



May 17, 2010

The \$957 billion in credit pledged by the European Union and the International Monetary Fund had exactly the “shock and awe” effect hoped for by the two organizations and European leaders – for all of one day, with the Dow soaring 404.71 points on Monday. Then investors began to think about the subtext of the loan: that making all of that money available to profligate countries would not incent them to curb their spendthrift ways; that the ready money would only increase debt loads and hinder economic growth; and, worst of all for American investors, a weakened Europe would impact the steadily improving American economy by increasing the price of its exports in Europe. So while Monday’s surge was enough to ensure that the major indexes would all be comfortably back in black last week (and also back up for 2010), triple-digit drops for the Dow on Thursday and Friday, and a stumbling euro, which hit an 18-month low, indicated that the market and investors felt that the problems in Europe were still a long way from being resolved.

While the upturn in the United States has not reached pre-recession levels, there have been enough positive signs of late to encourage investors, and last week saw more of the same. For example, the Commerce Department reported that retail sales in April rose a seasonally adjusted 0.4% or \$366.4 billion, though the increase was largely driven by a rise in the sale of building materials and was below the figure for March which was revised up to 2.1%. Even so, that makes seven months straight and sales were up 8.8% from a year ago.

	Key Market Data		
	Week ending		
	5/14/10	5/7/10	Change
Dow Jones Industrial Average Index	10,620.16	10,380.43	+2.31%
S&P 500 Index	1,135.68	1,110.88	+2.23%
NASDAQ Composite Index	2,346.85	2,265.64	+3.58%
10-Year Treasury Note Rate	3.444%	3.431%	+0.013 pct. pts.
NYMEX Crude Future (Barrel)	\$71.61	\$75.11	-4.66%
Euro/U.S. Dollar	\$1.2381	\$1.2731	-\$0.0350

The Federal Reserve said that industrial production rose by 0.8% in April after 0.2% in March and was 5.2% higher than in April of 2009. And the Census Bureau reported that wholesale inventories were up 0.4% in March while business inventories improved 0.4%. Lastly, in news that on the face of it did not seem that positive, the Commerce Department reported that the trade gap rose 2.5% in March to \$40.4 billion as imports increased 3.1% to \$188.3 billion. The announcement was nonetheless well received because exports rose 3.2% to \$147.9 billion, which will probably push up the recently released figure of gross domestic product (GDP) growth for the first quarter, also 3.2%. “The rise in imports shows increasing consumer confidence in America’s economic recovery,” Commerce Secretary Gary Locke said. “It’s heartening to see a corresponding increase in exports.”

And the earnings reports from the first quarter continued to impress. As of May 7, according to Thomson Reuters, with the majority of S&P 500 companies having already reported, the percentage coming in

above analyst estimates—the “surprise factor” – is currently 15%, well above the long-term average of 2% (since Thomson Reuters began tracking the data in 1994) and on par with the record of 15% recorded in the third quarter of last year. The three sectors leading the way with the highest percentage increases in earnings since January 1 are financials (+48%), consumer discretionary (+31%) and technology (+17%).

The Securities Exchange Commission (SEC) continued to try and find out what caused the market’s precipitous plunge on May 6, with suspicion falling on a single mutual fund firm engaged in futures trading, but the larger issue seemed to be the fact that there are no common protocols governing the nation’s many electronic exchanges. As SEC Chairman Mary Schapiro said at a congressional hearing last week, “It’s fair to say disparate exchange rules caused more dominoes to fall.”

As for Europe, there were plenty of headlines, not all of them upbeat, in the wake of last Sunday’s announcement of the €750 billion (\$957 billion) loan program and the follow-up announcement by the European Central Bank that it would reverse its previously stated policy and purchase European debt, effectively guaranteeing investors that they would not lose money by buying bonds from Greece et al. On Monday, markets across the globe jumped at the news and the rate on Greece’s 10-year Greek bond yield plummeted from 12.46% to 7.46%. Within days, Spain, which had been urged by President Obama to take “resolute action,” did so, introducing an austerity program that will cut €15 billion (\$19 billion), mostly by slashing civil service salaries, in an effort to lower its deficit to 6% in 2011 (it was 12.2% in 2009). Portugal followed suit later in the week with its own set of tax cuts designed to reduce its budget deficit to 5.1% next year (it was 9.4% in 2009).

In an effort to try and head off future crises, the EU’s executive arm, the European Commission, made a proposal that’s bound to raise the hackles of sovereign states, suggesting that member countries submit their budgets for review before they’re passed by national parliaments. The Commission also said the EU should consider punitive measures for countries that flout EU rules, such as failing to keep deficits down to the required 3% of GDP.

On Thursday, Germany’s Chancellor Angela Merkel, still smarting from her party’s decisive defeat in last week’s regional election, ominously said, “If the euro fails it’s not just the currency that fails, but Europe and the idea of European unification.” Also on Thursday, the former Fed chairman Paul Volcker was in London where he did nothing to calm the roiling markets by saying, “You have the great problem of a potential disintegration of the euro.” Meanwhile, England’s Prime Minister Gordon Brown lost an election and his Labor Party was replaced by the first coalition government since World War II, with David Cameron of the Conservative Party named as his successor while the deputy prime minister will be Nick Clegg of the Liberal Democrat Party. Despite not using the euro, they will also have to face the daunting economic prospects of rising debt and a record deficit. And at the end of the week, GDP for the euro zone in the first quarter came in at 0.8%, the third consecutive quarter of expansion, though it has yet to top 2%.

Meanwhile, the country at the heart of the crisis, Greece, escalated its battle with tax evaders by making public the list of its leading tax offenders –some estimate it loses about \$30 billion a year in tax receipts, which would go a long way toward addressing its debt woes. In this case, the list included 57 doctors with a combined, reported income of \$15 million from 2001 through 2008 who deposited almost \$39

billion in their bank accounts during that time.

The situation in Europe, as noted, could hinder our recovery by raising the price of our exports thanks to the falling euro, and, down the road, making vulnerable American banks that hold billions in European bonds. Europe has even impacted the Federal Reserve's plans to raise its federal funds rate, according to 57 economists polled by *The Wall Street Journal*, 42% of whom now feel that the rate will not go up until 2011 compared to only 28% who thought that a month earlier. At the same time, in the flight to safety, the rate on U.S. Treasuries has gone down just when they seemed poised to climb, while the price of gold has soared.

### **The broader view**

The much-discussed and hotly debated financial overhaul bill has yet to be passed – though some believe that will happen in the next two weeks. And even when it does pass, the Senate will have to caucus with the House, which passed its own version back in December, to reconcile the many differences between the two bills. That said, progress was made on a number of major sticking points last week, and amendments were approved that would ease the concern of Fed Chairman Benjamin Bernanke and make small businesses happy, while putting banks, and their lobbyists, on red alert.

The Fed had faced two possible constraints on its power: new congressional oversight of its monetary policy, which Mr. Bernanke had warned would politicize policy making, and the transfer of its supervision of more than 4,900 state-chartered banks and about 900 bank holding companies to the Federal Deposit Insurance Corporation (FDIC). Last week, both amendments went the Fed's way, but the Senate did pass one amendment, by a vote of 96-0, that will force the Fed to open its books and give a detailed accounting of its actions during the recent recession.

The amendment by the Senate to cut the fees that retailers pay banks for using credit and debit cards is one of the most significant steps yet as it is an issue that has been debated for years but never even reached a vote before Thursday, let alone get approved. Last year, debit card fees for Visa and MasterCard, the two cards named, totaled \$19.71 billion with \$15.8 billion passed on in profit to banks. The overall bill must still pass in the Senate and then be reconciled with the House version which does not address these "interchange" fees. In a separate action, the Democrats also fought off a GOP move to pare back the new bill's tighter rules on derivatives trading by a vote of 59-39.

Finally, the Senate approved two initiatives to address the role of major credit agencies in the 2008 financial collapse, including a proposal to eliminate the reliance on companies like Moody's Investors Services and Standard & Poor's. The amendment would create a governmental credit-rating board to end the alleged conflicts of interest whereby bond issuers select ratings agencies and pay for ratings; in other words, the revenue of the rating firms currently hinges on the firms whose bonds they're rating.

### **A look ahead**

This week, the market will continue to watch Europe and weigh whether or not the nearly trillion-dollar bailout will pay dividends in the form of investor confidence. There will also be a number of new reports that will provide a clearer picture of the impact of the recently expired homebuyers tax credit on the housing market, including housing starts, building permits and mortgage applications, as well as the darker side: the latest on delinquencies and foreclosures. Other releases will include the consumer price index, the Conference Board's leading indicators, and the minutes of the Fed's most recent meeting on April 27 and 28.



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The Dow Jones Industrial Average Index<sup>®</sup> is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Standard and Poor's 500 Index<sup>®</sup> (S&P 500<sup>®</sup>) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Standard & Poor's offers sector indices on the S&P 500 based upon the Global Industry Classification Standard (GICS<sup>®</sup>). This standard is jointly maintained by Standard & Poor's and MSCI. Each stock is classified into one of 10 sectors, 24 industry groups, 67 industries and 147 sub-industries according to their largest source of revenue. Standard & Poor's and MSCI jointly determine all classifications. The 10 sectors are Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services, and Utilities.

The NASDAQ Composite Index<sup>®</sup>. Stocks traded on the NASDAQ stock market are usually the smaller, more volatile corporations and include many start up companies.

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