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2nd Quarter Market Overview: **Adapting to a Dynamic Market**

The fear that once warranted a prayer before picking up the paper and looking at its headlines dissipated during the second quarter. Even though the headlines were still profound, they were not potent enough to rattle the markets. Fraud, bankruptcy, increased regulation and a pandemic littered the headlines, but the market seemed to brush them aside and continue its climb to recovery.

The S&P 500, a broad measure of the 500 largest U.S. companies, was able to pull its head above water by gaining more than 15% for the quarter, which pushed its return for the year to 3.16%. As for the Dow Jones Industrial Average, a condensed measure composed of 30 large U.S. stocks, it, too, had a strong quarter (gain of 11.96%). But that was not enough to pull it into positive territory for the year. It is still off 2.01% year-to-date.

A large reason behind the market's strength was increased stability generated from transparency of all the government agencies during the first quarter. This stability took fear out of the market, lowered the volatility index and allowed some of the sidelined money to get back into the game. Markets that were hit the hardest, emerging and high-yield, were able to bounce back as investors increase their appetite for risk.

As this rally takes a well-deserved and overdue breather, it is a good idea to take a look back at the major events in the second quarter and try to determine their implications on the future. To a pure capitalist, the idea of intervention is one that causes severe anguish, but it was a recurring theme for the second quarter.

Banks were one of the top targets and the first intervention was the consequence of the bank stress tests. A number of banks needed to raise a combined \$75 billion in new capital. The Fed gave those banks a deadline to generate a plan and outline a procedure to raise that extra capital. As always, there were arguments over the validity of the test but, in the end, all of the banks were able to raise the necessary capital through various means. In addition to the revised capital requirements, the government put restrictions on executive pay, dividend increases, hiring foreign workers for U.S. jobs and lavish corporate spending. It also signed a bill into law requiring increased disclosure on credit card statements along with fee restrictions.

Second, the government also increased its presence in the U.S. auto industry. With a forceful hand, the government helped orchestrate concessions from bondholders and the UAW, but GM and Chrysler still ended up in bankruptcy. On top of the individual company intervention, President Obama urged policy makers to revamp many financial regulations for the overall economy. Bank regulation will most likely be at the forefront but it will also likely include regulation for any firm that causes a systemic risk.

The Federal Reserve (Fed) also intervened in the fixed-income market, where they constructed a plan to buy long-term Treasuries, agencies and mortgage-backed securities (MBS). The purchases of MBS and agencies were used to increase demand and thaw out the markets. The Treasury purchases were

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Adapting to a Dynamic Market

used to keep long-term interest rates at depressed levels in order to spur economic activity.

Last, the Treasury has started looking to place all of the over-the-counter derivative markets on one exchange or another so the activity can be tracked and regulated more efficiently. Intervention will always be a controversial topic, but because of the recent financial crisis, it is going to be an inevitable part of the market's future.

The two organizations that are going to lead this intervention are the Fed and the U.S. government. Over the past year, the Fed has used a plethora of programs to increase the market's liquidity. They have done well so far and the U.S. economy has avoided a depression, but their job is far from over. The biggest question now will be how the Fed plans to rein in all of its intervention into the market. The Fed's balance sheet has substantially increased over the past year, which has led to an increase in the money supply. This is typically inflationary over the long run. As the economy starts to recover, the Fed will have to make some important decisions on when and how to trim all of the added liquidity in a way that will not be too detrimental to economic growth.

Understanding the Fed's future plans and the effect of its decisions may be difficult, but understanding the impact of the U.S. government might prove to be even more perplexing. The Obama administration is ambitious, and there are many ideas being discussed. Whether it is health care reform, energy independence or increased regulation, all of these are going to affect the market in one way or another. Change is definitely warranted after the recent crisis but there is concern about the cost of all the new programs. The deficit has already reached relatively high levels with the stimulus and multiple bailout packages, so policy changes could be down the line if economic activity is not as historically robust.

So what does this all mean for the economy? Many new regulations and restrictions could hinder the growth of the United States over time. This doesn't mean the United States will not be able to grow; it is a small hurdle to overcome. Financial innovation and leverage, which were large drivers for past growth, have decreased significantly and will also limit growth. However, the entrepreneurial drive and competitiveness that engulfs the American spirit will carry us forward and create many new opportunities for growth.

With this in mind, we still think that a well-balanced portfolio should have exposure to many asset categories. We still like domestic as opposed to international equities. The Euro zone just pumped more money into its banking system, which signals that there are still issues overseas. We also are cautious with any exposure to emerging markets. These markets function on quite a bit of debt, and with lending standards becoming tougher, it is going to put some downward pressure on their growth rates. With a pullback to international and emerging allocations, we believe that an increase to domestic equities would be appropriate, particularly to the large-capitalization style. This will help to reduce the volatility of a portfolio and avoid the increased risk associated with the international and emerging marketplace. That being said, it is important for you to review your personal investment objectives with your financial advisor so they can help you correctly position your portfolio in today's dynamic market place.

If you have questions regarding your investments, please feel free to contact Cornerstone at **1-800-923-0900**.

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