



equity market review & outlook

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SECOND QUARTER OVERVIEW

Equity investors endured a disappointing quarter as the stock market recovery that began in March 2009 peaked in April, giving way to a broad and persistent sell-off. There was no shortage of reasons for the decline, beginning with the fact that US stocks, as measured by the *S&P 500*, had risen by more than 80% in just 14 months. Widely publicized issues involving sovereign credit in Southern Europe, a slowing economy in China, lackluster domestic employment growth and the Gulf disaster weighed heavily on investor sentiment. These macro concerns, none of which can be solved quickly, have fed growing anticipation of a second half economic slowdown, and as a result, forward earnings estimates are being viewed quite skeptically.

INDEX TOTAL RETURN		
	Second Quarter	Last 12 Months
S&P 500	-11.43%	14.43%
Russell 1000	-11.44	15.24
Growth	-11.75	13.62
Value	-11.15	16.92
Russell MidCap	-9.88	25.13
Growth	-10.20	21.30
Value	-9.57	28.91
Russell 2000	-9.92	21.48
Growth	-9.22	17.96
Value	-10.60	25.07
MSCI World	-12.51	10.73
MSCI Emerging Markets	-8.17	23.59

*Source: FactSet, data as of 6/30/10
Indexes are unmanaged, and you cannot invest directly in an index.*

US large cap stocks fell about 11.5% for the quarter. Several European and Asian markets were off by greater percentages. Lower equity prices coupled with a rise in the US dollar during the quarter (particularly against the euro) resulted in larger declines for dollar-based investors. Emerging market stocks fared better than most equity classes, falling “only” 8.2% in the quarter, but this would certainly not qualify as a win.

In its early stages, this sell-off was viewed as a normal pause after a spectacular rally. In fact, it marked the first formal 10%+ correction of this market cycle.

However, this decline has confounded many

fundamental stock analysts because the recovery in corporate earnings has been outstanding. Companies will begin to report second quarter earnings soon, and another quarter of solid results is expected. We anticipate investors will be listening more closely than usual for forward looking comments and guidance.

2010 earnings estimates for the *S&P 500* are primarily in a range of \$80 - \$82, which would represent a gain of more than 20% compared to 2009. Operating earnings for *S&P 500* companies rose over 50% in the first quarter of this year compared to a year ago—of course, the dismal economic conditions of early 2009 exaggerate the comparative increase. Second-quarter earnings are expected to be up 25% or more compared to last year. A majority of analysts and strategists expect a minimum of high single-digit earnings growth next year. Given this robust earnings outlook, valuations seem very reasonable, if not outright cheap, in the current range of a low-teens multiple of expected 2010 earnings. However some of the pressing macro concerns are causing investors to be even more skeptical than usual for now, which is holding back multiples considerably. Companies are not getting much, if any, credit in current valuations for healthy 2011 earnings forecasts.

Mid cap and small cap stocks outperformed large caps again, although not by much. More significantly, mid and small stocks now hold a large one-year performance advantage over large caps. This reflects the



somewhat stronger growth fundamentals observed among smaller companies coupled with the fact that many of these stocks were harder hit than some of the blue chips in the later phase of the 2008-09 bear market.

Examining performance on the basis of style, it is highly unusual that over the past quarter there was very little difference in index performance between the growth and value styles, regardless of market cap. In fact, growth and value returns are nearly identical for the quarter. On a 12-month basis, value holds an edge over growth, winning moderately among all three *Russell* capitalization segments.

SECTOR REVIEW

In addition to the narrow differences between the growth and value styles in the quarter, there were limited differences among the sectors. All sectors fell under the weight of broad-based selling. Basic materials were the weakest, down over 15%, on concerns of slowing global growth and reduced demand from China. Other major sectors such as consumer discretionary, energy, financials and technology declined in a range of 11% to 13%. Traditional defensive sectors such as staples and healthcare weren't spared either, declining 8% and 12%, respectively. Only telecom and utilities managed to contain the decline to less than 5%. As such, there were limited opportunities for investors to maneuver this quarter, with pressure seen across the board. Looking back over the past year, however, reveals a much more favorable picture. Discretionary and industrials have continued to lead, with sector gains above 25%. Financials and technology follow close behind, posting mid-teens gains.

INDEX PERFORMANCE ATTRIBUTION

	S&P 500 Second Quarter	S&P 500 Last 12 Months	Russell 2000 Second Quarter	Russell 2000 Last 12 Months
Consumer Discretionary	-10.89%	28.08%	-13.66%	33.54%
Consumer Staples	-8.14	13.69	-6.40	21.28
Energy	-12.75	2.08	-13.82	21.98
Financials	-13.34	16.90	-9.51	21.22
Healthcare	-11.80	8.99	-10.33	13.19
Industrials	-12.31	27.47	-7.59	19.95
Information Technology	-12.27	15.79	-8.71	21.04
Materials	-15.37	13.59	-13.15	37.90
Telecommunications Services	-4.24	3.93	-9.09	1.50
Utilities	-3.74	5.73	-3.18	13.69
Total Return	-11.43	14.43	-9.92	21.48

*Source: FactSet, data as of 6/30/10
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A similar story emerged within the *Russell 2000* over the past quarter, with all sectors showing declines. Losses ranged from only 3% for utilities to 14% each for discretionary and energy. During the past 12 months, consumer discretionary and materials led the way, with gains in the mid 30% range. Several other sectors posted gains of 20% or more.

THERE WERE SOME WINNING STOCKS

There were a few winners in the quarter. The unifying theme among the gainers was positive earnings surprise plus positive earnings revision. For example, within consumer discretionary, some auto parts companies and dollar stores saw their stocks move higher. Select media names also had positive momentum. Within healthcare, drug distributors posted gains. Winners in technology were mostly medium sized companies,



a trend also seen in other sectors. Companies such as a customer relationship management software supplier, a storage and data solution provider and a personal computer manufacturer were tech standouts, all posting excellent fundamental results. In fact, among the 47 companies in the *S&P 500* with market caps above \$40 billion, only the personal computer manufacturer finished higher for the quarter.

WHAT'S NEXT

This pullback in stock prices from their April highs has been somewhat deeper than expected, particularly given the exceptional earnings recovery underway. Macro concerns are currently dominating investor psychology, holding back multiples. Renewed market volatility, such as the “flash crash” in early May, has raised the fear factor as well. As companies report earnings later this quarter it will be very important to hear managements address how slowing growth in Europe and China may be affecting the business outlook, if at all. Companies have routinely exceeded earnings expectations for the past several quarters, and investors have become accustomed to firms beating conservative earnings estimates and raising their forward estimates. As the global economic outlook has grown somewhat less certain, some robust forecasts calling for *S&P 500* earnings growth in the 15% range for 2011 are being questioned. However, hard fought gains in productivity by US companies will not be given back easily as managements focus on defending profit margins. We see stocks as becoming more attractively valued into this pullback and advocate patience as investors digest this period of transition from the very fast improvement off recessionary lows to a likely more moderate, but sustainable, growth pace later this year.

The Russell 1000 Index measures the performance of the large cap segment of the US equity universe and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 2000 Index measures the performance of the small-cap segment of the US equity universe and includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 1000 and 2000 Value Indexes are unmanaged market capitalization-weighted indexes of those stocks of the 1,000 and 2,000, respectively, largest US domiciled companies that exhibit value-oriented characteristics. The Russell 1000 and 2000 Growth Indexes are unmanaged market capitalization-weighted indexes of those stocks of the 1,000 and 2,000, respectively, largest US domiciled companies that exhibit growth-oriented characteristics. The Russell Midcap Index measures the performance of the mid-cap segment of the US equity universe and is a subset of the Russell 1000 Index that includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap Growth and Midcap Value Indexes measures the performance of the mid-cap growth and value segments of the US equity universe, respectively. Standard & Poor's 500 Index (S&P 500) is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent US equity performance. The MSCI World Index is an unmanaged index that measures global developed market equity performance. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. All indexes are unmanaged. You cannot invest directly in an index. Past performance is no guarantee of future results.

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