



# investment update

**Alerus**  
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## stocks: hurt by European debt crisis, U.S. and China slowdown

Leading economic indicators in the U.S. and China fell in May and June suggesting that the global economy would slow down in the second half of 2010. Investors worried that high debt levels in Greece and other European countries would make it hard for them to access capital markets. The Dow Jones Industrial Average fell 10% in the 2nd quarter of 2010. Uncertainty surrounding financial regulatory reform in the U.S. and sovereign debt holdings of European banks hurt the broad Standard and Poor's 500-stock index even more—down 11.9%. Stocks of small and mid-sized companies least exposed to Europe did the best. The Russell 2000 fell 9.9% and the Midcap-400 index fell 7.4%.

International stock markets did worse than the U.S., as investors feared that Greece would default on its sovereign debt. A bailout package over \$1 Trillion from the ECB, IMF, and other European countries failed to impress investors. France's CAC and the U.K.'s FTSE indices fell 13.4%. Greece's stock market (down 39.3%) was the worst performing stock market in the 2nd quarter of 2010. Japan's Nikkei fell 15%.

With China tightening policies to combat inflationary pressures and a property bubble, emerging markets did not offer any respite to global stocks. The Shanghai Composite lost 22.9%, Brazil was down 13%, and Russia fell 15%.

## bonds: U.S. Treasurys offer safe haven

As global stocks fell, investors rushed to buy U.S. Treasurys as a safe haven from riskier assets. Treasurys returned 4.7% in the 2nd quarter as the 10-year bond yield fell from 3.84% to end the quarter at 2.96%. Corporate debt prices, on the other hand, followed stock prices and fell during the second quarter. Investment grade bond spreads over Treasurys rose from 1.5% to 2.0% and high-yield, or "junk bond," spreads rose from 5.5% to 7%.

With unemployment high, capacity utilization low, and deflationary pressures expected to continue, we expect the Federal Reserve to maintain the Fed. Funds rate near zero

for some time. In this environment, fixed income should continue to offer returns superior to cash.

## commodities: gold glitters


Despite a strengthening dollar and no signs of inflation, gold continued its bull run—rising 11.9% in the second quarter to settle at \$1,245.50 per troy ounce. Gold has no intrinsic value but investors hold it as a hedge against currency debasement and for fear of low real returns on financial assets. Other commodities; however, did not do so well. The Dow Jones-UBS Commodity Index lost 11% in the second quarter. Issues that affected stock prices also hurt commodities. Oil futures were down 9.7% and commercial metals such as aluminum and zinc fell 15.9% and 25.8% respectively. Natural gas bucked the trend rising 19.3%. Prices were buoyed by predictions of severe hot weather this summer in the U.S.

## currencies: stay with U.S. dollar

The debt crisis in Europe has revealed the fragility of the EU. It is a monetary union without a central government to impose fiscal discipline on its member countries. It is unclear that the Greeks and Spaniards will accept austerity measures to save French and German banks and whether the Germans want to bail out the Mediterranean countries. These issues and very low economic growth will keep the euro sliding—perhaps towards parity with the dollar. During the second quarter the euro fell 8.3% against the dollar and is down 18.3% from its peak. We are bullish on emerging market currencies in the long term. But with risk appetite fading, the dollar could strengthen through the end of the year.

## outlook: we might all have to become Germans

Germany is a producer country that exports more than it consumes. Its deficits are manageable and its debt as a percentage of Gross Domestic Product is acceptable to the financial markets. Germans live within their means. Compare that to the U.S. and U.K. and other European countries, which consume more than they produce and borrow to live beyond their means. The irony of globalization is that emerging markets with their low labor costs and high savings rate have provided the developed world with low-cost products and



low-interest debt. It has led to much higher borrowing and subsequently living standards in the West. It has also led to structural unemployment for those who lack formal education and have relied on factory jobs. This now needs to be reversed. However, consumers in emerging markets lack the purchasing power to buy Western products and often these countries lack the infrastructure to provide consumer financing. It will be a while before the global economy returns to its balance.

Inflation remains low and might even be declining. Under these conditions we expect the Federal Reserve to maintain near zero interest rates for an extended period. Fixed income assets will continue to offer solid real rates of returns. Investors with longer time horizons; however, should consider risk assets that offer value. Housing prices are down 30-35% from

their peak and interest rates are at historically low levels. We believe 2010 could prove to be a good time to buy a new home or trade up to a more expensive home. In many parts of the country, housing prices have stabilized and many homes are selling below their replacement costs. We also like large, high quality U.S. multinational companies with strong balance sheets, cash flows, and significant exposure to high growth emerging markets—companies such as IBM, McDonalds, Colgate, Abbott Laboratories, and United Technologies. With the recent decline in the euro and European stocks, large European multinational companies are now beginning to look as attractive as their U.S. counterparts.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs