



## 2010 – 2ND QUARTER REVIEW AND PREVIEW



### BOB'S CORNER

### NO MORE NIKE SWOOSH!

Since the start of the economic downturn two and a half years ago, we have been saying “this is different.” The now defined “Great Recession” has created many new normals. The new path of the stock market cycle is probably going to affect you more than one thinks.

In the past we have talked about the natural market cycle looking very similar to the Nike “swoosh.” On the left side the market goes down (approx 10-15 months), bottoms out and consolidates in the middle of the swoosh (approx 5-12 months) before the right side shows a steady growth pattern for approximately 50-70 months. We witnessed the November 2007 start of the downturn lasting until November 2008 (12 month drop), followed by a Christmas rally bounce and then the big drop ending March 2009 with the bounce ending in September of 2009 (10 month consolidation). Looks pretty normal to this point, but the expansion that should have started in September 2009 (right side of Nike “swoosh”) has gone sideways and it will take a lot longer before the true expansion will begin. This to me looks more like a soup bowl, deep and long at the bottom before the expansion will start.

Patience will be the key over the next 12-24 months. Keep buying bargains now!

## A Bumpy Quarter – Look for More of the Same

### MARKET OVERVIEW

#### Overview

The economy continued to expand in the 2nd quarter, but all signs indicate the pace of growth has slowed. Domestically, consumer spending remains subdued, the housing market is showing few signs of recovery, and unemployment is stubbornly high. This environment, combined with growing concerns about issues such as European debt problems (in Greece and other nations) left investors on edge. As a result, stocks pulled back significantly in the quarter.

One of the most notable risks confronting the markets today is the potential for fiscal policy missteps by major governments in the U.S., Japan, China and across Europe. Government debt has grown massively across the board, and a major challenge is to unwind massive fiscal and monetary stimulus without damaging a fragile economic recovery. Government leaders need to strike a balance, avoiding dramatic cuts that would put the economy at short-term risk while also demonstrating fiscal prudence to help avoid a permanent slowdown in future growth.

Still, investors should be reminded that the recent correction has created far more attractive stock valuations from a historical perspective. Inflation remains low and bond yields are extremely unattractive to any long-term investor, both factors that should contribute to a more favorable environment for stocks. While economic challenges won't disappear overnight, patient investors should be rewarded over time.

### ECONOMY

#### THE 2ND QUARTER

After showing signs of a rapid recovery in the quarters immediately following the end of the recession, the economy has tapered off a bit at mid-year. After enjoying a growth rate of 5.6% in the 4<sup>th</sup> quarter of 2009, the economy grew at a much more modest 2.7% rate in the 1<sup>st</sup> quarter of 2010. Leading economic indicators have leveled off as well, a sign that the economy may continue to expand, but very modestly, for the rest of 2010.

Even in that condition, the economy represents a significant improvement over the circumstances just 18 months ago. Worker productivity is high, business spending is strong and corporate profits have been improving and are forecasted to continue to do so. The Federal Reserve is likely to maintain its low interest rate policy given the modest level of economic growth and disappointing job situation. This has helped keep mortgage rates low even though the Fed is no longer purchasing mortgage securities and adding liquidity to the market. Broad inflation is at 2% and core inflation just half of that level. Because of this, the Fed has the flexibility to keep rates low, which is usually a positive for the stock market.

Business spending is leading the recovery, with non-defense business investment up 18% over the same period a year ago. Corporate profits have been strong, due in part to low interest rates, limited hiring and improved pricing margins in many industries. A particular bright spot in the economy is the manufacturing sector, which added jobs throughout the second quarter, albeit at a modest level. From a hiring perspective, many businesses remain cautious, preferring to extend work hours and employ more temporary staff. That caution extends to consumers, who are increasingly focused on saving. The nation's savings rate has reached 4% in recent months.

Two key pieces of legislation – one passed, one close to passing – affect companies representing about 30% of stock market value. Specifically, health care reform is now law, and by the end of the 2<sup>nd</sup> quarter, financial reform was on the verge of being enacted. These new regulatory elements have contributed to some of the market's uncertainty in recent months.



## **LOOKING AHEAD**

Modest growth is likely to continue for the rest of the year and the recovery will likely be uneven during that time. We expect the economy to expand at an annualized rate of about 2.5%, substantially below the typical rate of growth coming off of a severe recession. While growth may be slower than desired, we anticipate that economic expansion will prove to be longer and more durable than the average recovery.

The labor market is the biggest concern as unemployment remains slightly under 10%. Given that fact, fiscal and monetary policy likely will need to remain focused on providing economic stimulus until more people are back to work. Housing is also likely to remain weak. As consumers continue their frugality, business spending will need to continue to be the main driver of growth.

## **BOND MARKET**

### **THE 2ND QUARTER**

Bonds generated solid returns in the quarter, which helped investors diversified portfolios weather the storm in equities. Although many forecasters anticipated that interest rates would continue to trend upward in the 2<sup>nd</sup> quarter, a “flight to safety” caused a surprisingly dramatic reversal. The yield on the 10-year Treasury note fell by nearly 1%, to 2.95%, its lowest level since March 2009, the period when stocks bottomed out.

In contrast to previous quarters, higher quality sectors led the turnaround in bonds. The longest maturity-dated government bonds gained 14.9% during the period, while intermediate government bonds returned 3.4% and Treasury inflation protected bonds (TIPS) rose 3.2%. Also performing well were investment-grade corporate bond funds, which were up 2.5%. Intermediate-term municipal bonds returned 1.6% and high-yield municipal bonds gained 2.1%. Returns were more modest for multi-sector bonds 0.6% and ultra-short bonds 0.4%.

Credit-related sectors generally did not fare as well as yield spreads between high quality and credit-related bonds widened. Prominent sectors that actually lost ground during the quarter included bank loan funds -1.4%, emerging market bonds -0.8% and high-yield bond funds -0.6%. Weakness in the euro drove world bond funds lower as well -0.4%.

## **LOOKING AHEAD**

Widening spreads have made corporate and high-yield bond sectors more attractive from an historical perspective. Corporate bond issuers are well positioned, as cash levels are at their highest point in decades and corporate default rates have fallen. Some areas of the global bond market look more attractive as well following the 2<sup>nd</sup> quarter selloff in response to the European debt crisis. Investment-grade corporate, high-yield and emerging market bonds will likely offer the greatest potential in coming months.

It is unlikely that high-quality bonds will be able to match the strength they demonstrated in the 2<sup>nd</sup> quarter. There seems to be limited room for further interest rate declines on government bonds after the significant drop in the 2<sup>nd</sup> quarter. At the same time, rates may not be at risk of a dramatic upturn anytime soon given the weakness in the housing and employment markets.

## **DOMESTIC STOCK MARKET**

### **THE 2ND QUARTER**

Stocks experienced a full-blown correction by the end of the quarter, losing more than 10% across the broad market indexes for the three-month period. Investor confidence sagged with weakening economic data and growing fears related to Europe’s debt problems. The Russell 3000 Index (a measure of broad U.S. stock markets) declined -11.3% during the 2<sup>nd</sup> quarter.

Small and mid-cap stocks again outperformed the broader market while declining a bit less at -9.9%. Growth and value stocks also performed in sync, each declining about -11.0% for the quarter. These near-identical performances exemplified the broad-based nature of the selloff as investors had little opportunity to escape the market’s downturn.

Similar to the bond market, more defensive sectors were able to better withstand the market’s gyrations. Utility and telecom stocks declined only -4.8% and -5.7% respectively, while consumer staples stocks lost -8.9%. All other industry sectors suffered double-digit declines. The worst performers were materials stocks -15.7% and financial stocks -13.6%, as the latter was impacted by uncertainties related to the pending financial reform legislation.



## Performance Update

Market Index	2nd Qtr	YTD	1 Year	2 Years	3 Years	5 Years
DJ Ind Average	-9.38	-5.01	18.83	-4.33	-7.41	1.65
S&P 500	-11.45	-6.66	14.34	-8.11	-9.84	-0.81
Russell 2000	-9.92	-1.95	21.48	-4.55	-8.60	0.37
S&P Mid-Cap 400	-9.59	-1.36	24.93	-5.17	-5.90	2.21
<b>Russell 3000</b>	<b>-11.32</b>	<b>-6.05</b>	<b>15.72</b>	<b>-7.81</b>	<b>-9.47</b>	<b>-0.48</b>
MSCI EAFE	-13.97	-13.23	12.29	-14.73	-13.38	0.88
MSCI Em Mrkt USD	-8.37	-6.16	23.15	-5.88	-2.40	12.72
NASDAQ Comp	-12.04	-7.05	14.94	-4.09	-6.77	0.50
Barclays High-Yield	-0.11	4.51	26.77	11.23	6.54	7.17
Barclays Agg Bond	3.49	5.33	9.50	7.76	7.55	5.54
Barclays Credit Index	2.41	4.82	13.00	8.55	7.20	5.42
Barclays Gov Bond	4.24	5.40	6.46	6.54	7.58	5.37
Barclays Corp	3.27	5.62	14.68	9.25	7.41	5.31

### LOOKING AHEAD

Investors should be prepared for additional stock market volatility in the months ahead. A serious concern is whether corporate profits can live up to expectations in the face of slower-than-expected economic growth. While some profit forecasts may be revised downward, earnings should remain strong as companies continue to manage expenses and benefit from low borrowing costs.

The market may also offer more attractive potential in light of the severe downturn experienced in the past quarter. Looking beyond the headlines, it should be noted that corporate earnings are forecasted to grow by 16% next year. Corporate cash levels are at their highest point since 1963 while corporate cash flow is growing at its fastest rates since 1952. Stocks are selling at a 30% discount to historical levels. While the urge to sell stocks may be strong, the health of corporate balance sheets and earnings indicates that long-term investors are better served by riding out the current volatile environment.

### INTERNATIONAL MARKETS

#### THE 2ND QUARTER

International markets bore the brunt of “euro fatigue” during the quarter as multiple credit downgrades of Greece and other Eurozone sovereign debtors led to a sharp drop in the euro. Year-to-date, Europe’s common currency has lost -15% of its value compared to the dollar. Stock markets reacted with sharp declines

Across the globe, stock markets were down -11.8% for the quarter. European stocks led the decline, off -14.4%, with Japan feeling the effects as well, losing -13.0%. These results were in response to expectations of slower economic growth in both Europe and Japan.

Similar to domestic trends, smaller stocks fared better. While foreign large-cap stocks were off -13.7%, small-cap stocks lost just -9.9% for the period. Emerging market stocks held up slightly better, but still lost -8.9%. The best performing region and sector was emerging Asian stocks, with a decline of -4.3%.

### LOOKING AHEAD

Emerging markets continue to show better value and stronger growth rates than developed markets, and the recent pullback in these stock prices made relative valuations even more attractive. We are attempting to target our investments in countries and regions with the best relative growth and valuation prospects. These include investments in Emerging Asian markets and in Brazil.

We have also added back a Foreign Small-Cap investment to our long-term strategic allocation, while tactically trimming our funds with exposure to Europe and Japan. Europe’s ongoing sovereign debt concerns and Japan’s aging demographics may dampen long-term investment prospects in those regions.

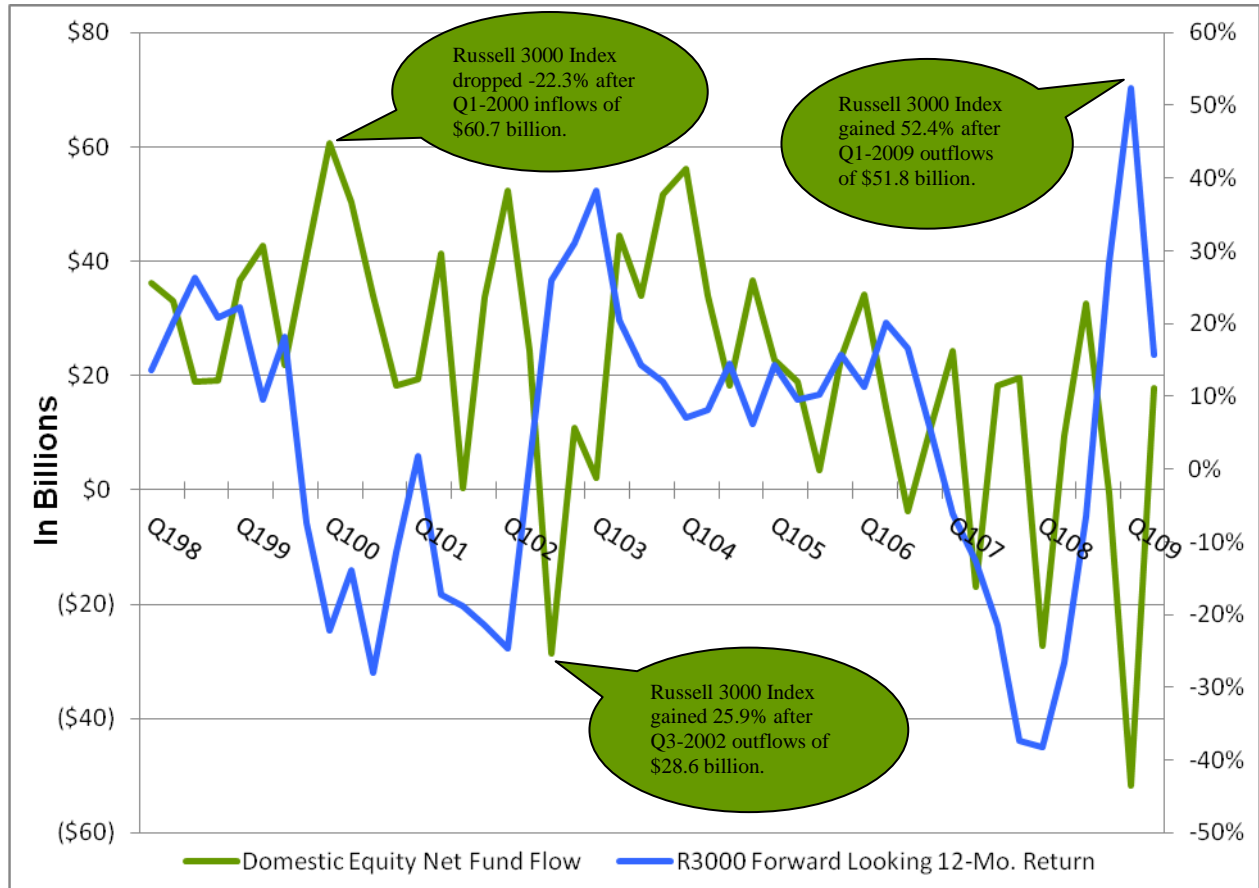
## SUMMARY

The overriding question for investors going into the 2<sup>nd</sup> half of 2010 is whether the slowdown in the economy will ultimately lead to a “double-dip” recession. It is too early to tell, though double-dip recessions are rare events. The most likely outcome is that we will experience slower economic growth driven by higher debt levels that are starting to be reduced, slower consumer spending and cautious business hiring.

In this environment, particularly on the heels of a significant stock market correction, it would be a mistake for investors to abandon long-term equity allocations. Stock valuations are currently about half of the level they reached prior to the financial crisis and technology bubble. Even slow economic growth represents an improvement over the severe recession we experienced until the middle of 2009. Greater pricing risk may actually exist in Treasury bonds and Gold than in the stock market given today’s prices. The road toward long-term sustainable growth will be bumpy, but we are here to provide stability during these volatile times.



### Are Investors Buying High & Selling Low?



Whether most investors want to admit it or not, the emotions of **greed** and **fear** drive a lot of their investment decisions. There is plenty of statistical evidence that shows how the average investor is not successful at “timing” the markets. The majority of investors buy high and sell low. For example, the first quarter of 2000 saw the largest quarterly inflow into domestic stocks (**more than \$60 billion**) since this data has been collected by Morningstar. The subsequent 12-month return of the Russell 3000 Index (3/31/00-3/31/01) was **-22.3%**. Another more recent example was the first quarter of 2009, when we saw the largest quarterly outflow from domestic stocks (**more than \$51 billion**). The ensuing 12-month return of the Russell 3000 Index (3/31/09-3/31/10) was **52.4%**. These are two examples that give credence to the belief that the herd does not always know when to buy and sell stocks.

Over the past quarter there has been a glut of negative economic news, starting with the sovereign debt crisis in Europe, the debt-burdens of the American consumer, along with the fear of a rising interest rate environment. One cannot ignore these factors when making their investment decisions; however these issues do not guarantee investment “failure” for the near or intermediate future. The question you need to answer is, “What is the long-term value in the market and if everyone is scared and selling doesn’t that mean I should be buying?” Our view is that the market is a great value today when we look 3-5 years down the road!

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