



August 23, 2010

With the dog days of August upon us and Washington and Wall Street on vacation, there wasn't a lot of news to stir the market one way or the other last week, but what little there was did nothing to lift the gloomy spirits of investors. The Dow fell for the second week in a row, down 0.87% and now off 2.1% for all of 2010.

The week got off to a slow start when the National Association of Homebuilders reported that its confidence index dipped to its lowest point since March 2009. With U.S. Treasuries flirting with record lows and interest rates at their lowest level since the government began keeping track in 1971 (at week's end the average 30-year mortgage rate was 4.42% compared to 5.12% a year ago), analysts have been split as to whether or not the rates would spur a new round of buying and refinancing. But on Tuesday, promising news on that front helped drive the Dow to a gain of 103.84 points after the Commerce Department said that housing starts rose 1.7% in July to a seasonally adjusted annual rate of 549,000. And before the week was over, the Mortgage Bankers Association said its refinance index jumped 17% to 4,676.70 in the week through Wednesday, its highest level since March of last year.

In other positive news, the Labor Department announced that producer prices inched up 0.2% in July, the first increase in three months, after a 0.5% drop in June. Excluding the volatile food and energy, prices increased 0.3%, the largest core index gain since January. Better still, taken in tandem with the previous week's release

	Key Market Data		
	Week ending...		
	8/20/10	8/13/10	Change
Dow Jones Industrial Average Index	10,213.62	10,303.15	-0.87%
S&P 500 Index	1,071.69	1,079.25	-0.70%
NASDAQ Composite Index	2,179.76	2,173.48	+0.29%
10-Year Treasury Note Rate	2.614%	2.690%	-0.075 pct. pts.
NYMEX Crude Future (Barrel)	\$73.46	\$75.39	-2.56%
Euro/U.S. Dollar	\$1.2708	\$1.2753	-\$0.0045

about the consumer price index (up 0.3% in July with the core index up 0.1%), the numbers in the near term should ease fears about deflation, a drop in prices and salaries. And a Federal Reserve report showed that output from manufacturing rose 1.1% in July, twice the forecast, after falling 0.5% in June, with industrial production up 1.0%.

Furthermore, the Conference Board said its index of leading economic indicators improved 0.1% in July to 109.8 after a 0.3% drop in June. However, the week ended with still more disappointing news about jobs when the Labor Department said that initial jobless claims for the week ending August 14 were up 12,000 to 500,000 – the first time they've reached the mid-million mark since last November. The four-week moving average climbed 8,000 to 482,500 – its highest point this year. (The peak during the recession was 651,000 in March 2009 while the low was 439,000 this past February.)

On the corporate front, there were signs that companies were starting to spend some of

that money they've hoarded over the past year or so. Intel said it was acquiring McAfee, the maker of antivirus software, for \$7.68 billion. And GM, as expected, filed for an IPO to raise cash and also enable the federal government to sell enough of its stake so it was no longer the company's majority shareholder.

While the final numbers aren't yet in, Thomson Reuters said that through August 13, 459 companies in the S&P 500 Index had reported earnings for the second quarter with 75% beating analyst expectations, 9% in line, and 16% falling short of the mark. All together, the companies were reporting earnings that were 10% above the estimates, well above the average surprise factor of 2% since 1994 but slightly below the 12% recorded over the past four quarters. In addition, also through August 13, 455 of the S&P 500 companies had reported second-quarter revenues, with 63% coming in above analyst expectations and 37% below. All ten sectors showed an improvement in earnings year-to-year, with materials, energy, consumer discretionary and information technology leading the way.

Finally, James Bullard, the president of the Federal Reserve Bank of St. Louis, responded to comments that last week's decision by the Fed to buy U.S. securities and expand its balance sheet was a sign that a new crisis was upon us: "I wanted to push back against the idea that if we were going to do this, we would do this in the crisis mode we were in during 2008 and early 2009," he told reporters. "We are way beyond that at this point. The economy is far stronger."

The broader view

Early last week, there was an announcement that was all but inevitable but was still of global importance: China, after a strong second quarter, displaced Japan as the world's second largest economy behind the United States, its GDP put at \$1.339 trillion for the quarter compared to Japan's \$1.288,

and about \$5 trillion in total. (Ours was \$14 billion in 2009, and the rest of the top five is rounded out by Germany and France.) Further, economists estimate that by the year 2030, China will bypass us and claim the top spot.

These figures show that in a remarkably short time – a little more than a decade ago China had the world's seventh largest GDP and five years back its GDP was only half that of Japan's – China has recast the global economy in a number of important ways: through its dominance in trade, where it is now the globe's leading exporter; though its massive purchases of foreign debt totaling \$2.5 trillion – China holds about \$900 billion in U.S. bonds, the most money any country has ever borrowed from or loaned to another; and because of its enormous appetite for commodities such as oil, coal, and iron, which has helped keep the global economy afloat during the downturn.

The economic clout has had other consequences as well. Over the past year or so, China has become more assertive on both the diplomatic and economic fronts, starting to take its new role as the planet's only other superpower seriously. And, as *The New York Times* reported last week, China also has something going for it in an economic pinch that we don't: "an authoritarian government that is capable of taking decisive action – to stimulate the economy, build new projects and invest in specific industries."

Even so, it's not all clear sailing for China. According to the International Monetary Fund (IMF), China is still officially classified as a "developing country," and that status is most clearly underscored by its per capita GDP, which the IMF projects to be \$3,600 in 2010, compared to \$46,000 for the United States, putting China on par with the likes of Albania and Algeria. (For the record, the IMF projects China at #98, Japan at #17 with \$41,366, the United States at

#11, and Luxembourg #1 at \$107,599 per head.)

In the short run, that earning gap may not matter much in a country where the Communist Party still rules with a firm hand. However, the last few months have seen an unusual number of news reports about labor unrest in China, and the legions of China watchers are keeping a close eye on how and when the government will address the growing demands of its workers for a larger piece of the action – and wealth.

A look ahead

This week will be a quiet one, unless you count the beginning of the back-to-school buying season. There will be releases on



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existing and new home sales, durable goods orders, and personal consumption, as well as consumer confidence. The most significant report, however, will be the Commerce Department's update on second-quarter GDP, which originally came in at a disappointing 2.4% and is now expected to be revised down to somewhere in the 1-to-1.5% neighborhood.

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All index references and performance calculations are based on information provided through Bloomberg. Bloomberg is a provider of real-time and archived financial and market data, pricing, trading, analytics, and news.

The Dow Jones Industrial Average Index[®] 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[®] (S&P 500[®]) 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[®]). 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[®] Stocks traded on the NASDAQ stock market are usually the smaller, more volatile corporations and include many start-up companies.

NASDAQ - National Association of Security Dealers Automated Quotations. The NASDAQ is a computer-operated system owned by the NASD that provides dealers with price quotations for over the counter stocks.

Bear market calculations and interpretations are derived from data supplied by Ned Davis Research, Inc.

The National Association of Homebuilders (NAHB) Housing Market Index (HMI) is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months as well as the traffic of prospective buyers of new homes.

The Mortgage Bankers Association (MBA) Refinance Index is calculated from its Weekly Mortgage Applications Survey covers over 50 percent of all U.S. retail residential mortgage applications. Respondents include mortgage bankers, commercial banks and thrifts.

The Labor Department's Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The Labor Department's Consumer Price Indexes (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

The Conference Board Leading Economic Index is intended to forecast future economic activity and is calculated by The Conference Board, a non-governmental organization, which determines the value of the index from the values of ten key variables. These variables have historically turned downward before a recession and upward before an expansion.

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The International Monetary Fund (IMF) is an organization of 187 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth and reduce poverty around the world.