The Sittenfeld, Stuard & Thornberry Group
Private Wealth Management

Subject: Thoughts on the Second Quarter 2010

Date: 16 July 2010

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Markets

What a difference three months make. By late March, we had enjoyed a market that had moved upward with minimal resistance for 13 months in a row. Then we watched television coverage of the growing debt crisis in Greece and other parts of Europe along with oil spewing from a deepwater well in the Gulf of Mexico. Without warning, the bear awakened with a start. During the "flash crash" of May 6, the Dow fell nearly 1000 points intraday only to recover most of its losses before the close. The reasons for this harrowing blip remain unknown, but, understandably, it damaged investor confidence. The market decline over subsequent weeks resulted in the S&P 500 posting a second quarter loss of 11.4%: the worst quarter since the end of 2008.

In previous letters, we have referenced the low quality rally that occurred in response to the steep market decline. After severe market drops, investors often buy stocks that have been most beaten down in an effort to try to benefit the most from a market bounce. The targets tend to be low quality stocks with lower profitability, poor balance sheets and smaller market capitalizations. When the rally matures, high quality stocks often move back into favor. We started to see the rotation back to high quality occur in the second quarter just as Europe's debt problems became pronounced. Unfortunately, many high quality companies were significantly impacted by Europe's troubles. In the near term, this could take some wind out of the sails of stocks poised to return to favor, but these high quality stocks are better positioned for the long run.

Economy

Now we are faced with both a stock market and an economy struggling to find their footing. The fragile recovery is battling a weak housing market; anemic job creation; struggling consumer confidence; concern about China's economy; worry over European debt; uncertainty over the fallout of the Congress' latest attempt at financial reform; and inevitably higher taxes in 2011.

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Excessive leverage is what took us into deep recession and it is important to remember that deleveraging will take time and will not come easily. Individuals and corporations have made strides in debt reduction which will be favorable in the long run, but will hurt the recovery in the short run.

Individuals' balance sheets are being helped by relatively tame inflation and modest fuel expenses along with low interest rates on credit cards and mortgages. The all-important consumer spending remains tempered. U.S. companies are showing improvements in earnings as a result of major cost cutting and fulfilling pent-up demand.

Although the June unemployment rate fell to 9.5%, the work week and hourly pay rate both fell slightly and fewer private sector jobs were created than expected. It is normal for job growth to lag during economic recoveries since employers will push their existing workforce as far as possible before adding to their staff.

Housing remains a significant roadblock to recovery. With the expiration of the tax credit for homebuyers, the real estate market has slowed dramatically. If home prices continue to drift lower, banks will face more defaults and foreclosures with more homes that are "underwater." Mortgage applications for purchases fell 15% in June and pending home sales plunged 30% when the tax credit expired. When the "cash for clunkers" credit expired, auto sales fell briefly, but have since rebounded. It remains to be seen if housing will recover in a similar fashion. The Federal Reserve seems determined to sustain low interest rates in support of the housing market.

Interest Rates

Some might argue that the Federal Reserve's continuation of its near zero interest rate policy has reached the point where it has outlived its usefulness. With many investors unwilling to commit money to stocks the consequence is earning virtually nothing on their cash. This impacts those who are retired or who depend on investment income. Interest rates have been low for so long that borrowing is less enticing. Even with rates at historic lows, consumers and businesses are less inclined to borrow and more disposed to reduce debt. Consumers are decreasing purchases: buying everyday items but cutting back on optional choices. Inflation, at least for now, is less of a concern.

Outlook

No amount of analysis or research can anticipate all the moving parts that affect the direction of markets. Consideration of each individual investor's time horizon is critical. Investors need to think in terms of their short term needs in the years immediately ahead. Those who will not retire for a decade or more can appropriately assume more risk in return for more growth opportunity.

Many individual investors, understandably, were frightened by the crash of 2008/2009 and are still skittish. If the market decline continues, those investors will be even more reluctant to embrace the equity market.

Europe's debt challenges reflect on the U.S.' massive and growing debt. Europe's tone of austerity is creeping to the U.S. as some state and local governments attempt extreme measures to control expenses and create balanced budgets. Again, in the long run, this will be healthy, but in the short run, we could find belt-tightening uncomfortable.

With such uncertainty, a defensive posture is warranted, but how risk averse depends upon each individual situation. We encourage you to call or meet with us at any time.

Best wishes.