

KWAG August E-mail Update

Welcome to August! We hope everyone is enjoying this beautiful summer. We've been fortunate so far, with generally cool temperatures and more than enough rain. In contrast, the financial markets have been red hot! At this point, the recession appears to be nearing an end and the stock market (which is forward-looking) is rallying in response to better-than-expected economic data. For example, second quarter gross domestic product (GDP), while still negative, was much better than expected and significantly better than what we saw in the previous two quarters. In addition, the latest reports show that the housing sector, manufacturing and unemployment, while still under pressure, have begun to improve and look to be moving in the right direction...although the consumer continues to struggle.

The Numbers

After a blistering second quarter, which saw the S&P 500 index (large cap stocks) rise more than 15% and the Russell 2000 index (small cap stocks) climb more than 20%, July surprised us with a another significant gain, led by small cap stocks. In July, the S&P 500 was up more than 9%, while the Russell 2000 grew by more than 11%. And this rally, which is now entering its sixth month, has continued through the first few days of August. The reason for the rally is simple...the U.S. economy has been more resilient than many thought and growth in the global economy has exceeded expectations. As of today, both the S&P 500 and the Russell 2000 have posted double-digit gains for the year. And from the low point in early March, the S&P 500 has gained more than 45%, while the Russell 2000 has risen more than 60%. But this rally has not been limited just to the stock market or our stock fund managers. At this point our convertible bond fund is up more than 24% year-to-date, while our bond fund that focuses on beaten-down corporate bonds is up an impressive 25%.

Gross Domestic Product

GDP measures our countries output of goods and services. It is calculated by adding our countries total consumption, investment, government spending, and net exports. Over the past few weeks, as manufacturing, unemployment, and housing data has been released, it has become clear that GDP is better than most expected. This

quarter, the decrease was much lower than expected and today the Wall Street Journal reported that most economists have raised their third quarter estimates. This follows the typical vacillation from pessimism to optimism that we see near the end of every recession. Let's examine the state of each of the four GDP factors, so you can get a better idea about where our economy stands today.

Consumption

Personal consumption declined by 1.2% in the second quarter, indicating consumers' continued unwillingness to spend. This was further confirmed by the data on consumer spending, consumer income and consumer confidence – all of which continued to show declines in June. It's clear that the weak labor market will have a negative effect on GDP for some time to come. That said, however, the rate at which jobs are being lost has slowed significantly, which is typical in the late stages of a recession. Typically, job gains don't begin to occur until approximately nine months after a recession has ended.

Investment

Private domestic investment was the worst of the second quarter GDP components. However, like a number of other economic reports, the loss was less than expected and showed improvement as the quarter continued. For example, durable goods orders, which are a proxy for business investment, rose 1.1% in June. This was reinforced by building permits and the Chicago Purchasing Managers Index which also showed increases. In addition, increases in industrial activity across Europe and China, although they have no bearing on domestic GDP, served to reinforce the notion that the recession may finally be nearing an end.

Government Spending

It should come as no surprise that government spending drove most of the gains in GDP, but what we found interesting was how little has actually been spent to date. According to www.recovery.gov only \$70 billion of the authorized \$192 billion in stimulus funds has been distributed to date. (Remember, the total planned stimulus package totals \$787 billion, which comes in the form of lower taxes, spending

incentives, and direct distributions.) Most of the distributions to date have been to state and local governments and directed towards helping with unemployment and education.

The bulk of the stimulus money has yet to be distributed because transportation and infrastructure projects take time to initiate. Ultimately, however, these additional funds will be distributed and will then show up in the GDP figures, further supporting the economy. We should also note that the “cash for clunkers” program, which offered consumers up to \$4,500 for trading in older gas guzzlers, has been wildly successful. For a struggling auto industry it has been great news and the increased activity in showrooms across the country couldn’t have come at a better time.

Net Exports

Exports fell by 7% in the second quarter, while imports declined 15.1%. The combined effect resulted in a nice second quarter gain in net exports, which provided a boost to GDP. This followed a quarter in which exports fell by 29.9% and imports dropped a whopping 36.4%. Going forward, we believe U.S. exporters will benefit from a potentially weaker dollar and stronger growth around the world. Which when taken together, should provide strong demand for U.S. goods and services abroad.

In Sum

In sum, GDP contracted 1% in the second quarter, which was significantly better than expected, and the global financial markets believe this helps to confirm that the recession is coming to an end. It also suggests that the final two quarters of the year could surpass previous estimates. This, along with other signs of improvement, has helped drive all our financial markets higher (with the exception of Treasuries). However, we continue to believe that the increase is probably overdone at this juncture, having gone too far, too fast. As a result, we remain prudently cautious in our portfolios and want our clients to understand that a stock market dip of 10% to 20% would not be at all surprising over the next few weeks or months. Please note that we are NOT predicting a dip, but do feel one is somewhat likely and want our clients to be psychologically prepared to weather the storm should it occur.

Please stay in touch

As usual, if you have any questions about our updates, our newsletter, your accounts or our managers, please feel free to call or e-mail us at anytime. Enjoy the remainder of your summer...and thank you for your continued confidence in our firm. The recent referrals are much appreciated and, as you know, we remain 100% committed towards your financial wellbeing at all times.

- Joe and The Gang at The Kiely Group