

Second Quarter 2011 Market Review



The two-year-old bull market that began in the first quarter of 2009, took a breather in the second quarter of 2011, as investors focused on the sovereign debt crisis, the sub-par recovery in the economy, high energy costs, and the deteriorating employment outlook.

Within the U.S. equity market, the S&P 500 was barely positive for the quarter, up 0.1%. For the quarter, the bulk of the losses were concentrated in the S&P 500's three largest sectors--technology, financials, and energy. At the market's recent peak, on April 29, 2010, the S&P 500 had more than doubled since the bear market low of 676.5, on March 9, 2009. Despite the recent setback, we've come a long way from those bear market lows. The S&P 500 ended the quarter trading at 15.2 times trailing earnings, a notable discount to the 19.8 times average multiple over the past 20 years. The Russell 2000, a small capitalization stock index, was down 1.6% during the quarter, trailing the S&P 500. We ended the quarter with small capitalization stocks, as measured by the Russell 2000 Index, still trading at a substantial premium to large capitalization stocks. Going forward, this may favor investors in larger companies.

The non-U.S. developed equity markets generally fared better than U.S. equities during the quarter. The MSCI EAFE Index, an indicator of the developed markets, was up 1.8%. The strength within the developed markets was concentrated in Germany (up 7.0%) and France (up 5.2%). The MSCI Emerging Market's index was down 1.0%. This is the second quarter in a row in which emerging markets have underperformed the developed economies. While developed market equities, like their S&P 500 counterparts, are trading at a discount to historical valuation levels, the emerging markets are priced in line with their valuations over the past 10 years.

In this challenging environment, investors benefited from their bond holdings, as virtually all of the major fixed income indices were positive. Long Bonds, as measured by the Barclays Long Government Index, were up 3.3%. The Barclays Aggregate Bond Index was up 2.3%, outperforming the 1.0% return on high yield bonds. Cash rates remained close to zero throughout the quarter.

Looking forward, the capital markets are clearly struggling between rising economic uncertainty and the relatively attractive valuations of U.S. large cap and non-U.S. developed market equities. For now, however, unease about the global economy is dominant.

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When interest rates change, we may change our assumptions. However, we are cautious about making changes. We have designed our assumptions to be strategic in nature, so they will typically not be adjusted to short-term market spikes. We use our judgment to determine whether interest rate moves are sustainable. In practice, we continuously review our assumptions and work to refine our methodology as we gain additional information relating to the capital markets, but we do not anticipate changes every time interest rates rise in 25 or 50 basis point increments.