

# The Economy and the Markets

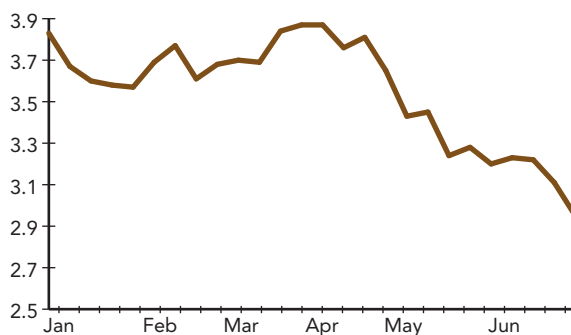
The economy continued to grow in the second quarter, but key measures pointed out areas of weakness. In the first quarter, the wind was at the economy's back. In the second quarter, economic headwinds returned.

Spending, housing and employment all fell short of expectations. Consumer spending slowed considerably from the first quarter. The housing market weakened following the end of the federal homebuyer tax credit, with new home sales dropping dramatically. The number of jobs rose in May, but the increase came from temporary Census Bureau work. The June number dropped by 125,000 after many of those jobs ended.

There are, however, some positive signs in the labor markets. Temporary employment, which historically increases ahead of full-time hiring, is up and household surveys are registering jobs growth. It is possible that we'll experience some improvement in jobs at the same time that the overall growth rate slows. Several components of the federal stimulus program, including dollars going to state governments, have ended and their absence is likely to impede economic growth.

The weakness in employment makes consumers uneasy, demonstrated by increases in the consumer savings rate and decreases in the spending rate. Consumers have led the nation out of previous recessions, but they're not yet ready to lead us out of this one.

## 10-year Treasury Yields



*Treasury yields dropped dramatically in the second quarter, as concerns over slow growth and European government debt solvency prompted a flight to safety.*

## Equities

While earnings reports and projections were largely positive, stock prices fell. The Standard & Poor's 500 Index was -11.43 percent for the quarter. It's off 6.65 percent for the year through June 30 and down 15 percent from its April 2010 high.

Companies continue to figure out ways to cut costs, and margins have improved. But investors appeared to dial back their expectations for growth, and began viewing stocks as overpriced for a lower growth economy.

There's also less appetite for risk. A lot of money remains on the sidelines in cash and cash equivalents. Incidents like the May 6 "flash crash," when the market plummeted for reasons that still aren't clear, only help make investors more skittish.

## Fixed Income

Concerns about the solvency of Greece and other European countries led to a drop in the value of the Euro, and sparked a flight to quality that spurred demand for U.S. Treasuries. Treasuries were up 4.68 percent for the quarter, as measured by the Barclays Capital U.S. Treasury Index.

Credit market spreads widened, and the risk premium rose in almost every area of the fixed income markets. Corporate bonds were up 3.42 percent for the quarter and 5.79 percent for the year, as measured by the Barclays U.S. Corporate Index. Issues of new debt remain muted. Companies continue to be cautious and acquisition activity remains low.

Mortgage securities were in high demand. Mortgage rates are low, but credit limits and lack of equity rule out refinancing for many homeowners. With pre-payment risk practically eliminated, mortgage securities prices are trading at an all-time high.

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## Real Estate

The commercial real estate market appears to be bottoming out and there are now some good values to be found. Commercial real estate sectors with shorter lease arrangements – apartments and hotels – have fared the best in this environment, and are starting to see improvements. Suburban office properties have been hit the hardest, and are not likely to recover until jobs growth resumes.

The residential market continues to struggle, with plenty of unsold homes on the market. The government's homebuyer tax credit is no longer stimulating demand. Foreclosures continue to increase, and housing's woes will still take some time to work through.

## Outlook

The economy may be recovering from the recession, but it is not in a position of strength. Negative events – Greece's debt, the Gulf oil spill, prospects for a slowdown in Europe – keep popping up and feeding an already bearish mood. A number of uncertainties – jobs, the direction of the housing market, the impact of financial reform and health care, and more—need to be resolved before the economy can build any kind of sustainable momentum. While the federal stimulus may have prevented the economy's collapse, it also probably lengthened the time it will take to fully recover.

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*The S&P 500 Dividend-Adjusted Index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and Nasdaq. The weightings make each company's influence on the performance of this index directly proportional to that company's market value.*

*The Barclays Capital U.S. Treasury Index measures the performance of the US Treasury bond market, one of the largest and most liquid government bond markets in the world. Using market capitalization weighting and a standard rule based inclusion methodology; the index accurately reflects the performance and characteristics of the Treasury market.*

*The Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.*

*You cannot invest directly in an index.*

*Past performance is not indicative of future results.*

*This article contains forward-looking statements based on expectations and assumptions. Actual results could differ materially because of changes to these expectations and assumptions.*

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