

Capital Market Review

Second Quarter, 2010

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Summary

In the **Harry Potter** series, there is a character called a dementor which makes people feel that “all the happiness is gone from the world”. That pretty much sums up the second quarter -- a consistent drumbeat of negative news. European debt crisis, flash crashes, BP oil spill, less robust economic news, unbelievable political fighting have at times made me feel that “all the happiness is gone”.

While outright European debt defaults are unlikely, the austerity measures being taken and their ramifications will impact global economic growth for years to come. If the United States does not get its spending under control, these measures may be a preview of what may happen here.

The U.S. economy appears to have hit a “speed bump” – it is still growing but at a slower rate than the past six months. I do not expect a double-dip recession. But until we can get more Americans back to work, economic growth will be less than optimal. Unfortunately, all the new laws, regulation, and higher expected taxes hinder business growth and investment. There is extreme uncertainty about the short- and long-term prospects for the U.S. economy and the market is reflecting

that uncertainty through higher volatility. But there is good news. Corporations are flush with cash and profitability is high. Housing prices have generally stabilized, inventories have come down, and affordability is high. Lastly, assuming a slowly growing economy, the stock market appears to be slightly undervalued.

U.S. stocks returned -11.3% during the second quarter. Emerging market stocks did better and developed international stocks did worse. U.S. bonds returned 3.5% as interest rates came down. Current yield on the 10-year Treasury is 3.0%, significantly lower than a year ago. Long-term bonds were the best performing maturity segment and Government bonds were the best performing sector. Real estate returned -4.0% and commodities returned -4.8%.

Economic Conditions

The economy is providing mixed signals -- which are probably not too surprising after the severe recession -- it simply takes time to heal. Nearly all numbers over the past year show robust growth. But, those are historical numbers.

Using recent monthly results paints a less rosy picture. Leading economic indicators have turned flat and retail sales have seen negative growth. Surveys of future economic activity still indicate expansion -- but respondents are simply less optimistic. After expiration of the housing credit, housing sales are down along with new housing starts.

Inflation remains contained. In fact, the possibility of deflation has many worried again. Interest rates remain low although access to capital is still constrained. Industrial production is growing and announced layoffs have significantly declined. Labor productivity is up.

In short, it is an economy that is growing slowly, and appears to have become less sure of itself. This is cause for concern as, given the depth of the recession, the economy should be growing quicker by now.

Stock Market Returns

During the second quarter, U.S. stocks returned -11.3%, ahead of the -14% return of developed international stocks but below the -9.1% return of the emerging markets. Mid- and small-cap stocks outperformed large-cap stocks and the value approach had a slight edge over growth. Utilities (-3.7%), Telecommunication (-4.2%), and Consumer Staples (-8.1%) were the best performing economic sectors while Technology (-15.3%) and Finance (-13.3%) were the worst performing sectors.

Year-to-date, U.S. stock returns of -6.1% outperformed both developed international and the emerging markets. The mid- and small-cap return of around -2.0% is ahead of the large-cap return of -6.4%. The value approach returned -4.8%, which compares favorably to the growth approach return of -7.3%. Industrials (-0.9%) and Materials (-1.0%), were the best performing sectors while Energy (-12.2%), and Technology (-12.9%) were the worst.

Bottom-up analyst expectations for 2011 S&P 500 earnings growth are robust. Based on consensus estimates, large, mid, and small-cap stocks have 2011 expected earnings growth of 16.0%, 22.9%, and 32.1%, respectively. This seems too high. From a fundamental perspective, it appears that large-cap stocks are more attractively valued vis-a-vis mid- and small-cap stocks. And yet, from a technical perspective, mid- and small-cap stocks have outperformed. Divergences between fundamental and technical factors frequently occur. Prices will eventually move toward fundamentals. The key issue is timing.

Bond Market Returns

The bond market continued to be captivated by the European debt problems. For now, the bailout mainly financed by Germany, has calmed markets. We will see if this holds. The citizenry of many European countries are protesting the significant austerity measures required.

Here at home, at the beginning of the year, the consensus was for rising interest rates and, of course, the consensus was wrong as interest rates have fallen. The 10-year yield is currently around 3.0%, about 0.8% lower than the start of the year. If there is 2% inflation, real bond yields are around 1%.

Unless deflation or extremely low inflation continues, we would expect interest rates to eventually rise. The question is one of timing. They currently reflect a slow economy, global economic uncertainty, and demand from investors who have moved their money from stocks to bonds.

During the quarter, U.S. bonds returned 3.5%, outperforming developed international and emerging market bonds. Long-term and Government bonds were the best performing maturity segment and sector, respectively. High yield bonds returned -0.1% as quality spreads widened. Municipal bonds returned 2.0%.

Year-to-date, U.S. bonds returned 5.3% similar to the emerging market bond return of 5.6% and outperformed developed international bonds. High yield bonds returned 4.5%.

Stock Returns For Periods Ending June 30, 2010

	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>		<u>Qtr</u>	<u>1 Year</u>
Nationality						Developed Country		
U.S. Market	-11.3%	-6.1%	15.7%	-9.5%	-0.5%	U.S.	-11.3%	15.7%
Developed Intl	-14.0	-13.2	5.9	-13.4	0.9	Canada	-10.9	15.6
Emerging Market	-9.1	-7.2	20.6	-4.7	10.2			
Size						Europe		
Large	-11.4	-6.4	15.2	-9.5	-0.6	France	-20.5	-2.0
Mid	-9.9	-2.1	25.1	-8.2	1.2	Germany	-14.6	4.5
Small	-9.9	-2.0	21.5	-8.6	0.4	Italy	-23.4	-12.8
Micro	-8.3	2.5	22.3	-10.0	-0.8	United Kingdom	-14.7	4.7
Approach						Pacific		
Value	-11.1	-4.8	17.6	-12.1	-1.6	Australia	-19.6	13.5
Core	-11.3	-6.1	15.7	-9.5	-0.5	Hong Kong	-7.2	11.0
Growth	-11.6	-7.3	14.0	-7.0	0.5	Japan	-10.1	-0.9
Sector						Emerging Market		
Cons Discretionary	-10.9	-1.6	28.1	-8.0	-0.9	China	-6.2	8.5
Cons Staples	-8.1	-2.8	13.7	0.9	5.0	India	-2.9	30.2
Energy	-12.8	-12.2	2.1	-9.3	3.6	Korea	-7.6	3.6
Finance	-13.3	-3.7	16.9	-25.5	-11.8	Czech Republic	-16.7	-6.8
Healthcare	-11.8	-8.8	9.0	-5.2	0.0	Hungary	-31.1	14.1
Industrials	-12.3	-0.9	27.5	-10.1	-0.3	Poland	-22.8	19.4
Technology	-15.3	-12.9	13.7	-9.6	3.0	Russia	-16.7	24.2
Materials	-12.3	-1.0	15.8	-4.4	2.1	Brazil	-16.0	18.6
Telecomm	-4.2	-8.4	3.9	-12.4	1.0	Chile	1.5	23.0
Utilities	-3.7	-7.1	5.7	-6.8	1.6	Mexico	-9.5	28.9

Stock Fundamentals As Of June 30, 2010

	<u>United States</u>		<u>Developed</u>		<u>Emerging</u>	
	<u>Current</u>	<u>1 Year Ago</u>	<u>Current</u>	<u>1 Year Ago</u>	<u>Current</u>	<u>1 Year Ago</u>
Price/Earnings Current	17.4	13.5	11.4	9.9	14.2	1.5
Price/Forecast Earnings	15.3	14.0	11.6	10.4	11.8	12.8
Price/Book	2.1	1.9	1.4	1.2	1.9	1.1
Price/Cash Flow	9.1	7.0	6.2	n/a	7.0	n/a
Price/Sales	1.3	0.9	0.8	0.6	1.2	1.1
Forecast LT EPS Growth	10.1	10.2	8.9	9.8	16.3	13.7
	2010	2011	2011	2010/2011	Estimated Return	
	Expected EPS	Expected EPS	EPS Growth	PE Ratio	PE Ratio = 15x	
Large	81.71	94.78	16.00%	11.4x to 13.3x	13.1% to 31.2%	
Mid	43.65	53.63	22.90%	13.8x to 17.0x	-11.8% to 8.4%	
Small	17.56	23.19	32.10%	14.5x to 19.2x	-21.85 to 3.3%	

Bond Returns And Characteristics For Periods Ending June 30, 2010

	<u>Returns</u>					<u>U.S. Bond Yields</u>	<u>Last</u>	<u>1 Year</u>	
	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>		<u>Qtr</u>	<u>Qtr</u>	<u>Ago</u>
<u>Nationality</u>						Fed Funds	0.15%	0.16%	0.21%
U.S. Market	3.5%	5.3%	9.5%	7.6%	5.5%	Prime Rate	3.25	3.25	3.25
Developed Intl	0.0	-1.9	3.0	8.5	5.4	3 Month Treasury	0.15	0.16	0.18
Emerging Market	1.2	5.6	18.4	8.3	8.1	1 Year Treasury	0.31	0.44	0.51
						2 Year Treasury	0.61	1.06	1.18
						5 Year Treasury	1.78	2.60	2.71
<u>Maturity</u>						10 Year Treasury	2.97	3.88	3.72
Cash	0.0	0.0	0.1	1.3	2.7	30 Year Treasury	3.94	4.75	4.52
Short-Term	1.1	2.0	3.8	5.1	4.5	Aaa Corporate	4.71	5.37	5.61
Intermediate-Term	3.0	4.6	8.3	7.0	5.3	Baa Corporate	6.09	6.36	7.50
Long-Term	8.6	10.2	16.5	9.4	5.6				
						Barclays Aggregate	3.68	3.81	4.36
<u>Sector</u>						Barclays Credit	4.71	4.88	5.15
Corporate	3.3	5.6	14.7	7.4	5.3	Barclays Treasury.	2.00	2.09	2.65
Government	4.2	5.4	6.5	7.6	5.4	Barclays Mortgage.	3.69	3.61	3.85
Mortgage	2.9	4.5	7.5	8.2	6.3	Barclays Municipal	3.71	3.75	3.88
						Barclays High Yield	11.36	11.76	13.25
<u>Other</u>						Barclays TIP	2.98	2.05	3.38
High Yield	-0.1	4.5	26.8	6.5	7.2	Citi Intl Treasury	2.51	2.16	n/a
Inflation Protected	3.8	4.4	9.5	7.6	5.0	JPM Emerging	5.36	5.53	6.03
Municipal	2.0	3.3	9.6	5.5	4.4				

10-Year Sovereign Bond Yields

Spreads Versus 10-Year Treasury

<u>Developed Mkts</u>	<u>Qtr</u>	<u>Last</u>	<u>6 Mo</u>		<u>Qtr</u>	<u>Last</u>	<u>1 Year</u>
		<u>Qtr</u>	<u>Ago</u>			<u>Qtr</u>	<u>Qtr</u>
United States	3.11%	3.82%	3.80%	Aaa	1.74	1.49	1.89
Canada	3.23	3.66	3.75	Baa	3.12	2.48	3.78
France	3.07	3.40	3.61				
Germany	2.64	3.07	3.38	Barclays Aggregate	0.71	-0.07	0.64
Italy	4.03	3.91	4.05	Barclays Credit	1.74	1.00	1.43
United Kingdom	3.43	4.00	4.14	Barclays Treasury.	-0.97	-1.79	-1.07
Euro Zone	2.69	3.07	3.38	Barclays Mortgage	0.72	-0.27	0.13
Australia	5.33	5.69	5.74	Barclays Municipal	0.74	-0.13	0.16
Hong Kong	2.31	2.49	2.55	Barclays High Yield	8.39	7.88	9.53
Japan	1.15	1.31	1.33	Barclays TIP	0.01	-1.83	-0.34
				Citi Intl Treasury	-0.46	-1.72	n/a
<u>Emerging</u>				JPM Emerging	2.39	1.65	2.31
Brazil	6.16	6.16	6.16				
China	3.10	3.29	3.71	Maturity (10yr-2yr)	2.36	2.82	2.54
India	8.12	8.19	7.72				
Russia	5.72	6.29	8.01				

Summary of Current Economic & Financial Conditions

	Percent Change					Data As Of
	3 Month % Change	3 Month % Change Annualized	6 Month % Change	6 Month % Change Annualized	1 Year % Change	
	Gross Domestic Product	0.68	2.74	2.05	4.14	
Leading Economic Indicators	0.27	1.10	2.43	4.91	8.61	June
ECRI Weekly Leading Index	-8.13	-28.77	-8.33	-15.97	2.03	July
Consumer Sentiment	3.26	13.70	4.83	9.89	7.34	June
Retail Sales	-1.44	-5.64	1.58	3.19	5.04	June
Retail Sales Excluding Motor Vehicles	-1.21	-4.75	1.69	3.40	4.65	June
Industrial Production	1.73	7.10	3.30	6.70	8.22	June
ISM Purchasing Managers Index	-5.70	-20.94	2.37	4.79	24.06	June
Number of Unemployed	-2.55	-9.80	-4.22	-8.26	-0.67	June
Announced Layoffs	-41.79	-88.52	-12.72	-23.82	-47.09	June
Output Per Person	0.92	3.72	3.13	6.35	6.15	March
CPI - All Urban Consumers	-0.37	-1.46	-0.14	-0.27	1.11	June
PPI - Finished Goods	-0.89	-3.51	0.73	1.47	2.71	June
KR-CRB Futures Index	0.88	3.57	-2.69	-5.32	18.21	June
Gold Price	10.74	50.39	8.65	18.06	30.38	June
Oil Price	-7.25	-26.00	1.41	2.85	8.14	June
Housing Starts	-1.98	-7.70	0.68	1.36	7.82	May
New Single Family Home - Sales	-13.54	-44.13	-18.48	-33.54	-18.26	May

Actual Value / Diffusion Index

	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	
Phili Fed Survey - General Activity - 6 Months Ahead	25.00	44.20	43.30	47.00	July
Phili Fed Survey - New Orders - 6 Months Ahead	17.90	46.50	44.60	40.90	July
Capacity Utilization - Total	74.14	72.80	71.57	68.17	June
Unemployment Rate	9.50	9.70	10.00	9.50	June
Manpower Employment Outlook Survey	6.00	-2.00	0.00	0.00	September
AAII Percent Bullish Investor Sentiment	20.94	42.45	29.83	48.48	July
AAII Percent Bearish Investor Sentiment	57.07	30.66	50.88	29.70	July
AAII - Stock Allocation Survey	52.86	59.08	63.76	57.11	June
S&P 500 PE	18.01	19.66	20.70	101.87	July
VIX - Volatility Index	34.54	17.59	21.68	26.35	June
3 Month Treasury Yield	0.15	0.16	0.05	0.18	June
1 Year Treasury Yield	0.31	0.44	0.45	0.51	June
5 Year Treasury Yield	1.78	2.60	2.61	2.71	June
10 Year Treasury Yield	3.20	3.73	3.80	3.72	June
30 Year Treasury Yield	3.94	4.75	4.61	4.52	June
Aaa Corporate Bond Yield	4.71	5.37	5.30	5.61	June
Baa Corporate Bond Yield	6.09	6.36	6.36	7.50	June
Quality Spread (Baa - Aaa Bond Yield)	1.38	0.99	1.06	1.89	June
Term Spread (10 Year - 1 Year Treasury Yield)	2.89	3.29	3.35	3.21	June
Real Yield Spread (10 Yr TBond- 1 Yr Expected Infl)	0.00	1.03	1.30	0.62	June