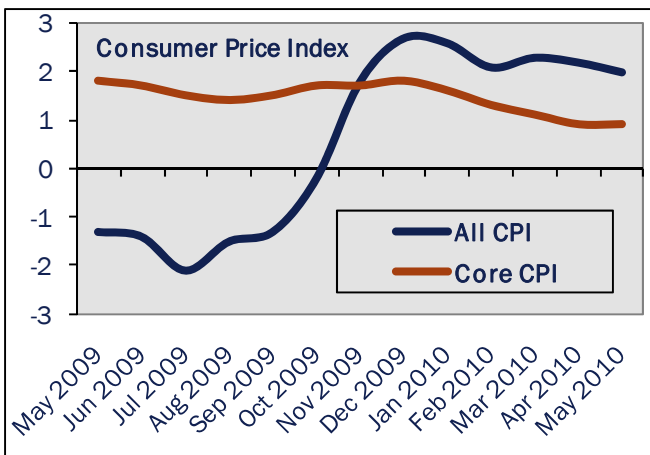
Without signs that the private sector can pick up where the public sector left off and lead the developed economies out of this tepid growth stage, it is likely investors will continue to fear a "double dip" recession, especially in Europe, and thus we see continued near term volatility in the equity markets. Emerging countries, especially China, are viewed as the future growth engines of the world; however, as they tighten the money supply and slow economic growth, investors may still view this as a negative, even though the absolute growth rate is projected to be in the high single digits. We still believe the emerging economies, with large cash balances, are in the best position to weather another economic downturn.

## Bonds

During the quarter, the Barclay's U.S. Aggregate Index was up 3.5%. With investors worrying about the possibility of a "double dip" recession in many developed countries, and as the emerging market countries slow growth in order to fight the potential onslaught of inflation, investors have sought a safe haven in bonds, especially U.S. Treasuries. Even with Treasury yields at relatively low levels, investors continue to buy them, thus driving yields even lower. As of December 31, 2009, the 10-year Treasury was yielding 3.85% and the 30-year was yielding 4.63%. The chart below shows current yields even lower, although they are up since their most recent low on December 18, 2008.



The Fed remained dovish at the June meeting and decided to keep the fed funds rate at an "exceptionally low level," currently between 0%-0.25%, for an "extended period". Using the CPI as an inflation gauge, this is not surprising. The Fed's comments regarding the economy were per-



ceived as more cautious than the language from previous meetings, given the sovereign debt issues in Europe. With talk of an economic slowdown and lower assumed consumption, it is not likely the U.S. will soon experience inflation, and thus, we do not expect to see the Fed turn hawkish and raise the fed funds rate in the near term.

## Commodities

The DJ-UBS Commodity Index fell 4.8% during the quarter, about half the loss experienced in equities. The common theme that sent the equity markets tumbling, negatively affected the commodities markets. Uncertainty in the Euro-zone, along with China's slowing economy, weighed on the group. Slowing growth could equal less demand and lower prices. We do believe commodities belong in a well diversified portfolio with a long-term view. With lower, yet healthy growth rates, emerging countries, especially China, should continue to demand various commodities. This asset class also offers portfolio insurance against a future spike in inflation, which currently is a low probability. That is not to say that the actions of governments around the world may ultimately prove to be inflationary. On a positive note, there was one commodity that performed especially well during the quarter, and that was gold. As risk-averse investors sought safety, gold charged higher.

## Summary

"If uncertainty is the theme, then how should an institution invest when visibility is extremely low?" We continue to believe that, with the looming uncertainty surrounding the sustainability of the global economic recovery, that true diversification is critically important. We are not talking about a portfolio consisting, mainly of equities, diversified across market capitalization levels and geographic regions. If we experience a "double dip" recession in many of the developed countries, all equities will fall. We believe it is critically important to include assets in a portfolio that have different performance drivers and may fall less or actually do well during a period of equity market dislocation.