



July 12, 2010

The holiday break proved to be the perfect tonic for the stock market last week after a gloomy end to the second quarter, with all of the major indexes rising by at least 5% and the Dow turning in its best week of 2010, up 5.3%. The rebound was driven in part by the perception that the selloff had gone too far, but also by investors getting ready for what's expected to be a strong corporate earnings season, with Thomson Reuters forecasting that earnings will be up 27%. By way of example, the stock of Alcoa, which today will be the first company to announce earnings, was the Dow's top performer last week, jumping 9.4%.

In other news, the Institute for Supply Management (ISM) reported that the service sector index grew for the sixth month in a row – any reading over 50 indicates growth – but the index fell to 53.8 in June from 55.4 in May. Still, that's well above the low of 37.2 in June 2008 (if also way off the high of 67.7 in 2004). The service sector accounts for 80% of employment and is driven by consumer spending. In a sign that those consumers are still being cautious, the Federal Reserve said that outstanding consumer credit declined in May for the fourth straight month, falling \$9.1 billion or 4.5%. And in mixed news, the Commerce Department announced that wholesale inventories improved 0.5% in May, but sales dropped for the first time in more than a year, off 0.3% after a 0.9% gain in April. Inventories were down 2.1% from last May but sales were up 15.1% year to year. In what was purely positive news, the Labor Department said that first-time unemployment claims fell last week by

	Key Market Data		
	Week ending...		
	7/9/10	7/2/10	Change
Dow Jones Industrial Average Index	10,198.03	9,686.48	+5.28%
S&P 500 Index	1,077.96	1,022.58	+5.42%
NASDAQ Composite Index	2,196.45	2,091.79	+5.00%
10-Year Treasury Note Rate	3.056%	2.977%	+0.078 pct. pts.
NYMEX Crude Future (Barrel)	\$76.09	\$72.14	+5.48%
Euro/U.S. Dollar	\$1.2640	\$1.2565	\$.0090

21,000 to 450,000, the lowest level since May. And in a sign that low mortgage rates may have finally stirred the housing industry, the Mortgage Bankers Association reported that mortgage applications rose 7% last week from the week before because of the near-record-low rates (the average 30-year rate fell to 4.58%), with refinancings up 9%.

Congress, meanwhile, continued to spar over the stalled bill to extend jobless benefits, lend money to small businesses and provide funding to state and local governments, with the GOP taking a stance that something had to be done about the deficit and the Dems saying they wanted to help the unemployed. Referring to the bill in his weekly video address, Mr. Obama said, "Republican leaders in Washington just don't get it," while Senator Saxby Chambliss (R - Ga.), voiced the opposition's view: "At some point we have to say, enough is enough," adding, "We have to make tough decisions about spending beyond our means." In any case, it's safe to say that very little usually happens in

Congress after the long summer recess before an election.

The Treasury Department finally released its much-delayed currency report, originally due on April 15, and while not branding China a “currency manipulator,” because of its recent action to adjust its currency, did conclude the renminbi “remains undervalued.” It also looked as if China and Google had finally hammered out an agreement allowing Google to continue to operate in China.

In Europe, there was a dramatic step taken on the regulatory front when the European Parliament approved rules to curtail compensation at banks. Our Federal Reserve has accused U.S. banks of taking too long to change the compensation practices that encourage risk taking, and the Europeans put some hard numbers against the size and terms of the bonuses that can be awarded. As a result, bankers in the 27 European Union (EU) countries will not be able to get a bonus of more than 30% of their salary beginning next year. About 70% of any bonus would be delayed for up to three years and paid in a new class of security called “contingent capital” that would decline in value if the bank’s performance subsequently dipped. Banks that choose not to comply will have to set aside more capital to offset risk. The only caveats are how many people are subject to the new restrictions, which will be left up to individual governments, and the fact that the rules do not cap total pay.

Lastly, the International Monetary Fund (IMF) said the worldwide recovery is losing steam and will continue to do so, with its updated *World Economic Outlook* forecasting that global economic expansion will dip to 4.3% in 2011 from 4.6% in 2010. With a nod toward Europe, the report concluded that, “Downside risks have risen sharply amid renewed financial turbulence.”

The broader view

While the debate continues about the health of the global recovery, there’s one thing for certain: the Asia-Pacific region is well ahead of the rest of the world. For example, the concern in China has been about its economy overheating, not underperforming, as it turns in near double-digit growth that gives the rest of the world a leg up, in part because of its voracious appetite for commodities. South Korea raised short-term interest rates last week only 24 hours after Malaysia had done so for the third time this year and just a week after India also announced its third hike this year. And while Australia kept interest rates unchanged, it has led the way as one of the first countries to raise its rate more than once since the recovery began. The region’s healthier economies are partly the result of the same stimulus spending that worked for the rest of the world, but also because they have less debt to manage and their major banks and financial firms weathered the recession in far better shape than those in Europe and the United States. That explains why the IMF last week said that the Asia-Pacific region could experience GDP growth of 9.2% this year compared with 3.3% for the U.S. and 1% for Europe.

On the flipside, both the Bank of England and the European Central Bank (ECB) left their rates unchanged last week, at 1% and 0.5% respectively. Jean-Claude Trichet, the ECB’s president, said the bank remained “cautious and prudent,” but added “the second quarter in the euro area is likely to be much better than the first quarter,” while also noting that outside observers have tended to be “excessively pessimistic.” Jürgen Stark, one of the ECB’s chief economists, was more upbeat, saying “the worst was over” for Europe’s debt crisis and expressing confidence about the continent’s growth. Stark also said the IMF’s latest report was behind the times and too pessimistic about Europe’s growth prospects, though many of his peers at the meeting on economics did not share his optimism.

The recovery story is somewhat different in the West because of the recession's greater toll on the banking systems, but also because of the ongoing – and justifiable – concern about the solvency of countries such as Greece and Spain and the looming deficits of almost every other member of the European Union, with Great Britain, Germany and France all having recently announced plans to pare spending.

That said, Europe took some steps last week to get back on track. For starters, it was announced that 91 European banks, holding 65% of the continent's bank assets, are set for stress tests to restore investor confidence by demonstrating how they would hold up if the economy deteriorated. Further, Spain said it would overhaul its saving banks regulation which Prime Minister José Luis Rodríguez Zapatero trumpeted as “the most important reform ever of our banking system.” (Spain will also get a much needed and positive boost from its World Cup victory, which will lift the spirits of consumers and, economists say, Spain's brand.) And Greece took a tough and unpopular step, approving a pension bill that would sharply cut back on the retirement age and benefits, against a backdrop of strikes and protests, and has now actually exceeded the deficit cutting steps pledged to the IMF when it borrowed €10 billion euros (\$140 billion) three months ago. This week will be telling because Greece will



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auction government bonds for the first time since it received that bailout money, the sale of which will be a good indication of whether investors believe the money and new austerity program will make a difference for Greece – and all of Europe.

A look ahead

Aside from the first wave of earnings announcements, which in addition to Alcoa will cover Bank of America, JPMorgan Chase, Intel and GM, there will be a number of key releases and updates, including the latest on the trade gap, retail sales, business inventories, the producer price index, industrial production and capacity utilization. Also, the Federal Reserve will release the minutes from its June 22-23 meeting, and the Senate's confirmation hearings will begin on President Obama's nominees for the three positions opening up on the Fed's board of governors: Janet Yellen, president of the San Francisco Federal Reserve Bank; Sarah Raskin, currently Maryland's commissioner of financial regulation; and Peter Diamond, an economics professor at the Massachusetts Institute of Technology.

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