

Market Update

February 2010 Review

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It's a Small World After All

The 2010 Winter Olympic Games in Vancouver came to a close on the last day of February with the top five medal winning countries being the United States, Germany, Canada, Austria and Norway. As the world can now shift the focus from competitive sports to financial and economic news, five other countries may be grabbing everyone's attention: Portugal, Italy, Ireland, Greece and Spain. These five nations are now looking at debt levels that exceed their respective Gross Domestic Products ("GDPs") and Greece, specifically, has already entered the headlines by sparking the discussion about sovereign debt defaults. How the European Union ("EU") will eventually handle this situation and how the rest of the world will ultimately react to it may set the stage for the global markets in 2010.

The Olympic Games can bring out nationalism and pride for one's country, but it just as much reminds everyone that it is about the world coming together. During the opening ceremony, athletes enter the arena country by country separated by their national flags. But after two weeks of intense competition, during the closing ceremony the athletes commingle and are not separated by nationality anymore. The world has symbolically come together and the Olympics' global message has become prevalent.

As the lines of national heritage blur in the Olympics, so do the financial markets of the world as they act less as independent, stand alone markets and more closely correlated in an ever advancing technology driven world. The debt problems in Greece have become an issue for the entire EU. One country's problem becomes the next country's problem. Individual events cannot be seen in isolation anymore and the effects spread around the world very quickly. Germany and France have indicated that they will back up Greece. While this has stabilized their currency, the Euro is still expected to remain volatile and some damage has already been done: the Euro lost 4.9% relative to the USD in the first two months of 2010.

Currencies have major impacts on economies. First, the weak dollar we experienced over the last two years has helped the U.S. export more goods and services. Second, currency translation has a major impact on performance numbers of international investments; impacting not only global companies, but investors in the international markets as well. The European markets (e.g., UK) were down 4.4% in local currency terms through the end of February. However, the USD-based investor experienced a loss of 8.5% after the effects of currency. The impact on the MSCI EAFE was somewhat more muted as the index experienced a negative return of 2.9% in local currency terms through the end of February and a loss of 5.1% in USD terms. Currencies can also work in your favor; as witnessed by the Japanese market. While their Equity index lost 1.6% in domestic terms, the U.S. investor actually experienced a gain of 3.0% in USD terms due to a strongly appreciating Yen.

In the U.S., the Dow Jones Industrial Average was down 0.5% through the first two months of the year, the NASDAQ down 1.2% and the S&P 500 was down 0.6%. The domestic investor is looking at an equity market that is basically flat. The prime rate is unchanged at 3.3% and oil is also flat at 79.70 USD. Has nothing happened in the first 60 days of the year?

	Feb	YTD	2009
DJIA	3.0%	-0.5%	22.7%
S&P 500	3.1%	-0.6%	26.5%
NASDAQ	4.4%	-1.2%	45.3%
MSCI EAFE	-0.7%	-5.1%	32.5%
Barclays Aggregate	0.4%	1.9%	5.9%

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Some headlines that grabbed investors' attention:

- The Fed raised the discount rate from 0.5% to 0.75% indicating the start of an exit strategy from the emergency stimulus out of the financial system.
- New home sales fell by 12.0% in January reaching a new all-time low of 309,000 sales per year and existing home sales fell 7.2%. The median price of an existing single family home fell 3.5% MoM to a new eight year low.
- Unemployment dipped below 10.0%, but de facto unemployment of 17.0% (underemployment & unemployment calculated for a 40 hour week) remains a major concern and is capping salary growth expectations.
- FDIC has taken over two more banks, which makes 22 this year compared to 16 at this time in 2009. Banks, in general, remain in the headlines: credit is still shrinking in absolute terms (13-week rate of change bank lending to households and businesses has collapsed by 12.0% annual rate) and in relative terms (lending as a share of assets is the lowest in recorded history).

A proposal by the White House to prohibit home loan foreclosure without Home Affordable Modification Program ("HAMP") is unlikely to spur lending activities. This action would prevent banks from foreclosing on defaulted homeowners unless they have been screened and rejected by the government's HAMP.

U.S. real GDP was revised up for Q4 to 5.9 annual rate from 5.7. As expected the revisions were mainly in inventories and capital expenditures (Capex grew at 18.2% annual rate). The U.S. has now shown two quarters of positive GDP growth and hopes are sparking that this recession is indeed history. While the day-to-day financial news has not been very positive, the surprises to the upside prevented the continued larger profit taking we saw in January.

All Fixed Income indices showed a positive year-to-date performance. TIPS are weakening, the High Yield market has lost some steam likely due to the news from Greece and the resulting credit spread expansion, but overall the Fixed Income market shows stability. The Barclays Aggregate Index is up 1.9% through the end of February.

Commodities remain very volatile without any indication of direction as we are riding the emotional roller coaster of conflicting news concerning economic recovery and economic slowdown. Gold prices are up 1.9%. China and India – two countries that are driving commodity prices – have announced a tightening credit policy and China also entered renewed discussions about selling U.S. treasuries. Rising yields in an environment of credit contraction in terms of declining Money Multiplier and Velocity of money is making a solid recovery more difficult. Despite all the news, the major domestic equity indices posted positive results for the month of February with the DJIA up 3.0%, the NASDAQ up 4.4% and the S&P 500 up 3.1%.

The Olympic torch goes out in cold Vancouver, but will soon be lit again in London, England for the 2012 Summer Games. No matter which countries dominate the headlines then, we will have to realize that a global economy works closely correlated and that one country's problem is the other country's problem as the world becomes a smaller world after all.

Definitions & Disclosures:

An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You can not invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.

The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.

The NASDAQ Composite Index is a market-value weighted index that measures all domestic and non-U.S.-based securities listed on the NASDAQ Stock Market.

Gross Domestic Product (GDP) is the market value of the goods and services produced by labor and property in the U.S. It is comprised of consumer and government purchases, net exports of goods and services, and private domestic investments. The Commerce Department releases figures for GDP on a quarterly basis. Inflation adjusted GDP (or real GDP) is used to measure growth of the U.S. economy.

The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.

The Barclays Capital U.S. Aggregate Index covers the U.S. Dollar denominated investment grade, fixed-rate, taxable bond market of SEC-registered securities.

The Barclays Capital US. TIPS Index represents public obligations inflation-linked bonds offered by the U.S. Treasury only remaining maturities of one year or more.

The Barclays Capital Investment Grade CMBS Index is an index designed to mirror commercial mortgage back securities of investment grade quality (Baa3/BBB-/BBB- or above) using Moody's, S&P, and Fitch respectively, with maturity of at least one year.

The MSCI Emerging Markets Index (EM) is a free-float-adjusted market-capitalization index developed by Morgan Stanley Capital International. It is designed to measure the equity market performance of 26 emerging market countries.