

Summary

The economy is showing additional signs of slowing down as the pressures of elevated energy and food prices impact various segments. The consumer seems to be the hardest hit as higher costs, combined with low wage growth and soft housing values, have reduced the ability to spend on other items. As the consumer reduces discretionary spending, the manufacturing side of the economy is starting to feel the impact. The Institute for Supply Management (ISM) manufacturing index fell sharply in May in virtually all areas of the index. While it is still above the 50 level that indicates growth, the amount of growth has slowed as the index returns to levels last seen in the fall of 2009. The Leading Economic Index also fell in April for the first time since June 2010. With these signs of weakness, companies seem reluctant to increase employment. In May, the private sector had the smallest jobs gain in nearly a year.

While these indications of slower growth are concerns, we continue to view this as a slowdown, not the beginning of the next severe downturn. The consumer appears to be adjusting to the new economic scenario. Various consumer confidence indicators show positives and negatives, depending on their focus, which we take as an indication of crosscurrents in the economy. Since the positives are not able to outweigh the negatives, the result should be a continuation of slower growth. As the year progresses and the negatives are worked through, the positives may once again take the lead and move the economy back on an upward growth path.

POSITIVES

- ❑ Rise in ISM non-manufacturing index in May
- ❑ Fed remains committed to keeping short-term interest rates at low levels
- ❑ Consumer continues to spend, just at a reduced rate on discretionary items

NEGATIVES

- ❑ Weakness in nonfarm payrolls and rise in unemployment rate
- ❑ Housing market remains soft with foreclosures appearing to increase
- ❑ Growth in manufacturing sector slowed due to reduced order levels

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- ❑ Impact of conclusion of QE2 stimulus program
- ❑ Congressional resolution to the debt ceiling issue

Summary

Overwhelmed by a cascade of weak economic reports, equity markets in the U.S. came under pressure in May. The S&P 500 declined 1.13%, with similar losses in the Dow Jones industrial average and NASDAQ Composite Index. Although, year-to-date through the end of May, the S&P 500 returned 7.8%.

Defensive sectors continued a winning streak that began in April, with staples and health care gaining 2.4% and 2.2%, respectively. The weakest sectors in May were energy, down 4.6%, and financials, off 3.4%.

Foremost in investors' minds may be the lack of meaningful employment growth in U.S. labor markets and the headwinds that corporate profitability faces as a result.

While negative earnings revisions may be in the cards this summer, to date this has not been the case. The fits and starts in the market recently may be a reflection of investors dealing with pockets of deflation in housing and wages and a structurally high rate of unemployment, not a concern about earnings in general.

That said, with the S&P 500 closing at 1,345 on May 31 and consensus estimates of approximately \$98 in earnings, the market's current price-earnings ratio is 13.6. With 10-year U.S. Treasury yields under 3.0%, equity markets do not appear overvalued. We continue to hold a 5% cash reserve in all equity accounts and will use the current pullback to add to stock positions.

POSITIVES

- ❑ Strong corporate earnings
- ❑ Valuations reasonable
- ❑ Third year of a presidential cycle

NEGATIVES

- ❑ Employment not gaining traction
- ❑ Housing prices double dip
- ❑ Inflation acting as a tax on consumption

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- ❑ Outcome of European sovereign debt crisis

Summary

Fixed income returns were up again in May following a strong April, a contrast to the bleak returns of the first quarter. Treasury yields declined across the curve with intermediate maturities again declining the most. The yield of the 5- and 7-year maturity Treasury notes declined 27 and 28 basis points, respectively, while longer and shorter maturities declined by a lesser degree. With this occurring two months in a row, the yield curve has flattened from the 2-year to the 5-year by just over 20 basis points and steepened from the 5-year to the 30-year by almost 30 basis points. This fairly dramatic transformation of the yield curve over a two-month period is consistent with the belief that short rates are likely to remain low for a longer period than previously thought, while concerns about higher inflation remain elevated. Corporate credit underperformed during the month as financial sector spreads widened due to increasing concerns over a slowing economy, increased capital requirements and litigation risks. As measured by the Barclays Capital Government/Credit Index, the market returned 1.46% for the month, bringing the year-to-date total to 3.09%.

Unlike last month, rates are not declining solely due to the increasing turmoil in the European debt markets, specifically the Greek bailout. A steady drumbeat of disappointing economic reports has been driving investors to the safe haven of fixed income securities. After growing only 1.8% in the first quarter, economists have been forced to ratchet down expectations of gross domestic product (GDP) for the second quarter and the entire year. It appears the economy will remain below trend growth for the foreseeable future.

POSITIVES

- ❑ Economic indicators show increasing softness after weak GDP report
- ❑ Core-level inflation remains well contained
- ❑ Uncertainty in European debt markets
- ❑ Geopolitical turmoil in the Middle East and North Africa

NEGATIVES

- ❑ Rising commodity prices in energy, metals and agriculture
- ❑ Declining U.S. dollar due to expansionary Fed policies (QE2)
- ❑ Little progress towards ending stream of \$1-trillion budget deficits

UNKNOWNNS

- ❑ Investor speculation in commodity prices versus real demand
- ❑ Ultimate resolution of European debt crisis
- ❑ Continued attraction of U.S. Treasury debt auctions to international investors