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Dear Valued Investor:

We are starting to see some parts of our economy begin to heal from the big bank meltdown that started last fall. And after severe declines in U.S. GDP in the fourth quarter of last year and the first quarter of this year, the second quarter report shows a modest 1% drop in real GDP. However, many areas remain weak—consumer spending, business investment, residential construction and inventory investment were all down, while net exports (due to huge declines in imports) and government spending were up.

Looking forward, one silver lining is the big inventory decline. Inventory "corrections" like this one usually set the stage for economic recoveries as production finally lifts to rebuild depleted supplies. I expect we will see modest growth in the economy in the second half of the year. However, I do not expect to see rising employment this year as businesses, small and large, remain cautious. The July report on employment showed continued, but moderating job losses, with payroll employment down 247,000 compared to the big 600-700 thousand declines in prior months and the unemployment rate actually fell slightly. Another July report from the Institute of Supply Management points toward recovery in U.S manufacturing with new orders, production, vendor deliveries and U.S. exports finally rising, while their employment measure continued to fall. This is typical of a beginning recovery—turnarounds in business activity, while cost control stays in place for some time.

Second quarter earnings season is more than halfway complete, and so far company earnings reports are generally better than expected. Viewing reports from the "glass half empty" side, revenues are weak, with just about everybody cutting back on spending and companies cutting expenses—hence the fall in business investment and employment. On the "glass half full" view, company earnings have generally been stronger than expected, though still weak because of all the cost cutting, which may set the stage for a rebound in earnings if, as I believe, the economy turns around over the second half of the year. The consensus of analysts' 2010 earnings estimates leaves the forward Price/Earnings ratio for the S&P 500 in the 13 to 14 range, despite the significant rise in the price side of the equation since March. This looks to me to be a relatively conservative valuation, not a reflection of an optimistic outlook.

The stock and bond markets have recovered considerably since March reflecting, in my opinion, a better outlook on the economy. However, big items like the redesign of the financial system and regulatory apparatus are underway and it will be important to get this right. I will be paying careful attention to these reforms and will continue to watch the economic and financial marketplace and put your best interests at the heart of our decision making on your investments. As always, please call your financial professional with any questions or concerns.

Best Regards,

Lincoln Anderson
Senior Economic Consultant