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## Perspectives

July 27, 2010

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*For the past few quarters, we have urged investors to remain cautious and recognize the possibility of renewed volatility and more modest returns until the longer-term economic uncertainties can be favorably resolved. During the second quarter of 2010, volatility did return, with the domestic equity markets correcting after four straight quarters of considerable gains. Yet, our overall investment thesis has not materially changed. While there remains considerable uncertainty about the longer-term sustainability of the recovery, we expect that, given the current conditions, it will continue, albeit at a restrained pace. We believe that the recent weakness in the U.S. equity markets represents an overdue correction and an example of the type of volatility that investors may now be forced to anticipate but that it does not amount to the inception of a new bear market. We also continue to expect that, over the shorter term, the likely persistence of low inflation, accommodative monetary policy, and moderate economic growth should favor risk assets such as equities and corporate bonds over risk-free assets such as Treasuries.*

### REVIEW

**U.S. Equities.** After four consecutive quarters of positive returns, the equity markets turned sharply negative – and more volatile – in

the second quarter, with each of the major U.S. indices entering into correction territory. The quarter actually began with continued gains, and, by late April, the Dow Jones Industrial Average and the S&P 500 Index had reached their highest levels since the week in which Lehman Brothers filed for bankruptcy protection in September of 2008. By early May, however, concerns surrounding the Greek debt crisis had developed into widespread fears that the crisis would spread throughout Europe. These concerns were compounded by lingering uncertainties about the global recovery, increasing fears that China would react too quickly to restrain its rapid growth, and the mysterious “flash crash” of May 6<sup>th</sup>, in which the Dow suddenly fell nearly 1,000 points before it could stabilize and recover much of those losses by the end of the day.

On a price-return basis, the Dow fell about 10% for the quarter. Taking dividends into account, however, its net loss was 9.4% for the quarter. The S&P 500 lost 11.4%, and the NASDAQ Composite Index lost 12% for the quarter.

In terms of volatility, the S&P 500 moved more than 1% on about 70% of the trading days in May. The VIX, an index that measures market volatility, rose above 45 on May 20<sup>th</sup> for the first time since the

beginning of 2009, but it remained well below its average level of almost 60 during the peak of the financial crisis at the end of 2008. The 10-year average for the VIX is about 22.

**U.S. Fixed Income.** As the European sovereign debt crisis intensified, so too did demand for the safety of U.S. Treasuries. Conversely, demand for riskier investment-grade and high-yield corporate debt declined, with the pace of new issuances falling from the prior quarter. “Spreads” of investment-grade bond yields over Treasury yields rose to over 2.0% from about 1.5% the prior quarter, but they remained well below their 2008 panic levels of over 6%.

The Barclays Capital Intermediate Government Bond Index, which focuses on U.S. government and agency securities, was up 3.3%. In comparison, the Barclays Capital Intermediate Government/Credit Index, which tracks a mix of government and corporate bonds, was up 3.0%; and the Barclays Capital Intermediate Credit Index, which tracks corporate bonds, was up 2.4%. The Barclays Capital 1-10 Year Municipal Blend Index, which includes municipal bonds from around the country, was up 1.8%.

**Real Assets.** Commodity prices experienced substantial volatility

throughout the quarter, as investors sought to reconcile continued signs of global growth with their fears of the European sovereign debt crisis and China's efforts to slow its overheated economy. This volatility was exacerbated by the fact that many commodities are priced in U.S. dollars, which rose in relative value during the quarter. The Dow Jones UBS Commodity Index eventually finished the quarter down 4.9%, but its components were largely mixed.

Concerns about slower growth and the oil spill in the Gulf of Mexico weighed on oil prices. Oil ended the quarter at \$75.63 per barrel, down 9.7% for its first quarterly loss in six quarters. In contrast, natural gas moved higher on predictions for increased demand, rising 19.3% to \$4.62 per MMBTU. Gold was the beneficiary of investors' efforts to protect themselves from volatile markets and currencies. It finished the quarter at \$1,245.50 per ounce for a gain of 11.9%.

The housing market continued to demonstrate some level of stabilization, as prices remained steady on a seasonally adjusted basis through the first four months of the year. According to the S&P Case Shiller Composite 20 Price Index, by the close of April, home prices were up about 0.4% year to date and about 4% over their lows of May, 2009. Foreclosure inventory remains high, however, and sales and construction data released toward the end of the quarter fell short of market expectations.

**U.S. Dollar.** The U.S. dollar continued to benefit from relative weakness in Europe, as investors sought out the relative safety of the dollar even in the face of large deficits and low interest rates in the U.S. The U.S. Dollar Index, which measures the dollar against a trade-weighted basket of currencies, fin-

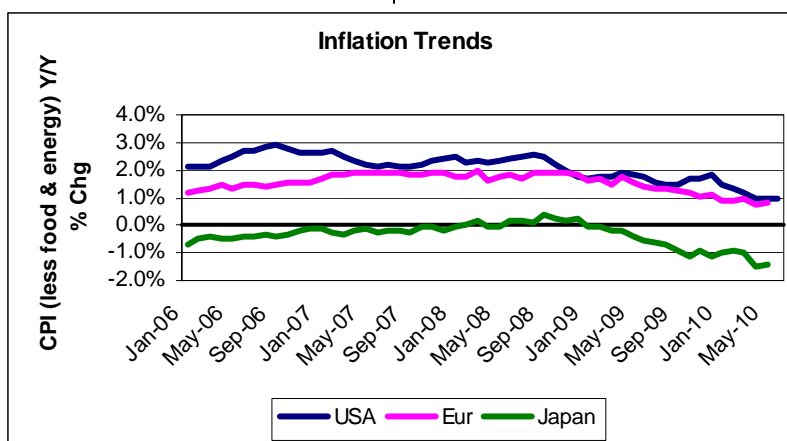
ished the quarter up 6.1%. Meanwhile, as the sovereign debt crisis threatened to undermine the European Union and the viability of the euro as a common currency, the euro fell 8.3% against the dollar during the quarter.

**International Markets.** Like the U.S. markets, the international markets were weighed down by a combination of the woes in Europe, concerns about a possible slowdown in China, and general uncertainty about economic growth in the U.S. and elsewhere. The Dow Jones Global Index, excluding the U.S., was down 12.7% for the quarter in U.S. dollar terms, again trailing all three of the major U.S. equity indices.

asia, and Far East) Index of developed economies lost 14.0% for the quarter. Again, major indices in Greece, Spain, and Portugal all suffered significant losses, and even the larger European markets generally were unable to remain positive during the second quarter. The United Kingdom's FTSE 100 lost 13.4%; Germany's DAX lost 3.1%; and France's CAC-40 lost 13.4%.

## ANALYSIS

While the precise causes of the recent market declines are multifaceted, the overall phenomenon can be simplified into a single word, "fear." More specifically, investors around the world fear that



Last year, China was among the top performers in the world. This year, investors are concerned about overheated Chinese inflation and property markets, as well as the likelihood of mitigating action from the Chinese government. Consequently, on the heels of its first-quarter losses, the Shanghai Composite Index moved into bear market territory during the second quarter, falling an additional 22.9%. In other emerging markets, the Hang Seng lost 5.2%, and the Brazilian Bovespa lost 13.4%. The MSCI Emerging Market Index lost 8.4% for the quarter.

The MSCI EAFE (Europe, Austral-

self-sustaining growth has not been achieved and that a renewed contraction – a “double dip” recession – may be on the horizon.

We do not dismiss as unfounded the possibility of a double-dip recession, but we believe that fears of its probability are overstated given the current conditions. The correction experienced by the financial markets during the second quarter was not unusual, particularly given the magnitude and uninterrupted nature of the gains leading up to that correction, and history suggests that double-dip recessions are rare. Our investment thesis remains the same: the

recovery that began last year will likely be moderate, fragile, and uneven, but it should be sustained in the absence of any further major shocks to the global economic system. Longer-term, however, a relapse remains a real possibility without the removal of growth impediments such as high unemployment, housing weakness, high budget deficits, and deleveraging.

In the current environment of low inflation, accommodative monetary policy, and moderate economic growth, we continue to favor risk assets such as equities and corporate bonds over risk-free assets such as Treasuries. Longer-term, however, we remain prepared to assume a more defensive tactical posture when necessary.

**Monetary policy should remain accommodative until there are further signs of economic strength.** There have been two

nificant tightening in the U.S. by the end of 2010 now seem unrealistic. Inflation remains contained, with the U.S. core inflation rate nearly at a four-decade low in the face of continued high unemployment and weakened housing markets. Trends in Europe are similar, while Japan actually is in a *deflationary* environment, as shown on the graph on page two. Of course, commodity-producing nations such as Canada and Australia, as well as certain emerging economies, have been or may begin raising rates this year, but the general trend among the world's major economies is for continuing loose monetary policy.

**The European sovereign debt crisis is cause for concern, but the European Union should hold together, and, barring further setbacks, the crisis should not derail the global recovery (although it may be slowed in Europe).** Greece has been at the

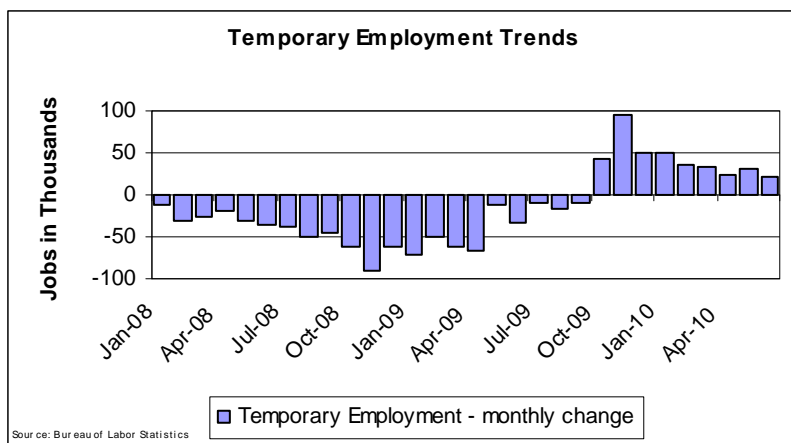
concerns about the recovery in Europe, further limit the international credit markets, and even threaten the future of the European Union.

These are real concerns, and we must follow the course of events as they unfold in Europe. Nevertheless, in May, the International Monetary Fund, the European Union, and the Euro-zone governments announced a €750 billion plan to bolster the troubled sovereign debt. They also imposed fiscal restraint throughout the European Union.

In the end, if Greece cannot resolve its fiscal problems, it might be forced out of the European Union, but we believe that, barring further setbacks, the remainder of the Union should hold together. We are far more concerned that the efforts of Euro-zone countries to impose fiscal restraint could slow down the recovery in Europe and now believe that the prospects for growth in the U.S., where fiscal restraint has not yet been imposed, have improved relative to Europe.

**Consumers continue to struggle, but progress has been made to improve their financial condition.** Total household-sector debt is down \$600 billion from the all-time high reached in 2008 – the most significant drop of its kind since the 1950s. Moreover, income growth has improved for those employees with a job, further aiding consumer health.

Job creation, however, will be the ultimate determinant of the direction of consumer spending. Thus far, employment trends have been volatile, and job creation has been disappointing, stoking fears of a “jobless recovery.” See the graph on this page. Average weekly hours are up, as companies evidently have preferred to increase the hours of current employees rather than hire new ones. Employment itself has also risen, but the rise has been modest. The June payroll report showed only



instances of double-dip recessions in the U.S. – in 1931 and 1981. One conspicuously common feature of these two events was a premature tightening of monetary policy.

With regard to the current recovery, it appears likely that any substantial tightening of monetary policy in the U.S., Europe, or Japan is still several months away. Indeed, prior calls by some for sig-

center of the European sovereign debt crisis, but its overall debt burden is relatively small. The larger concern is that Greece's problems may foreshadow the problems of other Euro-zone countries, such as Portugal, Italy, Ireland, and Spain, which, together with Greece, owe some \$5.5 trillion to foreign creditors. Banks in Germany and France hold approximately \$1.6 trillion of this debt, and any significant default on the debt could fuel

83,000 new jobs in the private sector. Nevertheless, the rebound in temporary employment is exceeding past recoveries and is viewed as a leading indicator of permanent employment. Relative to other cycles, the improvement in non-farm payroll growth is only slightly lagging, and we currently project sufficient growth to sustain the recovery. As we have written before, we estimate that, given current demographic trends, employment must rise by more than 150,000 jobs per month in order to reduce the unemployment rate, and we will be watching future labor trends to see if that target is met.

**A gradual revival of capital spending should bolster the recovery.** During the recession of 2008-2009, business investment

has been strong. As long as profits continue to grow, companies generally have ample capacity to make capital investments. Historically, the gap between the return on capital and the cost of capital has been correlated with the capital spending cycle. With capital returns exceeding the cost of capital by the greatest margin in the past 30 years, the incentive for firms to invest is apparent.

**Relative fundamentals support select risk assets.** We believe that the U.S. equity markets should continue to find support in the remedial combination of rising earnings, low inflation, accommodative monetary policy, and moderate economic growth. As mentioned above, they should also be supported by strengthening corporate

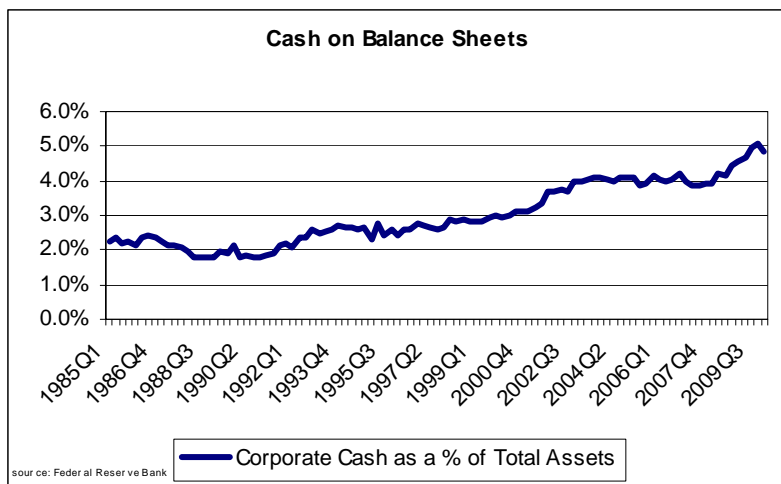
for relative strength, having recently been held back by fears stoked by the European sovereign debt crisis. As discussed above, spreads have moved higher and could fall on the strength of corporate balance sheets and earnings.

Internationally, we continue to favor select developed and emerging markets. We also favor a wide range of commodities that can benefit from increasing emerging-market demand.

## CONCLUSION

Despite the correction experienced by the financial markets in the second quarter, the recovery process continues, and near-term conditions appear to remain favorable for select equities, corporate bonds, and other risk assets. Inflation remains low; monetary policy remains loose; corporate earnings and balance sheets are improving; and the economy is growing, albeit at a moderated pace.

Longer term, uncertainty persists, exacerbated by the crisis in Europe. Problems such as unemployment, housing sector weakness, restrained credit, high budget deficits, and deleveraging cannot be ignored. Until they are resolved, the longer-term sustainability of the recovery will continue to be in question. We remain alert and prepared to make tactical moves in response to any significant signs of deteriorating conditions.



spending fell to its lowest level relative to GDP since the 1970s. In our view, this is not a sustainable situation, and it sets the stage for the return of capital spending. Thus far, the rebound in capital spending has been anemic, reflecting the cautious mood of the corporate sector. Yet, the sharp reduction in capital stock over the past three years and the pressure to sustain productivity gains argue for a more robust spending recovery.

U.S. corporate balance sheets are in solid shape, and profit growth

balance sheets. By some measures, as seen in the chart above, there has never been more cash on corporate balance sheets.

Valuations appear to be reasonable by historical standards, with the S&P 500 trading at 15.5 times trailing earnings and 12.6 times forward earnings (based on analysts' expectations as reported by BCA Research). By way of comparison, the historic median forward price-to-earnings ratio of the S&P 500 is approximately 14.8.

Corporate bonds are also poised

Sources: BCA Research, FactSet, Bloomberg, FHS Investment Consulting Services, Market Analysis, Research and Education, and the *Wall Street Journal*.

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