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After peaking in late April, the equity markets experienced a strong correction during the balance of the second quarter. The Dow was down -10.4% for the quarter, while the Nasdaq and the S&P were both down -12%. The initial decline was precipitated by the downgrade of Greece's debt to junk status, but there are many factors contributing to investors' nervousness right now in addition to the sovereign debt crisis in Europe. Recent economic data indicates that China has been successful in slowing their blistering growth, and the US economy also appears to be decelerating after its strong performance coming out of the recession.

The main concern for US equity markets is whether the economy is going to slip back into recession. The retail index which is a good proxy of the consumer is down 23% from its April high, and consumer sentiment took a plunge in June to 52.9 from 62.7 in May. Even though cash flow and cash levels are very high, businesses are extremely reluctant to invest or hire. This consumer and business malaise brought on by high debt levels, the prospect of increased taxes, and the anti-business sentiment out of Washington has brought the forward P/E ratio for the S&P 500 down to 12.1 from 14.3 in April.

However, the ISM index remains comfortably above 50 at 56.2 which is a sign that the economy is still expanding. It may be expanding at a slower rate though which is typical for this phase of a recovery. A recent report by Goldman Sachs points out that double dip recessions are extremely rare, only two instances in 1981 and 1931, and were caused by extremely negative changes in monetary or fiscal policy. It is very unlikely that the Federal Reserve will raise rates in the face of continued high unemployment in the US. In addition to low interest rates, energy prices are moderate and corporate earnings have been strong due to productivity gains.

As the market began to deteriorate in May, we started to lock in gains and sell positions that were not acting well. This has left most portfolios with a sizeable cash position. While valuations and earnings look attractive, the technical action in the market warrants caution right now. We have written many times about how the economy needs time to heal from the excesses of the credit bubble, and this current market environment is symptomatic of that healing process. The cash and fixed income in our balanced accounts gives us flexibility to respond to these conditions.

Please give us a call if you would like to schedule a quarterly review or discuss your portfolio. If you come in, we will make sure to introduce you to our newest colleague, Lexia Limon.

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www.crossvault.com