



Second Quarter 2010

Quarterly Economic News

While the oil spill in the Gulf of Mexico leads the news for the second quarter, the economy comes in a close second. What started off as an impressive market rally in April ended up in a nosedive with the Dow Jones Industrial Average (DJIA) closing the quarter at a new low for the year. U.S. Treasuries were one of the best performing asset classes in the second quarter, gaining favor as investors sought shelter from the stresses of the stock market. The worsening crisis in Europe has spurred angst that the global economic recovery may be in jeopardy. The U.S. budget deficit seems to be growing with no end in sight. But not all is lost – with global demand for goods continuing to rise, real gross domestic product (GDP) numbers for the first quarter of 2010 marked an increase of 2.7%, and nondefense capital equipment spending in the manufacturing sector is growing.

Market Roulette

Investors entered the second quarter with something to smile about: March returns reached highs not seen since October 2008 and early April returns looked even more promising. On April 11, the DJIA broke through 11,000, and reached its 19-month high (11,205.03) on April 26. These gains were fueled by upbeat news about the economy: corporate profits were up, Greece’s debt relief plan was in place and March retail sales numbers were strong. Investor confidence eroded quickly in May when a mysterious flash crash temporarily sent the DJIA plummeting. Despite the quick rebound, the effects of this crash reverberated in investors’ minds. Numbers posted for May illustrated the DJIA’s worst monthly decline (in percentage terms) since 1940, and the worst May ever measured by points. This sent investors rushing back to the safety of U.S. Treasury debt, and the yield on the 10-year Treasury reached its lowest level seen in a year. The downward trend continued in June amidst less than desirable economic news. The DJIA closed the second quarter down 10%, the first quarterly drop since Q1, 2009. The following table shows returns for various indices:

Index	2nd Qrt	1 Year	5 Year	10 Year
S&P 500	-11.42%	14.43%	-3.91%	-14.81%
Russell 2000	-9.92%	21.48%	1.85%	34.42%
MSCI EAFE (Net)	-13.97%	5.92%	4.46%	1.46%
Barclays Agg. Bond	3.55%	7.97%	31.41%	84.26%

The S&P 500 is a commonly used measure of common stock total return performance.

The Russell 2000 is a commonly used measure of small capitalization stocks.

The MSCI EAFE is a commonly used measure of common stock total return performance of international markets.

The Barclay’s Aggregate Bond Index (formerly Lehman Brothers’ Aggregate Bond Index) is a commonly used measure of the bond market.

All referenced indices are unmanaged and not available for direct investment.

Past performance is not a guarantee of future results.

Flash Crash

It was the biggest one-day point decline on an intraday basis in DJIA history. The May 6 “Flash Crash” wreaked havoc on markets, causing the DJIA to lose nearly a tenth of its value (998.5 points) in less than half an hour. As shocking as the crash was, it was followed almost immediately by a rebound. The market recovered two-thirds of the loss before the closing bell.

A number of theories on the cause of the crash have been touted: a “fat finger” trade, an exceptionally large sell order that caused computer-automated trades to dump stock, deliberate market manipulation, even hacker or terrorist activity. At this time, there is still much speculation about the cause of the plunge, and it remains unclear whether a single trade triggered the market’s temporary collapse. Although Waddell & Reed, a Kansas-based asset management firm, was identified as the possible culprit in the May 6 market plunge, SEC Chairman Mary Shapiro testified at a congressional hearing that high frequency trading firms immediately identified as culprits may have exacerbated the sell off, but likely didn’t cause it.

Exchanges are expected to implement trading curbs, known as “circuit breakers”, for a six-month trial period ending in December 2010. These “circuit breakers” would halt trading when individual stocks drop or rise more than 10 percent in a five minute period.

Euro Zone Trouble

What was initially pegged as an “emergency only” bailout agreement for Greece’s ailing finances quickly made an about-face when Standard & Poors downgraded Greece’s debt to junk status on April 27. Euro zone finance ministers jointly with the IMF pledged €110 billion (\$145 billion) in loans over three years to help Greece ride out its debt crisis. What is more, a €750 billion (\$955 billion) bailout agreement was negotiated by members of the European Union to stem spreading worries about debt problems elsewhere in the euro zone. Drastic measures are being taken by sovereign nations to avert further crisis in Europe - Italian Prime Minister Silvio Berlusconi approved €24 billion (\$30 billion) in budget cuts for 2011-2012 in an effort to reduce Italy’s budget deficit and Spain announced spending cuts of €15 billion (\$18 billion) over two years. The euro plunged to its four-year low against the dollar on June 8. There is fear that this could make U.S. exports less desirable, which could be problematic considering Europe accounts for approximately 20% of all U.S. exports. The turmoil is also

affecting the bottom line of U.S. companies with significant retail presence in Europe.

Deficit Dilemma

The United States’ ballooning budget deficit has many worried that difficult changes lay ahead. President Obama appointed a bipartisan National Commission on Fiscal Responsibility and Reform to provide recommendations on ways to stabilize the short- and long term fiscal situation. During their first meeting, guest speaker Ben Bernanke stated that “no credible forecast suggests that future rates of growth of the U.S. economy will be sufficient to close [these] deficits without significant changes to [our] fiscal policies.” Cuts in Social Security, Medicare and Medicaid (which account for approximately 40% of overall yearly spending) are being considered, but discussions are ongoing. Regardless of the recommendations made by the Commission, it is clear that significant changes are inevitable in order to reduce the national debt and create a fiscally sustainable future. In what seems like an incredible bit of irony, the Commission recently requested additional funding to

fulfill their mission, citing lean staffing levels and a tight deadline (all recommendations must be provided by December 1, 2010).

Home Sweet Home

Data compiled for the S&P/Case-Shiller Home Price Index in the first quarter of 2010 indicated a 3.2% decrease in U.S. home prices; however, prices remain above levels seen for the same period one year ago. Existing home sales soared in March and April, propelled by a government homebuyer tax credit and exceptionally low mortgage rates. Home prices rose unexpectedly in April (up 0.4%), bouncing back from crisis lows. With government tax incentives expiring, a temporary fallback in home sales was expected. New home sales numbers for May, published by the U.S. Department of Housing and Urban Development, confirmed this prediction with a 32.7% decline from April numbers. The Pending Home Sales Index, a forward-looking indicator published by the National Association of Realtors that measures housing contract activity, hit its 6-month high in April, but plunged 30% in May. At quarter close, Congress passed an extension of the homebuyer tax credit closing deadline. The extension applies only

to transactions that have ratified contracts in place as of April 30, 2010 that have not yet closed. The new closing deadline for eligible transactions is September 30, 2010.

On The Mend?

On a positive note, real GDP grew at an annual rate of 2.7% in the first quarter of 2010, following an increase of 5.6% in the fourth quarter of 2009. Annual real GDP growth in a range of 2.5 to 3.5% is generally considered strong enough to provide corporate profits and job growth yet moderate enough to keep inflation at bay. At this time, inflation expectations are unclear and contradictory information abounds: some economists see the mounting deficit as a trigger for inflation while others foresee a risk of deflation in the near-term.

The manufacturing sector has lately been a key contributor in the economic recovery. At the end of the quarter, the Federal Reserve announced that business

spending on equipment and software “has risen significantly”. Capital goods orders (excluding defense and aircraft) are up considerably from the same period last year, which is a positive signal for other areas of the economy.

Unemployment numbers have remained flat for most of the quarter, ranging between 9.5 and 9.9%. Many economists surmise that any sustained drop in unemployment could be the catalyst that ignites the economic recovery.

If the second quarter has taught us anything it is that making assumptions can create false expectations. While we cannot predict how the third quarter will play out, early numbers are trending positively. To quote the German playwright Johann Wolfgang von Goethe: “In all things it is better to hope than to despair.”

The Executive Compensation Group

325 Williamson Boulevard
Suite 120
Daytona Beach, Florida 32114
Office: (386) 255-0519
Fax: (386) 252-4084

www.excg.com

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