

PWJohnson Wealth Management

Quarterly Commentary Q2 2010

Investment Markets and Performance

Stocks continued to slide in June, ending the first half of 2010 with losses in every segment of the equity market. The large-cap Vanguard 500 Stock Index lost 11.5% for the quarter, and was down 6.7% through June 30th. The small-cap iShares Russell 2000 and iShares Russell Midcap both lost 10% in the second quarter, though thanks to a strong first-quarter, both benchmarks were down just 2% through June. Turning abroad, the story was similarly painful. The Vanguard Total International Stock Index dropped 13.3% in the second quarter, bringing its year-to-date loss to 12%. The Vanguard Emerging Market Stock Index lost over 9% for the quarter and nearly 7% for the first half of the year.

Most of the positive news for the first six months of 2010 was in fixed income (bonds). The Vanguard Total Bond Market Index Fund, a proxy for high-quality, intermediate-term bonds, gained 3.6% over the second quarter, and was up 5.3% for the year through June, while foreign bonds were mixed. Below is a table showing returns for various investment classes so far this year.

June Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	Jun	2Q	YTD
Vanguard 500 Index	-5.2%	-11.5%	-6.7%
Russell 1000 iShares	-5.5%	-11.4%	-6.4%
Russell 1000 Growth iShares	-5.5%	-11.8%	-7.7%
Russell 1000 Value iShares	-5.6%	-11.1%	-5.2%
Mid-Cap Benchmarks			
Russell Midcap iShares	-6.2%	-9.9%	-2.1%
Russell Midcap Growth iShares	-6.3%	-10.2%	-3.4%
Russell Midcap Value iShares	-6.1%	-9.6%	-1.0%
Small-Cap Benchmarks			
Russell 2000 iShares	-7.7%	-9.9%	-2.0%
Russell 2000 Growth iShares	-6.7%	-9.2%	-2.3%
Russell 2000 Value iShares	-8.7%	-10.6%	-1.7%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-1.2%	-13.3%	-12.0%
Vanguard Emerging Mkt Stock Index	0.0%	-9.1%	-6.9%
Vanguard REIT Index	-5.2%	-4.0%	5.6%
Vanguard Total Bond Mkt Index	1.6%	3.6%	5.3%
Merrill U.S. High Yield Cash Pay	1.3%	0.0%	4.8%
Barclays 7 Yr Muni Bond Index	0.3%	2.3%	3.6%
Citigroup World Govt. Bond Index	1.7%	0.3%	-1.0%
JPMorgan GBI-EM Global Div. Index	0.9%	-2.0%	3.4%
DJ-UBSCI (Commodity Futures)	0.3%	-4.8%	-9.6%

Current Economic Situation

Right now, there's a tug of war occurring between cyclically improving economic and company fundamentals on one hand, and structural concerns about debt-related stress points, and questions about the viability and the longer-term strength of the economic recovery on the other. In addition, not since World War II have governments played such a large role in managing their economies through stimulus efforts and through increased regulation. The net of all these factors is an unusually high level of uncertainty, which is having a big impact on the capital markets. We believe this level of uncertainty could be with us for years to come because the economic challenges we face are deeply-rooted, and will not be resolved quickly. Against this backdrop, the outlook for growth and the returns of most investment classes — particularly stocks, bonds, and real estate — is likely to be muted for some time to come, and the volatility we've seen in recent weeks may be with us for months, if not years.

Regarding the debt situation, the US and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of de-leveraging. Most of these countries must also dramatically reduce public sector (government) debt growth, and in some cases they will need to reduce the absolute amount of debt. The timing and aggressiveness with which public sector debt and deficits are attacked will be extremely tricky to get right. On the one hand, too much austerity coming from very tight fiscal and monetary policy can be counterproductive because it risks smothering already weak growth, which reduces tax revenues, increases social safety net spending, and could weaken the political will that is needed to follow through on spending discipline. Waiting too long to tackle rising debt levels digs a deeper hole and risks a lenders' strike, which could result in government borrowers (and all others too) being forced to pay much higher interest rates to finance their debt.

Fortunately, key parts of the *developing* world are in much better shape than the more mature, *developed* countries, with stronger balance sheets, higher growth rates, younger populations, and emerging consumer sectors. Their strength is likely to be an important source of support for the global recovery, as well as an opportunity for investment. And there are other positive forces that help to mitigate the negatives. The continued impact of massive federal stimulus (though this will wane later this year in the United States), healthy corporate balance sheets and cash flow (after huge cuts to expenses), and a natural rebound in economic activity after a huge decline are also sources of strength in the U.S. and global economy. But job growth, while positive, is not improving at a fast enough rate.

This all nets out to a macro environment that while improving, is still very fragile, with serious intermediate-term challenges. A continued recovery is likely, but not assured, and a robust recovery still seems unlikely. Further complicating the picture is the risk of government fiscal policy, monetary policy, and/or regulatory mistakes. Finding the right balance between addressing deficits and growth will be tricky, but we believe it is made many times tougher given pressure that is based more on politics than on a sophisticated understanding of the complexity of the issues, or what is in the best interests for the macro economy.

Investment Outlook

Regarding equities, the first six months of 2010 have been a bit of a roller coaster; stocks were up early in the year, then down 5% by early February, then up almost 10% for the year by late April, then down over 5% for the year by early June. The S&P 500 ended June down 6.7% for the year. The VIX, a measure of market volatility based on options, is about 25 as of this writing, down from its recent high of 45 on May 20, indicating an elevated level of uncertainty in the short-term but not as high as what we've seen recently. Whether or not the recent decline in volatility represents the end of a market correction or the start of a further decline remains to be seen. Leading indicators are mixed. The Schiller S&P 500 P/E Ratio stands at just under 20, which is an historically high valuation level. On the other hand, the MSCI World Index P/E (which is calculated somewhat differently) is 8.8, well below its low of 18 in October 2002 (after the 2000 recession). As a result of our research, we continue to hold equity exposure in our clients' portfolios to as much as 20% below benchmark. At the same time, we have been increasing our investments in what we call active allocation funds, whose managers have the freedom (and proven track records) to further shift in and out of equities, depending on emerging economic and market developments.

In the bond area, we continue to minimize our investment in U.S. Treasuries. Although they have the potential for short-term rallies when market sentiment turns negative, longer term they offer only low yields, with the potential for substantial price declines. And while we continue to maintain small positions in inflation-protected bonds and in commodities as a hedge against future inflation (which is still a major concern), we anticipate moderate *deflation* for the remainder of this year. As with our broad active allocation funds, our flexible bond approach should allow us to generate mid to high single-digit returns through reallocations across appropriate bond asset classes. For example, we have been reducing allocations in high yield bonds, whose spreads have dropped and whose risk/return profiles have consequently turned more unfavorable, and in mortgage-backed securities, with rates at historical lows and reduced government support. At the same time, we are increasing our investments in sovereign (government) debt in countries with strong balance sheets, as well as in top-quality corporate bonds, both with an eye to boosting returns as well as to increasing diversification and decreasing risk.

As always, we welcome your questions and comments. Our goal is to help you make the best financial decisions you can and to help you sleep well at night, regardless of the economic environment we happen to be facing.

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