

Market Update

May 2010 Review

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The Charging Bull Stumbles...

Investor fear returned in May, as a culmination of worries sent risky asset prices down throughout the capital markets. Risk aversion was on full display, with the so-called "Flash Crash" on May 6th; bringing panic reminiscent of October 1987 and the fourth quarter of 2008, as well as residual instability that resonated throughout the capital markets for the remainder of the month.

The Dow Jones Industrial Average ("DJIA") finished the month of May down 7.6% to a level of 10,137, erasing gains from earlier in the year. The broader S&P 500 Index fared no better; giving back 8.0% for a year-to-date performance of -1.5% through May 31st. The NASDAQ Composite Index, which has had a strong run over the past few quarters thanks to leadership from technology stocks, lost 8.2%.

Overseas, developed economies were even more unsettled, with the MSCI EAFE Index shedding 11.4% of its value during May, reflecting contagion fears in Europe and weakness in Pacific Rim markets. The \$1 trillion European Union sovereign debt bailout plan announced on May 9th alleviated fears temporarily, but investors know quite well that announcing the plan is far easier than implementing it. Further, it is too early to tell if the bailout will wind up being no more than a temporary fix, and that debt restructuring or even default lie ahead. Although performing better on a relative basis during the month, developing economies could not sidestep the global correction despite significantly less debt laden balance sheets, as the MSCI Emerging Markets Index dropped 8.8%.

	May	Latest Quarter	YTD
DJIA	-7.6%	-1.2%	-1.6%
S&P 500	-8.0%	-0.9%	-1.5%
NASDAQ	-8.2%	1.1%	-0.2%
MSCI EAFE	-11.4%	-7.4%	-12.1%
Barclays Aggregate	0.8%	1.8%	3.7%
Barclays Corp High Yield	-3.6%	1.8%	3.2%

Volatility, while generally subdued over the past several months, returned with a vengeance during May. The DJIA, which ended last month just above 11,000, slid below 9,800 in intraday trading toward the end of May, only to recover to its current level above 10,100. The Chicago Board Options Exchange Volatility Index ("VIX"), commonly used as a gauge of market risk by measuring expected short-term volatility of the S&P 500 Index, spiked dramatically on May 6th and remains elevated, confirming the heightened anxiety of investors seeking to hedge their portfolios by buying protective put options.

The Barclays Treasury Index gained 1.7%, while the yield on the five-year Treasury note fell to 2.1% at the close of the month; reflecting demand from investors for the safety of Treasuries. The relative strength of Treasuries and Agency debt overcame the poor showing by more risky credit, which stumbled after months of outperformance, as the broad Barclays Capital U.S. Aggregate Index gained 0.8% for the month. After quarters of domination by lower quality credits, high yield issues took a breather alongside investment grade credits, as reflected by the 3.6% loss in the Barclays Capital U.S. Corporate High Yield Index. Despite the rock bottom interest rates, net inflows into fixed income funds remain strong, with nearly \$119 billion of positive flow, compared to approximately \$82 billion at this time last year, indicating investors' continued focus on capital preservation and income over riskier asset classes such as equities and commodities. To put this number into perspective, the inflow into taxable bonds in the first five months of this year exceeds the cumulative net inflow into equities over the last nine years.

Market Update

The big question that remains as a result of the heightened anxiety experienced during May is whether this is just a healthy market correction to cool down the enduring bull or whether this is the beginning of the end of what might be considered, in retrospect, as a dead cat bounce in a secular bear market.

After the low quality rally of 2009, which brought double, if not triple-digit returns in the equity and credit markets, investors are antsy about how far this cyclical bull market can advance given the still depressed economic environment. Although domestic economic news continues to be on an improving trend, investors remain on edge. Economic tribulations such as the sovereign debt crises, social unrest, high unemployment, currency devaluation, the aftermath of the housing bubble and borderline deflationary environments continue to weigh on the minds of investors.

But for all the doom and gloom that is pervasive across the news, there are optimists who point out the shafts of light that penetrate the darkness of the clouds. Some of the economic news released in May was favorable. Though the domestic unemployment rate actually rose to 9.9% in May, there is an indication of more workers entering, or re-entering, the labor force after continued improving job gains reported for the past several months reignited hope for the unemployed. Retail sales rose higher than expected and consumer spending is up 3.5% in the first quarter compared to 1.6% in the fourth quarter. Housing starts in April were over 40% higher than a year earlier, though, a good portion of activity can be attributed to government incentives. Industrial production has markedly improved. Consumer confidence, though low compared to historical standards, is on the rise.

Investor sentiment can be compared to the movements of a pendulum, with euphoria and pessimism at opposite extremes. The pendulum swings, but not always in a smooth, fluid motion. Sentiments about market direction can transform in an instant, with the "Flash Crash" exemplifying this. Prior to May 6th, volatility was relatively quiet as the market gently gained ground week after week. But in a 30-minute timeframe, investors fled from riskier assets sending the VIX upward. The question remains: where on this path is the pendulum now and which way is it headed?

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.

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 U.S. Corporate High Yield Index covers the U.S. Dollar denominated, non-investment grade, fixed income, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below.

The Chicago Board Options Exchange Volatility Index (VIX) shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

The Barclays Capital Treasury Index represents public obligations of the U.S. Treasury with a remaining maturity of one year or more.

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.