



HALFTIME REPORT – SURVIVING THE STORMS

The first half of 2010 has brought a variety of storms – some from Mother Nature, others from an economic and financial perspective. While we can't do much about the weather we can, as investors, take an in-depth look at where we are now and also at some economic indicators to help us understand what the future may bring.

The financial markets have been on a choppy course so far in 2010, especially in the second quarter. The broad, domestic markets swung from a 7% – 9% year-to-date gain in late April, to a 10% year-to-date decrease at the end of June (www.bigcharts.com). The economy is facing a number of headwinds, which are creating this volatile environment. I am referring to weak employment data, increasing government debt, debt issues in Greece, and a disaster in the gulf.

Through most of the first half of 2010 many economists agreed that a “double dip” recession seemed extremely unlikely. Then as the end of June approached, the whispers became louder that this was a real possibility. The news media along with many jittery investors stoked this fire; however, there is much economic data and other research that indicates that there is not much of a threat of this actually happening. Despite the headwinds mentioned above, we are seeing economic growth, albeit slower than prior recoveries, which will continue to drive this recovery. Additionally, we expect to see improvement in corporate earnings over the next quarter, which should provide some stability to the markets.

A number of items we are keeping an eye on and will summarize below include China's decision to let their currency float (appreciate) vs. the U.S. dollar, interest and inflation rates, the housing market, and unemployment. Each of these items has had some economic and financial impact over the last six months and will continue to be important to our economic recovery.

In recent years, China had pegged their currency, the Yuan, to the U.S. dollar, which maintained attractive prices of Chinese imports and helped drive the trade deficit between the two countries. Now, China has decided to let their currency float vs. the U.S. dollar, just like almost every other country does. This could have significant implications for us as well as China. For the Chinese, this step will lower inflation vs. U.S. inflation and will raise the standard of living for Chinese citizens. Why is this important to us? As the Chinese citizens' global wealth and purchasing power increases, they will be inclined to spend a larger share of their income. This can benefit the U.S. economy (and others) by increasing demand for our goods and services. Additionally, this could reduce our trade imbalance with China and subsequently reduce the demand for U.S. Treasuries (this may also alleviate the fear that China owns too much U.S. debt), which can impact interest rates.



In the first half of 2010 interest rates have remained low. The Federal Reserve has indicated they will continue to leave rates at record low levels until they see economic growth at a sustainable level. That has translated into a decrease in mortgage rates and significant increases in the profitability of financial institutions. Additionally, the uncertainty in the stock markets has driven demand for lower risk investments like U.S. treasuries, which drives down interest rates on those types of investments. As demand rises for U.S. treasuries, prices will rise, which then decreases the yield on these investments. We expect interest rates to begin to increase by early to mid-2011.

We have all heard much about the 2008 meltdown in the housing market that helped triggered the most recent recession. A prolonged period of low interest rates drove home prices higher, encouraged unsustainable borrowing practices, and expanded sub-prime lending practices. While we have seen some improvement in the housing sector, much of the improvement vanished after the incentives disappeared, similar to the Cash for Clunkers program that drove up auto sales temporarily. A significant drop-off followed when incentives expired. We are just now starting to see a natural recovery in auto sales. We expect a similar pattern to follow the home buying incentives, which recently helped drive home sales. As expected we are seeing home sales figures weaken which we expect to be followed by a natural recovery over the next year or two.

Unemployment has continued to recover at a slower rate than prior economic recoveries and we expect that trend to continue; however, we can balance that with some encouraging news. According to a June 9, 2010 article in the USA Today, which quoted Steven Davis, an economist from the University of Chicago, more people quit their jobs in the past three months than were laid off. Additionally, in a recent article by Ruth Mantell from Marketwatch, she reports that delinquencies on credit cards dropped to 3.88% in the first quarter – the lowest rate since the first quarter of 2002. In the same article she notes that delinquency rates on home mortgages have declined in the first quarter of 2010, according to the American Bankers Association chief economist. These items are very good news and even though we have mixed reports on the unemployment picture, this is the type of data we look at to help clarify what is really going on in the economy.

What does all this mean for your financial future? Well, first you should expect a continuation of the volatility we've experienced in the second quarter. The uncertainty of tax rates, health care reform, and other "headwinds" we reviewed here will all be contributing factors to the volatility. By the end of 2010 and into 2011 we expect to see interest rates and inflation begin to rise. This is an ideal time for bond owners to do a portfolio evaluation to determine how much interest rate risk your portfolio is subject to. Additionally, as we see inflation increase, real assets (e.g., real estate, commodities), can provide a hedge to a portfolio.



There are many issues beyond the control of individual investors that can impact the economy, investment markets, and your portfolio. The key to financial success is to control those areas that can be controlled, such as taking advantage of current tax laws, keeping a well-diversified portfolio, and also keeping the proper perspective. Consider the grim outlook before us in late 2008 – we were headed for a repeat of the great depression, the stock markets were headed to zero, and much of the economic chatter revolved around bailouts, down-sizing and bankruptcies. In reality, the road to recovery is long and hilly, but I believe we are weathering the storm and making strides towards sustainable economic growth.

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