

On the Horizon – A Slower-Paced Economic Recovery

Two significant investor concerns during the second quarter were the sovereign credit issues in Europe and the BP oil spill in the Gulf of Mexico. Standard & Poor's (S&P) downgraded Greece's debt rating to junk status in April. S&P also cut the debt ratings of Spain (to AA) and Portugal (to A-) and issued negative outlooks. Strikes, rioting, and demonstrations, particularly in Greece, have underscored the difficult austerity measures being undertaken by governments trying to repair balance sheets that have faltered under the weight of enormous unfunded entitlements. These fiscal constraints will limit additional stimulus programs and call into question whether the economic recovery in Europe will falter, resulting in a double-dip recession. At the same time, defending the Euro has come under increased pressure—both politically and financially as the fiscally stronger countries in the European Union are questioning the extent of their additional aide to the fiscally weaker countries.

Day # (fill in the blank) and counting. As the number of barrels of oil spewing into the Gulf of Mexico increases as a result of the Deepwater Horizon drilling rig explosion on April 20, the growing effects on the Gulf region can be felt in terms of the ecology and tourism. Overall, the national economic impact of this disaster is more uncertain. While the fishing and tourism industries are certainly operating at reduced levels, a completely new industry of remediation is just beginning. Many feel that the six month moratorium on drilling in the Gulf will have the largest economic impact, and that issue currently is tied up in the courts.

Another event impacting the markets was the “flash crash” that occurred on May 6, 2010, when the Dow Jones Industrial Average plunged 998 points in less than a half-hour before quickly rebounding nearly 400 points, the largest single trading day decline in Dow history. This sudden and still unexplained drop underscores just how fragile the domestic market recovery could be if the public was spooked into retrenching and possibly even halting the nascent economic recovery.

In economic news, unemployment continues to remain stubbornly high. The Labor Department reported that June's unemployment fell to 9.5% from 9.7% in the previous month, reflecting a decrease in the size of the labor force as more and more unemployed quit looking for work and are no longer counted in the potential labor pool. State and local government layoffs moderated in June with 10,000 positions trimmed compared to 85,000 job losses in the first five months of 2010 and 190,000 job losses since June last year. Another potential headwind is an estimated 400,000 job cuts from state and local governments seeking to close budget gaps for fiscal year 2011 that typically begins on July 1, 2010.

Housing demand remains weak as builders broke ground on fewer new homes in May than anticipated after the expiration of the government's incentive tax credit. Overall housing starts fell 10% with single-family starts down 17% – the largest drop since 1991. In addition, building permits – a sign of future construction – fell to a one-year

low. The National Association of Realtors reported that the number of contracts to purchase previously owned houses plunged 30% in May helping to confirm that the tax credit did help pull some sales forward into the early part of 2010 – much like the effect seen in auto sales following the “Cash for Clunkers” government program that ended in 2009.

The Department of Commerce’s report of the first quarter’s Gross Domestic Profit has been revised downward to 2.7% from the initial 3.2% estimate and a subsequent first revision of 3.0%. These results indicate a significant slowing from the 5.6% increase in fourth quarter 2009 GDP. Consensus estimates are for the economy to grow in the low 3% range for both 2010 and 2011, but the trend has been to rein in growth estimates. Further complementing the low growth scenario, Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, made recent comments that “with only a slow reduction in the unemployment rate forecast, inflation is likely to remain subdued.”

Total estimated operating earnings for the companies in the Standard & Poor’s 500 Index are around \$82 for 2010 and \$95 for 2011. With a June 30 Index value of 1030, this implies a price-to-earnings (P/E) ratio of 12.6 times 2010 earnings estimates that is below the midpoint of the P/E range over the last quarter century.

Portfolio Positioning - Growing More Positive on Stocks

Our basic message regarding the economy has not changed over the last several quarters in that we expect the economic recovery will be subdued well into 2011. We are, however, becoming more positive on the outlook for stocks as we believe that with 10-year U.S. Treasury notes yielding just under 3%, the long-term risk/reward opportunity now favors stocks.

The rally experienced in the equity markets during the first quarter continued into April. Unfortunately, by the end of May, broad index levels generally were below year-end levels. As the second quarter ended, most major market indexes were hovering near their lows so far during 2010. Historically, summer has often seen lower index levels as the market seems to go away on vacation, but we remain comfortable adding to stocks opportunistically and believe market valuations are attractive.

For fixed income investments, we now expect that interest rates will remain subdued for a longer period than we had previously anticipated. For clients with an allocation to bonds, we continue to see value in callable U.S. Agency bonds and higher quality corporate and municipal issuers. The next Federal Open Market Committee meeting is scheduled for August, and we anticipate that the Committee will continue to keep the Federal Funds Rate in the current 0.0%-0.25% range. When the Federal Reserve does decide to increase short-term rates, the actions may be swift to demonstrate its resolve to avoid the next bubble and keep inflation in check.

As always, we thank you for your support and welcome your comments.

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