



A Bumpy Ride for Investors

May 25, 2010

After a tumultuous week in the markets last week, investors remain shaken by market volatility that may continue as Europe's debt crisis deepens. Although current markets may be oversold and ready for another bounce up, they may fall further in the near term. But odds favor at least a partial recovery of recent declines, particularly in Asia, where markets have already experienced a significant drop.

Despite current market volatility, economic fundamentals remain strong:

- The U.S. economy continues to recover.
- U.S. corporate earnings continue to beat expectations.
- Employment continues to improve.
- Home sales are rising.

We believe investors should position themselves for an upcoming reduction in market volatility, continued recovery in the U.S. economy, and a return to stability in the financial markets as economic fundamentals continue to improve. Although we don't believe the current crisis in Europe will create a double-dip recession, we do believe it's a strong headwind for European growth.

Market Volatility, Credit Concerns Continue

The Chicago Board of Options Exchange Volatility Index (VIX) climbed 28% to 40.10 last Thursday – a 157% increase since April 12 and its highest level since March 2009. The volatility was largely a result of **Europe's unresolved sovereign debt crisis and doubts about the health of the European banking industry**. Since it will take time for individual European governments to agree to new fiscal rules, we anticipate that continued uncertainty will keep volatility high and the market at lower levels than normal.

The Eurozone's debt crisis has also had a negative impact on the credit markets, and as a result, banks are becoming less willing to lend to each other. On Monday, LIBOR (London interbank offered rate – the rate that banks pay for three-month loans) rose to 0.536% -- a 10-month high. On Tuesday, the TED spread (the difference between what banks pay to borrow from each other for three months and the interest rate for three-month Treasury bills) increased to 0.369% – the highest since July 2009. Still, these rates are still not that high on a relative historical basis.

Volatility has also been caused by the **U.S. financial reform bill**. Passage of the Senate bill on Friday was welcomed by investors and sent the markets and financial stocks higher. The bill now heads to the House Financial Services Committee to be reconciled with the House bill. We believe that the final bill will be more market-friendly than the Senate version and that it will be supportive of further market gains and financial stock price gains.

U.S. Equities Remain Attractive, but Not Without Risks

Prospects for U.S. equities remain good. Our price target for the S&P 500 is 1250 for year-end. (The index closed at 1073.65 on Monday, May 24, 2010). We're keeping our price estimates restrained, though, due to the slowing Eurozone and the looming threat of higher U.S. taxes and the negative effects of a massive U.S. budget deficit.

Sectors we currently like:

- **Financial sector** – The financial reform bill is wrapping up and should be less onerous than feared. Many financials are selling at or below book value. Earnings power is significant at many of these firms, and credit quality is showing significant improvement.
- **Consumer discretionary sector** – Consumer spending is stronger than expected and not fundamentally impacted by issues in Europe. Low inventory levels and cuts in capital expenditures have provided a lot of operating leverage as business improves.

Growth Indicators Remain Strong in Emerging Markets

International equity markets have been under intense pressure recently, but growth indicators remain strong in emerging markets, particularly Asia.

- **Emerging Markets** – Continued global economic growth and falling commodity prices may make emerging markets more attractive as these countries reevaluate the need for economic tightening adjustments.
- **Eurozone** – Although the European Unions' rescue package for economically distressed countries should help European markets recover, we believe it's still advisable to stay away from the debt-burdened countries of the Eurozone.

Corporate, High-Yield, and Municipal Bonds Will be Less Impacted by Rising Interest Rates

We expect moderate increases in interest rates during the next six to 12 months as the U.S. economy continues to recover. Treasury securities will be hurt most by the rising rates. Corporate, high-yield, and municipal bonds will be less impacted by the rising rates and may be good investment choices. Rising tax rates will no doubt make municipal bonds more attractive. Expect low- to mid-single-digit fixed-income returns during the next 12 to 18 months – similar to the 2004-2006 period.

The unmanaged **S&P 500 Index** tracks the performance of 500 U.S. large company stocks.

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