



May: Slight Bump in the Road

Market Summary May 2010

Before and after the first Thursday, May was a fairly placid month in the stock market (see chart, below). But the early trading that day was volatile enough, and virulent enough, to strip 99 points from the S&P 500. Trading glitches were discovered, and most of the early losses were restored the same day. But, errant or not, the morning trading on May proved to be a precursor: The remainder of the month was little more than a slow-motion reprise of its performance. When the markets adjourned for Memorial Day, the S&P 500 had dropped 98.6 points, or 8.0% (total return) for the month. Other equity benchmarks followed suit, shedding all or nearly all of gains they had accumulated through the entire first trimester of the year. At the beginning of May, nearly every equity index we follow was showing a gain for the quarter and year-to-date; at the end of the month, all were in the red for the quarter and all but the smaller caps also were down for the year.

Sovereign Anxiety

The culprit in May's slow slide, by consensus, was the uncertain state of sovereign debt in several nations in the euro zone, primarily Greece. The gross debt of the Greek government is 130% of the GDP, and its budget deficit is 13.6% – 4.5 multiples of the 3% permitted by European Union rules. High deficit/GDP ratios also have implicated Ireland (14.3%), Spain (11.2%) and Portugal (9.4%) in the Euro scare. Italy – though it has done better with its deficit ratio (5.3%) – is on the list too because its gross government debt ratio matches that of Greece. The five countries are now joined in infamy, as their initials have been combined into the unflattering acronym "PIIGS."

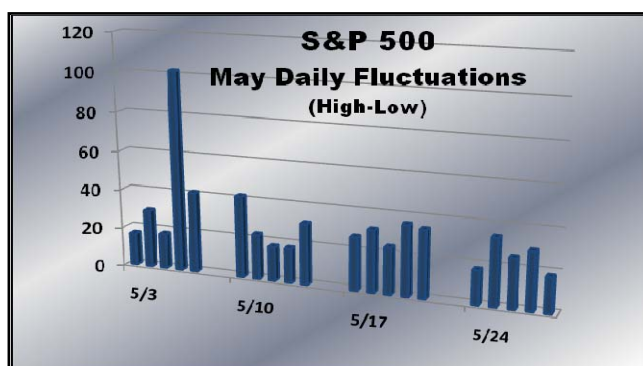
The imputation of swinish appetites derives from the high proportion of the PIIGS' public spending on wages and pensions (75% in Greece, according to J.P. Morgan Chase

economist Joyce Chang). That puts potential bailout nations – principally France and Germany – in the awkward position of taxing their own citizens to meet bloated public payrolls and make government transfer payments in Greece. Not surprisingly, this has encountered resistance from French and German tax payers.

A massive bailout has been arranged nevertheless. Finance ministers in the euro zone have gathered up €440 million, and the European Union and International Monetary Fund (IMF) have added €200 million to the €110 million in rescue money they already had raised. Altogether, it forms a near-trillion dollar fund (about \$897 billion by a recent exchange rate).

So thick a safety net presents an obvious temptation to profligate members of the euro zone consortium. It would be a simple matter for one or more of them to borrow at a rate suited to a Frankfurt banker and spend at a rate suitable for an Athenian sailor. For this reason, the IMF and the European Commission are insisting that firm budgetary rules be set down and strictly overseen. In a notable case of pots calling the kettle black, calls for discipline have come from spokesmen for the Treasuries of the U.S. and United Kingdom. The suggestion is that rigorous "stress tests" be performed on continental banks, and the results published for each institution. "It is clear that doubts remain over the solvency of some European banks," said Mark Hoban, financial secretary to the U.K. Treasury.

European regulators stress-tested their banks last year, and will again this year, but – not wishing to reveal the euro's points of vulnerability – have published results aggregated across all 16 members of the euro zone.



U.S. Jobs Report Disappoints

The U.S. added 431,000 jobs in May, the most in a decade, but markets fell on the news. For one May: Slight Bump in the Road thing, economists had predicted 515,000 new jobs; for another, 95% of the new positions were for temporary census workers (many of whom already were employed when hired). Only 41,000 of the new positions were in the private sector, as compared to 218,000 in April. Even that number includes several thousand short-term positions created by the blow-out of a British Petroleum oil well in the Gulf of Mexico, some analysts say.

Federal Reserve officials have been cautiously optimistic in recent public prognostications on the U.S. economy. "Relatively solid" is a phrase used by Charles Plosser, president of the Federal Reserve Bank of Philadelphia. Charles Evans, president of the Chicago Fed, said recovery is "well under way." However, both cited improvements in employment data as evidence, and both spoke before the May jobs report was released by the Bureau of Labor Statistics.

Although there is a body of opinion among Fed bank chairmen (e.g., Thomas Hoenig of Kansas City) for an end to the near-zero interest rate policy, Fed watchers agree that there is little chance of a move before next year, given the very grudging improvement in jobs data and continued quiescence in inflation measures.

Business Activity Rising

For the first time in more than two years, employment grew in May in both the manufacturing and non-manufacturing sectors, according to the monthly business activity survey by the Institute for Supply Management (ISM). Employment nudged up to 50.4 on ISM's index for non-manufacturing businesses, after 28 months of contractionary readings (>50 means growth). Employment in the manufacturing sector rose to 59.8 on the index, up 1.3 points from April and the sixth consecutive month it has registered growth.

Overall activity in the non-manufacturing sector registered 55.4, unchanged from April and the 5th consecutive month of growth. Manufacturing activity was gauged at 59.7, down a fraction from April but the 10th straight month of growth.

Markets Bloodied in May

As mentioned, equity markets took a punch in the nose in May. Every index that we follow finished the month with

a loss. Among large cap issues, the S&P 500's 8.0% drop was mirrored by the Dow Jones Industrial Average and the Russell 1000, which both fell 7.9%. The Russell 1000's Value component fell 8.2%; the Growth sub-index dropped 7.6%.

Among mid-caps, the S&P 400 fell 7.2%. The small-cap Russell 2000 fell 7.6% as its Growth component dropped 6.6% and its Value component 8.4%.

Internationals Not Spared

The weak euro affected international stocks as well, as the large-cap MSCI EAFE dropped 11.5%. The MSCI Emerging Markets Index fell 8.8%; the S&P/Citigroup EMI-EPAC shed 12.0%.

REITS ceased to roar in May. The Dow Jones U.S. Select REIT Index dropped 5.4%; the S&P Global REIT benchmark fell 7.7%.

Commodities provided no haven last month. The Dow Jones-UBS Commodity Index fell 6.9%; the Goldman Sachs Commodity Index fell 13.2%. The S&P Natural Resources Index lost 10.1%

Bonds Got a Little Respect

Though losses were heavy for some bond indices, especially among previously high-flying junk benchmarks, there were some gains scattered among the losses. The Barclay's Aggregate bond index rose 0.8%. Barclay's U.S. Treasury: Long Index gained 4.3%.

The JPM Global bond index (unhedged to the euro) gained 7.6%, the most of any index we follow. The worst loss was 7.4%, returned by Barclays' Ca-D U.S. High Yield.

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