



Monthly Economic Update

June 4, 2010

The Month in Brief

Stocks corrected sharply, as the S & P 500 Index turned in the worst performance in the month of May since 1962. European debts and rumors about a slowdown in China hung like dark clouds over the global equity markets and diverted attention away from positive trends in earnings and other encouraging indicators in the recovering U.S. economy.

Domestic Economic Health and Financial Markets

Consumer incomes outpaced consumer spending in April. While personal spending was flat, wages rose 0.4% and disposable incomes grew 0.5%, forcing the personal savings rate to increase by half a point to 3.6%. Consumer inflation stayed under control, as we actually experienced mild deflation in the Consumer Price Index. The unemployment rate kicked up to 9.9% for April, even as the economy added 290,000 more jobs, as more people were encouraged to reenter the workforce.

The consumer sentiment barometers showed monthly gains: the University of Michigan/Reuters survey improved to 73.6, and the Conference Board's index hit 63.3, a level unseen since September 2008. Other economic reports showed increases in industrial output (+0.8%), retail sales (+0.4%) and durable goods (+2.9%) during April.

On the political front, the Senate passed its version of the financial industry reform bill with a 59-39 vote on May 20th; the next step is reconciliation with the House bill passed in late 2009. The final law is scheduled to be completed in June, as the Democrats are pushing for President Obama's signature by the July 4th weekend.

In financial markets, the S & P 500 Index ended the month with an 8.2% monthly loss that more than erased the gains for the first four months of the year; after five months the market had lost 2.4%. As markets gyrated during the month, the VIX "fear index" doubled to over 45 in May, which was the biggest monthly percentage increase since October 2008.

Global Economic Health and Financial Markets

The whole world watched Europe, fearing that the EU/IMF plan to ease the debt burden on Greece and the other PIGS (Portugal, Italy and Spain) wouldn't be enough to save the European banks and spreading yet another banking crisis across the globe. The 27 European Union governments have now amassed debt equal to 80% of the EU Gross Domestic Product, causing speculation about a double-dip recession in the Eurozone, or even a protracted period of debt deflation. German chancellor Angele Merkel's mid-May opinion that the bailout effort had "done no more than buy time" demonstrated the frustration of Germany and others with the chronic fiscal mismanagement of the southern "Club Med" EU participants. But more recently

she has shifted to professing a more constructive and realistic “we will do whatever it takes” attitude.

Also, new tensions between North Korea and South Korea surfaced in late May, adding to global financial concerns. Meanwhile, Japan’s household spending retreated by 0.7% in April (better than the -2.5% economists expected), and its unemployment rate reached 5.1%. Manufacturing indexes in China, Taiwan, South Korea and Australia all pointed to further expansion in May, though the pace of expansion was slower than in April.

It was a dismal month across the globe for equity markets, with a few markets recording gains, but most following the lead of the United States. Most of the Eurozone countries showed losses for May somewhat below those of the U.S., with the notable exceptions of the Australia, Spain and Russia markets that experienced double-digit losses. In dollar terms, the MSCI World Index lost 9.91% and the MSCI Emerging Markets Index fell 9.18% in May.

Commodities Markets

On a brighter note, gold futures capitalized on the fear and turmoil, gaining 8.88% in May. The other notable commodities gains included: coal, +7.72%; milk, +7.59%; pork bellies, +6.30%; orange juice, +5.62%; silver, +5.15%. The major monthly declines included oil (-11.89%), gasoline (-12.46%), copper (-12.62%) and at the bottom, sugar (-14.47%). The U.S. Dollar Index benefitted from the financial and geopolitical uncertainty and gained 6.00% against a basket of currencies in May.

Housing & Interest Rates

The housing numbers were influenced by expiring tax breaks, an expiring school year and warmer weather, but they were still encouraging: existing home sales rose 7.6% for April according to the National Association of Realtors, and the Commerce Department had new home sales up 14.8% that month (and 47.8% above year-ago levels). Pending home sales, affected by the same phenomena, were 5.3% higher in March and reached a five-month peak. Housing starts increased by 5.8% for April, but the Commerce Department had building permits down 11.5% - again, an effect of expiring federal credits.

With no murmurs of the Federal Reserve hiking interest rates in the near future, average rates on assorted home loans remained low. In fact, they went lower. According to Freddie Mac’s Weekly Primary Mortgage Market Survey on May 27th, the average rate for a 30-year FRM was 4.78% versus 5.06% a month earlier. The average rate for a 15-year FRM went from 4.39% to 4.21% during the same period, while 1-year ARMs dropped from 4.25% to 3.95%.

June Outlook

As we enter the summer months, there are many unanswered questions about whether the austerity measures and bailout package in the European Union will restore investor confidence and trigger a resumption of the cyclical bull market in stocks and other risk assets. In our view, the stock market selloff is likely overdone and not reflective of the positive cyclical forces that are surfacing as the recovery progresses. While the recovery faces major headwinds a few quarters into the future, and the GDP growth rates for the U.S. and other developed countries will probably be lower than average going forward, we do not subscribe to the “double dip” thesis.

While we are not without worries, we see liquidity continuing to improve, profits strengthening, reasonable valuations and a recovery that is staying on track. This should be a positive environment for stocks and corporate bonds, but the gains over the next few months will be uneven and subject to violent movements based on perceptions about unfolding economic and political events.

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