



## NEWS RELEASE

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### AMERICAN TRUST FINANCIAL MANAGEMENT GROUP QUARTERLY ECONOMIC UPDATE 2Q 2010

**(DUBUQUE, IA)** – Published each quarter by the Financial Management Group for the benefit of American Trust & Savings Bank wealth management clients, The American Trust Quarterly Economic Update for second quarter 2010 describes U.S. and European economic conditions, challenges impacting the recovery from the Great Recession, recent market results, and the near term outlook for investments.

*The quarter in brief.* “Concerns about slowing U.S. growth and economic instability in Europe finally rocked the market in the second quarter, marking the first correction since the March, 2009 low,” said Mark Stevens, Senior Vice President, American Trust Financial Management Group. “The S&P 500 declined 11.43 percent with most other major world markets down double digits as well. Fear replaced optimism and the market sold first and asked questions later,” he added.

*U.S. economic data.* Economic growth (GDP) was originally estimated to be 3.2 percent for the first quarter. The U.S. Bureau of Economic Analysis then lowered the Q1 growth estimate to 3.0 percent in May, and again in June to 2.7 percent. Although down quite a bit from the 5.6 percent growth rate for fourth quarter 2009, this is still a healthy level.

Consumer spending remained positive for most of the quarter though at a declining rate. It was the same for manufacturing which saw the Purchasing Managers Index at healthy, but declining, levels. Unemployment showed modest improvement (9.9 percent in April to 9.5 percent in June). However, the Bureau of Labor Statistics indicated that the primary reason for the decline was that 625,000 job seekers stopped looking for work.

The month-to-month pace of new home sales went from 26.9 percent in March, to 14.8 percent in April, to a record low decline of -32.7 percent in May. Existing home sales were -2.2 percent for May as well. Historic low rates were not enough to prop up the real estate market absent government assistance. As a result, the President reinstated the mortgage tax credit (through September) to prop up a still fragile housing market.

*Euro zone.* The major economic development in the second quarter was the worsening of the European debt crisis. Kicked off by Greece, fears rose that a contagion could spread across Europe. How does an economy that is smaller than most major U.S. cities strike fear across the globe? First, it's not just Greece, its also Portugal, Italy, Ireland, and Spain. Second, much of the debt is owed to each other, as well as other European countries and their banks.

The European Union and the International Monetary Fund have put a band-aid on the problem by instituting bold rescue programs. Austerity plans have been put in place to curb spending and cut programs. Such moves are probably necessary, but they can't help but slow growth in the entire region.

*Structural headwinds.* According to Mark Stevens, "Our economy faces many structural challenges that make this recovery abnormal."

1. *Debt, debt, and more debt.* Excessive debt was used to fuel previous economic booms. Consumers, federal governments, and states all will be in a de-leveraging process that will take years to unwind. This process will undoubtedly curb future growth rates.

2. *Government reform.* The banking sector is now faced with new financial legislation at a time when they are already reluctant to lend. Health care reform was passed and cap-and-trade legislation is awaiting approval. Each is over 2,000 pages and contains as much ambiguity as the other. Businesses remain unclear about regulations not yet finalized and agencies yet to be created. It's difficult to hire new workers or make new investments when you're uncertain about the future. Small businesses employ roughly half of all American workers and their lack of confidence goes a long way in explaining why unemployment remains high and growth anemic.

3. *Demographics.* A recent Congressional Budget Office update indicated that an aging population and rising health-care costs will cause spending on health care and Social Security to grow from 10 percent of GDP now to 16 percent in 25 years if current laws are not changed. And if current laws are changed as expected, the federal debt would balloon from about 62 percent of GDP now to about 185 percent of GDP by 2035, a level far greater than Greece, or any other country that is at risk of default.

“These are long-term problems that will take years to fix,” said Mark Stevens. “To assume that these alone will derail the current recovery is probably premature. To assume that they will slow the rate of future growth is probably not.”

*The markets.* The U.S. stock market recovery continued into April as roughly 80 percent of companies in the S&P 500 beat expectations accompanied by solid revenue growth. Unfortunately, the barrage of negative economic news was too much to handle, stocks reversed course in late April, and the market experienced its first correction (decline greater than 10 percent) since the March bottom of last year.

The S&P 500 was off 11.43 percent with most other major market indices also down double digits. All of the S&P 500 economic sectors posted negative returns for the quarter with utilities performing the best (-4.8 percent) and materials the worst (-15.7 percent).

Major Indices	2Q 2010	1Q 2010	Y-T-D
DJIA	-9.36%	+4.82	-5.00%
NASDAQ	-12.04%	+5.68	-7.05%
S&P 500	-11.43%	+5.38	-6.65%
MSCI EAFE	-14.91%	+0.85	-14.72%
MSCI Emerg Mkts	-8.37%	+2.45	-6.17%

(Indices are unmanaged, do not incur fees or expenses and cannot be invested into directly.)

Developed international equity markets declined in the quarter with the MSCI EAFE Index returning -14.91 percent. Europe weighed on the index as the credit crisis in the Euro zone pushed the index lower each month in the quarter. Emerging Markets performed somewhat better (-8.37 percent) as many believe that emerging countries are actually less exposed to sovereign debt issues than their more established neighbors.

As painful as the market correction has been, it is not uncommon compared to history. New bull markets have historically averaged gains of around 55 percent before their first correction and have lasted about 17 months. The recent rally that began on March 9, 2009, was up nearly 80 percent and lasted 15 months before correcting. If history is any guide, we probably were due for a pullback.

*Outlook.* The economy is slowing. We get it. But are we setting up for a “double dip” recession where we have a short period of growth only to fall back into a recession? Double dips are rare and have only happened twice in the last 100 years (the Great Depression and early ‘80s). In each case, premature tightening by the Fed killed expansion. Today, we are seeing something quite different as the Fed seems steadfast in maintaining its accommodative policies. There is little evidence that the

Fed is willing to change any time soon. In addition, big business has rarely been this healthy coming out of a recession. Debt burden is a plight of consumers and governments, not most businesses.

After a 16 percent decline from April to June, the market appears to have adjusted for the shift in confidence. Stocks are now selling at less than 12 times 2011 earnings estimates, reasonable given the low level of interest rates. The earnings yield (earnings/price) is now 8.7 percent. This compares to the 10-year Treasury yield of around 3.0 percent and nearly zero for money markets. Corporate earnings are strong and most companies are flush with cash. The balance sheets of most companies are in great shape after major housecleaning during the past two recessions.

Bond yields are at depressed levels and a cyclical rise in rates is likely in the years to come. It just doesn't look likely in the near term. The absence of inflationary evidence will keep the Fed easy and rates low until there is greater proof that this recovery is sustainable.

At current market levels the risk to reward on stocks over the next few years looks reasonable assuming we avoid calamity, especially when compared to alternative asset classes. Though we remain cautious, it seems too early to jump ship when historically it has been profitable owning equities this early in a new economic cycle. High volatility and risk aversion will dominate the market in the months ahead as investors wrestle with the prospects of weaker economic data and the benefits of being long stocks this early in a recovery.

“The recovery is now entering its fifth consecutive quarter. Whether the recent pause kills the recovery or sets the stage for a period of renewed acceleration may be determined over the next few months,” said Mark Stevens. “The problem is that the recovery's path will be increasingly influenced by Washington and the confidence the business community has in it.”

The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks. The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System. The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. The MSCI EAFE index is an unmanaged aggregate of 21 developed country indices that collectively represent many of the major markets of the world. MSCI Emerg Mkts is a capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. It is not possible to invest directly in an index. NYSE Group, Inc. (NYSE:NYX) operates two securities exchanges: the New York Stock Exchange (the "NYSE") and NYSE Arca (formerly known as the Archipelago Exchange, or ArcaEx®, and the Pacific Exchange). NYSE Group is a leading provider of securities listing, trading and market data products and services. The New York Mercantile Exchange, Inc. (NYMEX) is the world's largest physical commodity futures exchange and the preeminent trading forum for energy and precious metals, with trading conducted through two divisions – the NYMEX Division, home to the energy, platinum, and palladium markets, and the COMEX Division, on which all other metals trade. The statements and opinions expressed in this article are those of the author as of the date of the article. These views should not be construed as investment advice. Content and/or statistical data may be obtained from public sources and/or third party arrangements and is believed to be reliable; however we make no representation as to its completeness or accuracy. The underlying assumptions and the views are subject to change. All economic and performance data is historical and not indicative of future results. Investors have the opportunity for losses as well as profits. The market indices discussed are unmanaged and can not be invested into directly. Investors should consult their financial advisor for guidance concerning their particular situation.

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