USI Advisors, Inc.

Market Update

June 2010 Review

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Bear in Mind...

Following a difficult May, the month of June was another tough pill to swallow for investors. Markets tumbled, economic news remained relatively weak and the light at the end of the tunnel seemed to creep further away. Unfortunately, if the U.S. consumer continues to be bombarded with bad news on the economy, the end of the tunnel may be even further away than we originally thought.

Consumer spending accounts for 70% of domestic economic activity. In other words, as the consumer goes, so does the economy. So, what happens when consumers become increasingly concerned about the housing market, worries about job security and essentially loses confidence in the economy as a whole? They stop spending.

Over the last three months, consumer spending has begun to slow substantially, while personal savings has trended up, reaching its highest level in eight months. Interestingly, the Federal Reserve reported that household financial obligations as a percentage of disposable income fell in the first quarter to 17.4%, the lowest level in a decade. So, if consumers are paying down debt and are seeing their real disposable income increase, it becomes quite clear the reason spending has slowed is that the consumer simply lacks confidence in the economic recovery. The Conference Board's consumer confidence number plunged to 52.9 from 62.7 in June, following three months of gains. According to Lynn Franco, Director of The Conference Board Consumer Research Center; "Increasing uncertainty and apprehension about the future state of the economy and labor market, no doubt a result of the recent slowdown in job growth, are the primary reasons for the sharp reversal in confidence. Until the pace of job growth picks up, consumer confidence is not likely to pick up."

Indeed, the job market has not rebounded as quickly or as significantly as hoped. Aside from temporary U.S. Census hiring, job growth in the private sector has been sluggish at best. In May, economists expected a 188,000 increase in private payrolls, only to be vastly disappointed when it was announced that a meager 41,000 jobs were created. June showed improvement but was still rather disappointing, with an increase of 83,000 private payrolls, while estimates called for a 125,000 increase. Until jobs are created with some magnitude and regularity, the consumer will undoubtedly remain skittish.

Compounding the problem is the struggling housing market. Despite all time record low interest rates for mortgages, the expiration of the Housing Tax Credit caused the housing market to pull sharply back from its relatively weak advance. In May, single family home construction dropped 17% from April's figure, new home sales were down 3.3%, and existing home sales fell 2.2%. Moreover, building permits in April and May tumbled 12% and 6%, respectively, as the lack of the tax credit removed the incentive to build. In addition, foreclosures continue to rise and it is estimated that one in four homeowners are underwater, meaning they owe more on their mortgage than the house is worth.

With all of the challenges investors are facing with regard to current economic conditions, is it any wonder why the stock market plunged in June and is down year-to-date?

Risk aversion picked up across the board, as all major equity asset classes dropped between 9% and 14% in the second quarter, bringing year-to-date performance into negative territory. For the first six months of 2010, the Dow Jones Industrial Average shed 5% of its value while the broader S&P 500 Index lost 6.7%. Technology stocks, which started off the year on a strong note, have taken a hit over the past couple months as the NASDAQ Composite Index lost 7.1% for the first half of the year.

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On a relative basis, value outperformed growth and small and mid-caps outperformed large caps. The strength in defensive sectors also reflected the risk aversion theme, as telecom, utilities and consumer staples were respectively the top performing sectors in the second quarter. These sectors also happen to be the highest dividend payers, and with the uncertainty in the market, the importance of dividends and income may rise over time if the markets continue to move in a sideways or down market.

	June	Latest Quarter	YTD
DJIA	-3.4%	-9.4%	5.0%
S&P 500	-5.2%	-11.4%	-6.7%
NASDAQ	-6.6%	-12.0%	-7.1%
MSCI EAFE	-1.0%	-13.8%	-12.9%
Barclays Aggregate	1.6%	3.5%	5.3%
Barclays Corp High Yield	1.2%	-0.1%	4.5%

Overseas, the MSCI EAFE Index was relatively strong in June compared to domestic equities, but dropped 10.9% during the quarter in local currency terms. For the U.S. dollar investor this represented a loss of 13.8%, as the Euro continued to lose value compared to the dollar. The MSCI World ex-U.S. dropped 13.4%, dragging down year-to-date performance to -12.2%. Emerging markets were not excluded from the downdraft, as the MSCI Emerging Markets Index lost 8.3% for the quarter and is down 6.0% for the year.

Risk aversion was also on display in the fixed income markets. First, investors continue to pour money into the fixed income space, as evidenced by the $118 billion inflow between January 1st and June 30th 2010. To put this in perspective, the inflow into fixed income in the first six months of this year (at record low interest rates) is higher than the cumulative net flow into equities over the last nine years. Further, investors have recently shied away from risk assets and moved closer to safety by buying Treasuries. In fact, Treasuries were the best performing sector in the second quarter with the Barclays Capital U.S. Treasury Index producing a 4.7% rate of return. Most other fixed income assets gained in value, with only high yield and bank loans posting a small drop of 0.1% and -2.0%, respectively. Overall, strength was more pronounced on the long end of the yield curve, with the Barclays Capital Long U.S. Government/Credit Index posting a 8.6% gain over the past three months. Fixed income assets have performed well year-to-date, despite interest rates having nowhere to go but up.

In addition to fixed income, investors found solace in gold, which continued to move up and closed the quarter at $1,244/oz. Often viewed as a storage of wealth, this investment has been made readily investable through various mutual funds.

So, where do we stand now after two consecutive quarters of economic growth? Are we continuing to traverse the path to economic recovery or are we sliding down to a double-dip recession? "Bulls" on the market argue that the profit taking is part of the normal process after such a dramatic increase in prices and the current market pattern is typical for a recovery. "Bears" argue that it does not require a double-dip recession for an equity market to find a new low as witnessed by the 2002 market pullback. Halfway through this year, we are standing at a turning point, where the recent pullback can either be interpreted as a buying opportunity or the beginning of a sustained downturn. With all the economic issues we are currently facing, is it more likely we will be waking up to good news driving the market up or bad news driving the market down? In the end, however, it might not be the news making the market in the coming months, but the market making the news.

Definitions & Disclosures:

An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You can not invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.

The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.

The NASDAQ Composite Index is a market-value weighted index that measures all domestic and non-U.S. based securities listed on the NASDAQ Stock Market.

The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.

The Barclays Capital U.S. Aggregate Index covers the U.S. Dollar denominated investment grade, fixed-rate, taxable bond market of SEC-registered securities.

The Barclays Capital U.S. Corporate High Yield Index covers the U.S. Dollar denominated, non-investment grade, fixed income, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below.

The MSCI Emerging Markets Index (EM) is a free-float-adjusted market-capitalization index developed by Morgan Stanley Capital International. It is designed to measure the equity market performance of 26 emerging market countries.

The Barclays Capital Long U.S. Government/Credit Index is the long component of the Lehman US Government/Credit Index, a widely recognized index that features a blend of US Treasury, government-sponsored (U.S. Agency and supranational), mortgage, and corporate securities limited to a maturity of more than ten years.

The Barclays Capital US Treasury Index represents public obligations of the U.S. Treasury with a remaining maturity of one year or more.