



Perspective on the Latest Market Events

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After reaching the mid-year point in positive territory, the U.S. equity market started 2009's third quarter on a sour note as investors dumped stocks in response to a series of poor economic reports. The Standard & Poor's (S&P) 500 index, a popular proxy for large U.S. company shares, ended the holiday-shortened week down 2.4%, while small company stocks, as measured by the Russell 2000 index, gave up 3.1% by the close of trading last Thursday. International stocks fared little better, with 2.7% and 1.0% losses in developed and emerging equity markets, respectively.

Investors had plenty of economic news to evaluate before adjourning for the long July 4 weekend. Unfortunately, these reports on balance indicated that the U.S. economy is still struggling to transition from stabilization to expansion. Last Tuesday, the Conference Board's monthly gauge of consumer confidence jolted investors with a 5½-point drop to 49.5 in June, back below the important 50 threshold that marks the boundary between net optimism and net pessimism. The consensus forecast had been for confidence to rise for the fourth consecutive month in June, but nagging concerns about a still-deteriorating labor market and rising gasoline prices knocked consumer sentiment for an unexpected setback.

By last Thursday, consumers' sagging spirits were validated when the government reported that the U.S. economy shed another 467,000 payroll jobs in June, pushing the nation's unemployment rate up to 9.5%, a 26-year high. Similar to analysts' expectations for consumer confidence, job losses in June were significantly above both the 350,000 consensus estimate and the revised 345,000 job losses recorded in May. While employment levels are considered a lagging indicator of economic activity, June's spike in job losses showed that the U.S. economy has still not turned the corner from contraction to expansion.

In between the confidence and jobs reports, investors reviewed monthly data releases on factory orders, auto sales, construction spending, manufacturing activity and residential housing prices. Reported with a month delay, construction spending in May resumed its negative trajectory after April's surprise increase. Factory orders, also reported a month in arrears, notched a noticeable rise over April, but came up slightly short of analysts' expectations. Auto sales in June showed no meaningful improvement from the depressed levels that have persisted since last October, and the new orders component of the June Institute for Supply Management manufacturing index slid two points to a sub-50 level.

Among the best measures of residential real estate prices, and always reported with a two-month lag, the S&P/Case-Shiller Home Price index was perhaps the silver lining in an otherwise disappointing data week. National home prices fell again in April, but both the sequential monthly



and year-over-year rates of decline moderated, helping support many analysts' contentions that a bottoming process in housing prices is underway.

Unprecedented levels of fiscal and monetary stimulus successfully repelled the frightening specter of financial Armageddon earlier this year. Global markets responded accordingly with powerful rebounds that carried many equity indexes up 30% or more from the March 9 lows. In the last couple of weeks, however, this rally has stalled, and further upside in stock prices will most likely require more consistent signs of growth. Moreover, higher long-term interest rates represent a new headwind for a second-half economic recovery, creating yet another challenge for fiscal and monetary policy makers. Specifically, interest rates on the 10-year U.S. Treasury are now almost a full percentage point higher since the beginning of the second quarter, rendering the stimulative impact of the Federal Reserve's asset purchasing program at least partially moot.

Given the still tenuous nature of current economic conditions, our tactical asset allocation recommendations remain defensive overall. We continue to advocate selective increases to portfolio risk in emerging market equity and commodities, but are waiting for clearer evidence that an economic recovery is gaining traction before recommending a full return to normalized risk exposures.

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