

# INNOVEST MONTHLY MARKET COMMENTARY

## July 2010



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Latest Returns						
EQUITIES						
Index	Jul-10	3 months	YTD	1 Year	3 Years	5 Years
S&P 500	7.01%	-6.69%	-0.11%	13.84%	-6.78%	-0.17%
S&P 400 Midcap	6.91%	-7.29%	5.45%	22.82%	-2.36%	2.53%
S&P 600 Small Cap	6.34%	-8.31%	5.41%	19.17%	-4.08%	0.88%
MSCI EAFE	9.48%	-4.08%	-5.00%	6.26%	-10.28%	2.10%
MSCI Emerging Markets	8.33%	-1.93%	1.65%	19.92%	-1.57%	13.01%
FIXED INCOME						
Index	Jul-10	3 months	YTD	1 Year	3 Years	5 Years
BC Aggregate Bond	1.07%	3.52%	6.46%	8.91%	7.64%	5.96%
BC Muni Bond 1-10 Yr	1.26%	2.27%	3.99%	6.24%	6.27%	4.95%
BC High Yield	3.56%	1.08%	8.22%	23.74%	9.09%	7.55%
BC Global Aggregate Bond	3.40%	3.34%	3.38%	6.55%	7.38%	5.98%
CSFB Bank Loan Index	1.43%	-0.90%	4.73%	14.68%	3.20%	3.88%
OTHER						
Index	Jul-10	3 months	YTD	1 Year	3 Years	5 Years
DJ UBS Commodity	6.77%	-0.30%	-3.48%	6.27%	-6.97%	-0.89%
DJ Wilshire US REIT	9.89%	-1.61%	15.69%	54.93%	-4.91%	0.06%
S&P Developed World Property	9.09%	-2.40%	4.83%	24.77%	-9.79%	0.75%
LPX 50 TR	10.70%	-7.25%	6.11%	22.37%	-21.13%	-5.94%
HFRI Fund of Funds Index	0.74%	-2.75%	-0.47%	3.87%	-3.85%	2.13%
3 Month T-Bills	0.02%	0.05%	0.07%	0.16%	1.44%	2.72%

Returns provided by outside vendor. Innovest is not responsible for accuracy of numbers presented.

Bond Rates	8/6/2010	12/31/2009
U.S. Federal Funds Target Rate	0.25%	0.25%
U.S. Two-Year Treasury Yield	0.51%	1.14%
U.S. Ten-Year Treasury Yield	2.82%	3.84%
U.S. Ten-Year Muni Yield	2.83%	3.05%
High Yield (Merrill U.S. Corporates)	7.86%	8.63%

Exchange Rates		
\$ per €	1.33	1.43
\$ per £	1.60	1.61
¥ per \$	85.14	93.10

## The Economy

Economic reports in July subdued fears of a double-dip recession. The first quarter's gross domestic product (GDP) growth was revised upward from +2.7% to +3.7%, and second quarter estimates came in at an annualized +2.4% growth rate. The ISM Manufacturing Index fell during the month, but remained well above 50 (the threshold for expansion) for the twelfth straight month.

The Committee of European Banking Supervisors (CEBS) released the much-anticipated stress tests on European banks, with only 7 of 91 banks failing under adverse scenarios. Although the test results suggested that the European banking system is generally healthy, many experts have criticized the rigor of the scenarios tested. The next step will be for national authorities to assist those faltering banks with as much as €3.5 billion to recapitalize their balance sheets. In other news, Goldman Sachs agreed to pay \$550 million to settle a civil fraud suit brought

by the Securities Exchange Commission (SEC). The SEC had accused Goldman Sachs of defrauding investors by failing to disclosing conflicts of interest in a synthetic collateralized debt obligation. British Petroleum appeared to have successfully capped the Macondo oil well and subsequently injected a "static kill" to permanently seal the leak.

The government's willingness to increasingly regulate the private markets remains a wild card for many industries. President Obama signed the most historic financial regulatory reform bill since the Great Depression, placing new fees and restrictions on the nation's banks. As part of the bill, a new consumer financial protection division will be constructed to oversee mortgage and credit-card products. While a federal appeals court rejected President Obama's appeal to reinstate a six-month moratorium on deep-water offshore drilling, the House of Representatives passed a bill removing the \$75 million liability cap, as well as placing more stringent standards and oversight for offshore energy exploration.

## The Market

The herd-like behavior of investors pushed stocks to lower lows in early July, but markets quickly bounced back during the month in response to positive earnings reports. Large cap domestic stocks produced a positive 7% return, followed by mid cap and small cap equities returning +6.9% and +6.3%, respectively. International equities, as measured by the MSCI EAFE Index, produced moderate returns in local currency terms (+4.6%), but outpaced domestic stocks after including the impact of the stronger foreign currencies (+9.5%). Emerging markets also benefited from currency appreciation during the quarter, resulting in a +6.2% local market return and +8.3% in U.S. dollar terms.

Investment grade bonds continued to generate positive returns, with the Barclays Aggregate Bond Index up 1.1% for July. Below-investment-grade issues led returns for fixed income, as both high yield and floating rate corporate loans benefited from low default rates and moderating global concerns. Below-investment-grade securities have also generated meaningful year-to-date performance, but low LIBOR rates continued to dampen income generation for floating rate corporate loans.

Alternative asset classes had strong returns as well, with listed private equity rallying 10.7% and commodities up 6.8%. Real estate investment trusts (REITs), measured by the DJ US REIT index, returned another strong month (+9.1%) after record flows in the first six months contributed to exceptional year-to-date performance (+15.7%).

## Outlook

The European debt crisis increased fears of a double-dip recession and led to equity declines on a global basis. While there is certainly validity to sovereign debt concerns, much of the economic data suggests that the U.S. and most global economies remain on a gradual path to recovery. Corporate earnings have become the bright spot in the economy, with nearly 84% of second quarter earnings reported by the end of July beating consensus expectations. Moreover, the magnitude by which companies have exceeded analysts' estimates is the fourth highest on record, suggesting that modest revenue growth and cost cutting measures over the past year continue to translate into strong profits. Access to

the capital markets has largely regained functionality, but the availability of credit for small businesses remains challenged. Regional banks with significant exposure to commercial real estate loans may be pressured by possible write-downs in the next few years if market values and financing terms do not improve. The most concerning issue weighing on the markets may be the growing fiscal deficits and debt burden. If current trends persist, foreign investors could demand higher interest rates on U.S. government securities.

Despite looming economic and fiscal concerns, we believe that uncertainty and volatility often bring opportunity. High yield prospects still look reasonably attractive, as expected default rates may be too pessimistic should the economy continue to improve. Opportunities in the equity market also appear relatively attractive, supported by strong corporate balance sheets, positive earnings trends, and sensible valuations. Lastly, current commercial real estate values may provide an attractive entry point, as FDIC auctions and defaults are expected to create opportunity for investors with capital to deploy in the coming years.

As we process the emotional impact of market volatility, it is important to keep in mind that maintaining broad asset class diversification and a long-term perspective are two key components of successful investing. In the priceless words of famed investor John Bogle, "Time is your friend; impulse is your enemy."