

Second Quarter  
2010



## Investment Commentary

Stocks turned sharply lower in the second quarter of 2010, erasing all of the first quarter's gains and leaving the large-cap benchmark S&P 500 down approximately 11.5% for the quarter and off almost 6.7% through the first six months of the year. Losses were evident in virtually every segment of the market. For the quarter, the small-cap iShares Russell 2000 and iShares Russell Midcap both lost 10%, though thanks to a strong first-quarter, both benchmarks are down just 2% year-to-date. Turning abroad, the story was similarly painful. The Vanguard Total International Stock Index dropped 13.3% in the second quarter, bringing its year-to-date loss to 12%. The Vanguard Emerging Market Stock Index lost over 9% for the quarter and nearly 7% year-to-date.

Both tax-exempt and taxable fixed income securities generated positive returns for investors for the first six months of the year as yields continued at near record low levels in the U. S. Treasury and municipal bond markets. The Vanguard Total Bond Market Index Fund, a proxy for high-quality, intermediate-term bonds, gained 3.6% over the second quarter, and is up 5.3% for the year. Foreign bonds were mixed.

In addition, the first six months of 2010 have been a bit of a roller coaster—domestic stocks were up early in the year, then down 5% by early February, then up almost 10% for the year by late April, then down nearly 7% for the year by the end of June. This reflects what we see as an investor “tug of war” in the stock market, with improving economic and company fundamentals on the one side, and concerns about debt-related stress points and the longer-term strength of the economic recovery on the other. The tension



June Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	Jun	2Q	YTD
Vanguard 500 Index	-5.2%	-11.5%	-6.7%
Russell 1000 iShares	-5.5%	-11.4%	-6.4%
Russell 1000 Growth iShares	-5.5%	-11.8%	-7.7%
Russell 1000 Value iShares	-5.6%	-11.1%	-5.2%
Mid-Cap Benchmarks			
Russell Midcap iShares	-6.2%	-9.9%	-2.1%
Russell Midcap Growth iShares	-6.3%	-10.2%	-3.4%
Russell Midcap Value iShares	-6.1%	-9.6%	-1.0%
Small-Cap Benchmarks			
Russell 2000 iShares	-7.7%	-9.9%	-2.0%
Russell 2000 Growth iShares	-6.7%	-9.2%	-2.3%
Russell 2000 Value iShares	-8.7%	-10.6%	-1.7%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-1.2%	-13.3%	-12.0%
Vanguard Emerging Mkt Stock Index	0.0%	-9.1%	-6.9%
Vanguard REIT Index	-5.2%	-4.0%	5.6%
Vanguard Total Bond Mkt Index	1.6%	3.6%	5.3%
Merrill U.S. High Yield Cash Pay	1.3%	0.0%	4.8%
Barclays 7 Yr Muni Bond Index	0.3%	2.3%	3.6%
Citigroup World Govt. Bond Index	1.7%	0.3%	-1.0%
JPMorgan GBI-EM Global Div. Index	0.9%	-2.0%	3.4%
DJ-UBSCI (Commodity Futures)	0.3%	-4.8%	-9.6%

between these opposing forces has left investors uncertain and the stock markets stuck in a trading range.

### The Challenges We Face

It's no secret that there is too much debt in most of the developed world—the United States, Europe and Japan. In coming years the developed world must walk a tightrope as it deals with the pressing need to slow and ultimately reverse debt growth without also seriously harming economic growth rates. Household debt relative to income remains excessively high, though it is dropping. The United States and other countries with excessive household sector debt are in the early stages of what is likely to be a long process of deleveraging. Most countries must also dramatically reduce government debt growth as well. This huge challenge has not yet begun.

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The timing and aggressiveness with which government debt and deficits are attacked will be extremely tricky to get right given current economic headwinds. On the one hand, too much austerity coming from very tight fiscal policy can be counterproductive because it risks smothering already weak growth, which reduces tax revenues, increases social safety net spending, and could weaken the political will that is needed to follow through on spending discipline.

But waiting too long to tackle rising debt levels digs a deeper hole and risks a lenders' strike, which could result in government borrowers (and all others too) being forced to pay a much higher interest rate to finance their debt. Critically important will be the policymaker's ability in the United States to thread the economic needle so that the recovery has time to gain steam while maintaining lender confidence that the deficit/debt problems will be addressed over time. Slowing and ultimately reversing the growth of debt is further complicated by an aging population—a reality that most of the developed world faces to different degrees.

While the private sector gradually de-levers, and we wait for the public sector to later do the same, at least the United States is experiencing an economic recovery. There has been clear improvement from the depths of the recession. The economic growth is a plus, though big problems certainly present challenges ahead. Three variables critical to improvement in private-sector consumption and a normal recovery—the labor markets, credit growth, and housing—remain weak. We are still down about eight million jobs from the peak and private sector job growth is barely positive – though there is improvement from last year. Credit market debt is contracting as it has been for about two years, which removes an important driver of consumer spending. And the housing outlook, which is critical to household financial strength and the banking sector, remains cloudy and

risks renewed weakness with an expiration of the homebuyer tax credit.

The rest of the developed world also faces economic issues. Europe is experiencing very slow growth. Southern Europe is uncompetitive and has many countries in various stages of sovereign debt crisis. Economic policy is a challenge given the lack of political union and differing economic situations. Fortunately, key parts of the developing world are in much better shape with stronger balance sheets, higher growth rates, younger populations, and slowly emerging consumer sectors. Their strength is an important source of support for the global recovery. And there are other positives that help to mitigate the negatives. The continued impact of massive federal stimulus (though this will wane later this year in the United States), healthy corporate balance sheets and cash flow, and a natural rebound in economic activity after a huge decline are also sources of strength in the U.S. and global economy.

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This all nets out to a macro-environment which is fragile, yet improving. Recent market volatility is likely to continue as investors sort through the myriad of issues which we will face in the months ahead. In the meantime, we are working hard to ensure that when opportunities do present themselves we are in a position to recognize and take advantage of them, while also being highly attuned to the potential risks. Our commitment remains to thorough research and honest analysis as we seek to attain the investment goals and objectives established for your account.

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