

Quarterly Market Review

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Financial Markets and Economic Analysis, Second Quarter 2009

Perspective: Does “less bad” actually equal “better”

During the second quarter, an oft heard phrase in conjunction with many economic news reports was “better than expected,” as in “May’s Unemployment numbers were better than expected.” Indeed, looking at the global market returns in the second quarter, one could reasonably assume that the worldwide economy was in the midst of a robust expansion phase. In the global fixed income markets, credit spreads narrowed substantially (by more than 500 basis points in the domestic high yield markets¹) as investors got comfortable taking more risk. Safe instruments like Treasuries were the worst performers for the quarter and the year-to-date. Both domestically and globally, market participants appear to be looking beyond the current quarter to strengthening fundamentals and a more normal volatility/liquidity environment.

While the pace of the economic contraction has slowed, certainly domestically, the fact that the economy is still shrinking is undeniable by virtually any objective measure. Unemployment continues to rise, reaching 9.5% with June’s report and the Fed, according to its most recent statement, continues to be more worried about deflation and a continued recessionary environment. GDP estimates for the second quarter are forecast to contract as well, though at a slower rate than the first quarter. Many forecasts for the eventual recovery, whether in 2009 or 2010, anticipate a very slow growth pattern. The danger then for investors is getting overly excited about the recent market rally, and ignoring the reality that although “less bad” can be an indicator of better times to come, it isn’t necessarily an indicator that the better times have actually arrived.

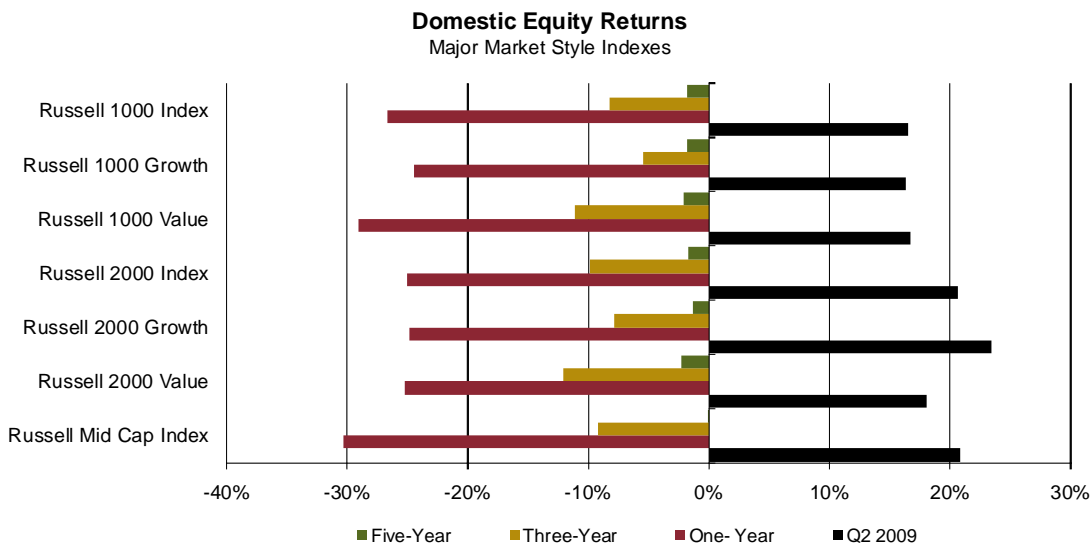
Domestic Equity Markets Overview

The domestic equity markets built on the momentum gained in March with double digit gains in most of the Russell style indexes. The rally began to peter out as the quarter neared its midpoint, and though May was a solid month, it finally fizzled in June with flat performance except for the Russell 2000 Growth Index, which was up 3.2% in the month. For both large caps and mid caps, the difference between value and growth (as represented by the Russell style indices) was less than 50 basis points for the quarter. However, for small caps, this amounted to more than 5% as growth sharply outperformed for the quarter. Despite the outstanding performance in the second quarter, the large cap value and small cap value indices remain in negative territory for the year to date, and all of the Russell domestic indexes remain down more than 20% on a trailing 12 month basis.

With its aforementioned performance in June, the Russell 2000 Growth was the best performing index during the second quarter by a fair margin. The index was driven by 30%+ returns in the Technology, Consumer Discretionary and Energy sectors, which accounted for more than 43% of the index coming into the quarter. As is typical of a relief rally, large caps did not perform nearly as well their mid and small cap counterparts, even the lagging small cap value index. There were several bright spots in the Russell 1000, namely the recovering Financials sector (+31%) and Technology (+20%), while it was “held back” by a 9% return in the largest sector, Healthcare.

¹ Barclays

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International Markets Summary

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Like the domestic equity markets, the international markets rallied sharply in the second quarter, pushing returns up 25-27% in dollar terms², despite slight losses in June. These returns were boosted sharply by a weakening dollar, which added 8-10% to the local currency returns³. The global developed markets have moved in concert over most of the last year, as first the markets were rocked by the financial crises of the second half of 2008 and now the reversion to a more normal environment with the government interventions in the first half of 2009. Disparity among the returns of the various regions was surprisingly small during the quarter though there were a few individual countries that stood out. Greece (+38.9%), Spain (36.6%) and Sweden (34.8%) led the way in Europe, while Singapore (46.0%) and Hong Kong (35.8%) were the leaders in the Far East⁴.

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Despite significant losses in June, the emerging markets had an explosive quarter, up more than 37%⁵ in dollar terms. Among the four BRIC countries, Russia was the worst performer at +33.9%, while India was up 60.6%⁶. As with the developed markets, the weakening dollar added more than 10% to the quarter's return. Aside from India, Hungary, Turkey, Indonesia, Thailand and Colombia all had dollar denominated returns in excess of 50%⁷. However, with the exception of Columbia, all of these countries have negative returns over the last 12 months despite the recent run up.

² MSCI

³ MSCI

⁴ MSCI Country Indices for each Country, net of tax transfers, in US Dollars

⁵ Russell Emerging Markets Large Cap Index

⁶ Russell Country Indexes

⁷ MSCI Country Indices for each Country, net of tax transfers, in US Dollars

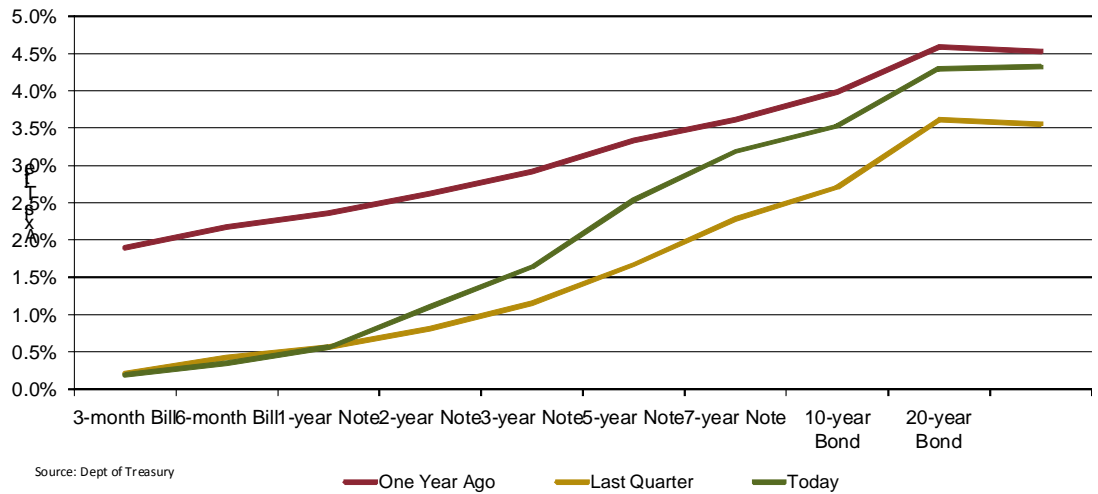
Fixed Income Summary

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The domestic fixed income market continued its strong bifurcation in the second quarter, complicated by a sharp steepening in the yield curve. While yields fell slightly on maturities from three months to one year, they continued to rise for all other maturities. At the long end, the 20-Year and 30-Year bond yields ended only slightly below the year ago levels. The Barclays U.S. Treasury Index (-3%) was down for the second consecutive quarter after posting a 13.7% return in 2008. Longer dated Treasuries, as represented by the Barclays 20+ Year Treasury Index, were down 9.4% in the quarter and 19.25% for the first six months of the year. In the securitized segment, the MBS market, represented by the Barclays U.S. MBS Index was up 70 basis points in the quarter, though results varied sharply depending on the nature of the issue. The consumer heavy ABS segment was up sharply and even the Home Equity backed issues were up more than 5%. The clear winners in the quarter however, were the high yield issues and the investment grade corporates. The Barclays U.S. High Yield Index was up 23.1% in the quarter, and the zero coupon component of that index was up an astonishing 64.5% (for a total trailing 12 month return of just 1.6%). As seen in the equity markets, investors' appetite for risk dramatically increased during the quarter and yield spreads on the index fell more than 550 basis points creating significant gains. A similar story unfolded in the corporate credit market as spreads on the Barclays U.S. Credit Index fell more than 200 basis points in the quarter and resulted in an 8.8% gain for that index. Unlike the first quarter, all three of the major sub sectors (Industrials, Utilities and Financial) showed substantial gains.

Much like the first quarter, the municipal markets had mixed results in the final month of the quarter, with the short end (1-4 years) showing slight gains with losses for the month for the rest of the maturities. The municipal yield curve did steepen slightly during the quarter, though much less dramatically than the taxable curve, and rates actually fell at the short end. For the quarter results were decidedly disappointing, except for those managers in the longest term issues. The most popular segment of the market, from 1-12 years in maturity, was up just 73 basis points, while the longer maturities were up from 2-4.5%. New issuance was off significantly both on a year-to-date basis as well as a year-over-year basis. One major factor contributing to the lack of new supply was the absence of the insurers, which forced smaller municipalities with lower credit ratings (or none at all) out of the market.

Treasury Yield Curve



Outlook

As it was coming into 2009, the keywords remain caution, risk management and due diligence.

The sharp rally that began in March carried through into the second quarter and all of the major market segments participated. However, the rally appeared to run out of steam in both the domestic and international equity markets in June. The Federal Reserve appears to be adamant about continuing its

very accommodative stance for the foreseeable future; as well it might given the overall poor economic statistics. Market forecasts for the remainder of 2009 and into 2010 remain mixed, and primarily hinge on the anticipation of the Fed eventually being forced to raise rates to stem the inflationary pressure of the recent government stimulus packages. Those who believe that the economy will be weak through the end of the year continue to point to the high unemployment levels, significant production slack in the economy and continued weak access to credit for businesses and consumers. As it was coming into 2009, the keywords remain caution, risk management and due diligence.

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