

## The 10 for 2010: Mid-Year Update

Our underlying premise for 2010 is for an accelerating pace in the recovery of the general economy both here and in many parts of Asia and other emerging Markets. The growing recovery can be seen in the year over year reading of the LEI which stands at 6.0%. We also see that \$400 billion of the original stimulus package is earmarked for 2010 here domestically on top of the existing and continuing stimulus from around the globe. Couple that with the lag impact of money spent in 2009, and we see envision a market place where stimulus induced liquidity evolves into a multiplied effect.

Secondly, we are reminded of the old but always wise mantra, "Don't fight the Fed." We continue to see an accommodative stance from the Fed in the form of tepid rate increases to err on the side of inflationary. Lastly, the job-less recovery that held back much of the last expansion, will reverse course in a much faster fashion as lending frees up small companies to take advantage of the many opportunities that have presented themselves from the knee jerk reaction of larger companies. This trend will accelerate throughout 2010 as the jobs stimulus package is released by the White House.

With our underlying premise of a recovery accelerating much faster than most are expecting, there are some assumptions that if do not come to fruition, could cause our conclusions to not bear fruit. So where could we be wrong? If the consumer truly becomes more pragmatic and resembles the consumer in Japan, a double-dip recession would be inevitable. If this were to occur, the case made more rewarding and hence more risky investments would not be conducive. The other catalyst for a double-dip recession is a Fed that is far less accommodative than we are predicting. By draining the punch bowl too early, the risks to the recovering banking system and overall economy could rise significantly. This could result in a direr economic environment than even the most cynical pundit envisions. We recognize the many arguments made for a minimal to slow recovery, but believe the indicators point to a different conclusion.

**Mid-Year Update:** *It appears to us that we have a tale of two quarters in areas of economics, markets and politics. The start of the year had many buying into the stronger than expected recovery; however some conflicting data increased the paranoia of a potential double-dip recession among some investors. In short, the economic numbers have shown a pronounced recovery on a year-over-year basis even though the monthly prints have been more volatile. This is common during recoveries, though history is conveniently forgotten to feed the predisposition of many investors who expect more troubles. If you are looking for a flood, you may construe a rain drop as a sign to build an ark. In viewing the many metrics that are commonly dissected as well as many that may be considered extraneous; we see a common theme of a continuing recovery in light of "swirling winds."*

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### Market Snapshot

3 Mo Tbill:	0.15%
2 Year:	0.66%
10 Year:	3.12%
30 Year:	4.11%
S&P 500:	1,095.34
DJIA:	10,363
NASDAQ:	2,242
Gold:	\$1212.65 oz
Crude:	\$77.25

Source: Bloomberg 7/12/10

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- *The Leading Economic Index continues to show robust growth as it stands at 9.2% on a year-over-year basis. The 30-year average is 3.0% and is nearly 2 standard deviations wide currently.*

- *We believe a severely steep yield curve continues to promote a growth story as well as an accommodative Fed for some time. With the European Union challenges, we see that the resulting loss of 20% in the Euro promotes a deflationary environment for nearly 20% of the world's GDP. With inflation in check domestically, that puts nearly half of the world's GDP in disinflationary mode for the near term. We believe the large amount of liquidity on the sidelines will ultimately be a "tinder" to the inflationary spark.*

- *Waste Freight has risen the most since 1984 signaling a higher rate of consumption. Corroborating this metric is the fact that rates to transport goods via freight has risen significantly as well. The shipment of empty containers to Asia has risen the most in 10 years showing a propensity of some exporting countries to export more goods, presumably for increased demand.*

- *There is a tremendous, dare we say historical amount of cash on the sidelines in nearly all components of the GDP. The government still has the lagging impact of nearly \$400 billion in stimulus being spent. The consumer is holding nearly \$9.3 trillion in overall cash equivalents according to a Bloomberg weekly article. Cash held at commercial banks is still near an all time high at nearly \$1.2 trillion. According to a Wall Street Journal article, non-financial companies are holding more cash than at any other time in history, \$1.84 trillion. Cash as a percentage of total assets are at levels not seen since the early 1960s. According to Reuters, we began the year with the total cash in the corporate coffers standing at over \$3 trillion.*

- *In a continuing sign that the balance sheet repair done by companies is potentially leading to an amplified expansion, cash on hands of investment grade companies has risen from \$580 billion last year to a current reading of nearly \$670 billion according to JP Morgan analyst Eric Beinstein.*

- *We have never encountered more stimulus being spent globally that will eventually work its way through the system. Though the bulk has been spent, with roughly 60% of the remaining global stimulus dollars being spent domestically.*

*It appears to us that the primary concern of investors is the one that seems to be least understood. The sovereign debt issue in the United States and elsewhere, will have far reaching ramifications as debt markets around the globe are in some way based or influenced by the United States' yield curve. We have moved from a level of "rewardless risk" to an unqualified "risk". As we sit today, the 30-year Treasury is at 4.02%. Consider that inflation over the last 25 years has averaged 2.9% and 4.1% over the 70 years, one can see on a simple real return what level of risk a long-term investor may be vulnerable to.*

*Though we are not disregarding European contagion nor the economic impacts of political policies and regulations, the path of economic recoveries are littered with emotional land mines. We believe the fear of a double-dip recession is very isolated when viewing our history. There were two: January 1920 to July 1921 following 8-month recession ending March 1919 and July 1981 to November 1982 following a 7-month recession that ended July 1980. What one notices is that double-dip recessions have only occurred after extremely short recessions; in fact they lasted only 42% of the duration of a normal recession.*

*With the current recession appearing to last nearly 30% longer than the average, one begins to see the present pessimism as being overly excessive, but understood. Adaptive Reasoning tells us that recent experiences influence our immediate expectations. The positive to this is that the predisposition for the negative sentiment to overrule logic presents a potential tremendous opportunity for the patient contrarian.*

*With the combination of a pull back in equity markets and risk assets as well as the continued recovery in general economic indicators, we see this as a once in a generational opportunity in many levels. The fear that is dominating markets and media headlines is a great contrarian indicator for those who desire a bit more than the anemic real returns in assets seen as risk free. Though we can't call this the absolute bottom, no one knows that answer, we see little chance of a double-dip recession, an accommodative Federal Reserve and an obscene amount of liquidity that will always attempt to find higher returns over the long run that will ultimately drive risk assets higher than most think possible.*

**Financials:** With the backdrop of a tremendous lending spread via the low cost of financing, the financials sector is our top theme for 2010. We see the insider buying of the small banks with the ability of nearly all lending institutions ability to raise capital at increasingly improving levels as a barometer for the financial and economy in general. For those seeking income, debt and preferred issues on many of the financial based companies appear attractive on a spread to treasuries with potential total return for the more aggressive investor. We see opportunities in the banking and financial service sectors, which may be accessed through an ETF.

**Mid-Year Update:** *After a rough beginning, the S&P Financials Index was up 18% by the middle of April. Currently, through the first week of June, the Financials Index is up 3% as the regulatory challenges and how they will be laid out, the SEC claim against Goldman Sachs and the fear about the contagion of the Euro banking crisis have weighed on the overall market place. Our belief in the fundamental reasons why financials continue to be attractive are still the low cost of funds, accommodative Fed for the foreseeable future, expanding economy and large credit lending spreads that we believe will exist for some time. The Financials sector continues to be one of our top themes for the immediate term and longer term.*

*We believe the Financials continue to be one of the better places to be as evidenced by the short run outperformance of the overall S&P 500 Index. We continue to see that the lending spreads are so extreme that the excess liquidity built into the banking system will eventually move its way aggressively throughout the economy for the simple reason of want of profit. Consider that the loans look to carry a higher than average collateralization compared to historical standards and a high level of credit quality due to lack of supply of loans, and we see a very positive environment for the financials in the near term and beyond. We continue to see insider buying of the small banks as another positive sign that should not go unnoticed.*

**REITs and Real Estate:** The recovery that started last year continues to pick up steam. When we consider the improving lending market, historic affordability levels and an improving job market, we

see a real estate as a significant beneficiary. We prefer the residential REITs for income seekers and a structured note that offers potential leveraged participation in the Philadelphia Housing index.

**Mid-Year Update:** *The data deluge with regards to the housing sector has many a prognosticator seeing the glass as half empty and full at the same time. Though some headwinds remain and certain regional challenges exist, there are some positive signs to the long term recovery in this sector. Some of these signs:*

- *Due to the pull back in housing prices, housing affordability is sitting at an all time high at 174.8. The average since being measured is 127.31, which sits over 2 standard deviations wide from its current level.*
- *Year-over-year pending home sales rising at a current rate of 24.6%*
- *National Association Home Builders Index at 22, off of its all time low of 8 set in January of 2009 and off of the beginning of the year level of 16.*
- *The RPX composite Index is up 2.36% on a year over year basis.*

*We continue to see the recovery in real estate in place. We see the historic pull back in real estate is an event that may occur only once in a generation, offering good potential returns for the patient investor as well as a good long-term hedge from future inflationary pressures. We also note that the paranoid levels of anxiety with regard to the commercial real estate markets appear overblown. As always, those events that are most anticipated often don't meet the high level of expectations.*

**Technology:** With the introduction of Windows 7 spurring companies that are holding historic amounts of cash to increase their spending on productivity gains and upgrades, technology should benefit. A large comprehensive upgrade within corporations has been building. The improving recovery will help spur this largely overdue upgrade. With very little technology debt in the market place, the primary way to invest is in equities. One can do this via ETFs, Unit Investment Trusts specific to this industry or levered structured notes tied to a technology index such as the CSFB Technology Index.

**Mid-Year Update:** *In following the pattern of the overall market, the technology sector has suffered a decline. With the reported cash in the corporate*

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*coffers estimated to be over \$3 trillion and the constant push to squeeze out productivity gains, we continue to see Technology as having a tremendous amount of potential. We do envision a long upgrade cycle for hardware and software throughout the corporate marketplace for many years to come. Though it may begin in a tepid manner, we see an acceleration to this in time potentially making technology as a place where margin expansion may exist from current levels.*

*Another sign that the Technology sector is still very underrated is to look at the Information Technology employment trends. There were 55,000 IT jobs added during the second quarter which puts the IT unemployment rate at 5.5%, or 4 percentage points lower than the overall unemployment rate. Though this sits at over a 5-year high, relative to the overall market it is much healthier.*

**Emerging Markets:** The expansion of the US economy will be led by a resurgence of the US consumer that will benefit Developing countries such as China, Brazil and India. Emerging markets, specifically those in the Asia will also benefit from an improving export market for competitively priced goods. For income seekers, one can look at emerging market government debt or Unit Investment Trusts specifically targeted to these countries. One can also invest in structured notes with principal protected participation in the MSCI Emerging Market index or for the more ambitious, a basket of currencies. We would prefer to target most emerging market other than those located in Eastern Europe.

**Mid-Year Update:** *We have seen a very “darwinistic” approach to the emerging markets.....as has been evidenced in many markets around the globe. We have seen markets like the Shanghai SE composite down 26% year-to-date. The Chilean Stock Market Select, (IPSA) is up over 12% year-to-date. We continue to see a strong tail wind for emerging markets over the next decade and see the current drop in certain markets as an entry point for investors. We continue to see the BRIC countries, Asian Emerging and select South American Markets as the best places to be.*

**Natural Gas and Energy:** We see the recent purchase of XTO by Exxon Mobil and general higher usage as a stimulus for a stronger market for Natural Gas. For those looking for income specific to this sector, we would prefer Income Royalty Trusts or Master

Limited Partnerships. For those looking for more equity exposure, look at the futures contract in the form of a principal protected structured note that offers potential leveraged participation.

**Mid-Year Update:** *With the BP oil spill issue not yet resolved, the energy markets have been struck by increased sensitivity to what would traditionally be more muted impacts. The Natural Gas market started out the year at a bit below \$5.85 and now stands at \$4.69. We continue to see the depressed level of natural gas as a good long term entry point. Short term, between large amount of supply and the pace of the global recovery, we see that the price may stay idle for the short term.*

*Considering we are back at levels not seen since 2004 and potential for extraneous events to be a catalyst for a price move a high probability, we would continue to hold and or initiate positions in this market. We see that the spreads between crude and natural gas prices may also assist in the substitution and subsequent higher use of natural gas.*

**Underweight High Grade Debt and Cash:** We would be underweight US Treasuries, Sovereign Government debt, cash and various other forms of high grade corporate debt. We see benefits in moving down the credit ladder as money flows into higher rewarding assets and away from anemic yielding risk adverse assets. Aside from moving down the credit ladder, one can hedge their portfolio via a structured note that participates in the bearish return of the US treasury index.

**Mid-Year Update:** *Perhaps the most dramatic event has been the “reflight” to quality and the drop in Treasury rates due to the sovereign concerns stemming from the European Union and particularly, the Greece, Italian and Portuguese issues. The Euro has dropped nearly 20% from its highs reflecting the perceived risk in the government issues. The 10-year Treasury’s path has seen it move from a starting level of 3.83% to 4.00% at the end of the first quarter to a current level of 2.98%. That is nearly a 7% move in price in the second quarter alone.*

*With the backdrop of a declining Euro, one sees that inflation is not an issue in nearly 65% (European Union, US, Japan, and UK) of the world’s GDP which correlates to a more accommodating Central Bank*

policy for some time. Though the currency impact has made avoiding many government debt issues a positive transaction, the dramatic improvement in the price of Treasuries has offset that position. It continues to feel like a situation that is building toward a crescendo that will ultimately move the way past situations when the Fed ultimately moves towards higher rates sometime next year. We also believe it is an opportune time to move from the continued high cash positions held on investors' balance sheets to look for higher potential returns in the form of appropriate investments.

**Commodities and Basic Materials:** We continue to believe the commodity story has a while before the final chapter is written. And as with all stories with volatile dynamics, the conclusion is often very dramatic. We believe oil will continue to have an upward bias and will ultimately have an impact on natural gas in the form of a bullish move. We continue to overweight the Agriculture side as there continues to be pressure on the balancing of supply (crop output, natural disasters, loss of arable land in key areas such as China) and demand (rising population) appear out of balance. Industrial metals will continue to see pressure on prices as the economic recovery gains steam throughout 2010. We would invest in this via structured products that invest directly in the commodity futures with principal protection.

**Mid-Year Update:** As increased fear of a double-dip recession has dominated the press, commodities have had a rough first half of the year. The UBS Bloomberg CMCI index has seen a drop of nearly 13% for the first half of the year. The deflationary impact of the Euro's drop and its draining perception on the global economy combined with the increased belief that the Chinese Renminbi may soon be floating with the free markets has had a tremendous impact on the value of commodities. We still see an increased global use of commodities as our belief in the fundamental economic recovery continues. The resulting impact of a true revaluation of the Renminbi would be an intense pick up in volatility in commodity pricing; however all signs point to a continuing broadening out of the peg with which the currency will trade.

The resulting impact on the Euro is a long overdue correction in our minds. We believe the quantitative easing that the ECB is embarking on will stabilize the Euro in the short run, however, we also think the drop dramatically improves the exports of Ger-

many and France. The increase in exports increases the use of commodities and offsets the potential exporting of inflation from China and other Asian markets. Though the short run may prove to be more of the same trading ranges in commodities, the long term recovery appears in place and we expect will bode well for commodity prices.

**Hedge Inflation:** Inflation is one area we have had to accelerate the adjustment for hedging. Due to the increased recovery rate of the jobs market, we now see inflation coming in sooner than previously thought. As such, we would hedge inflation directly in the form of CPI floaters for the income oriented and gold participating principal protected structured notes for those looking for more reward. Gold will continue to see an upward bias as inflation hedging and dollar diversification from Central Banks amplifies its significance.

**Mid-Year Update:** Perhaps the most dynamic shift in the inflation front is the deflationary impact of a Euro dropping below 1.20 at one point has had on the dislocation of inflation. With an overall 20% of the global economy in retrenchment mode, consumption and therefore wages looked to be under little pressure. For inflation to truly take hold, we need unemployment to recede and wages to correspondingly increase. This translates into inflation being put off for a little while. The year-over-year CPI rate still stands at 2.0% and should remain low for the rest of the year. However, the silver lining is the lack of pressure that exists on the Federal Reserve and ECB to raise rates to combat inflation that hasn't transpired.

This perpetuates one of the age old axioms in don't fight the Fed and confirmation that economic patterns exist. We believe that the Central Banks will leave the punch bowl of easy monetary policy in place for far longer than most expect. Inflation will take hold, only a bit longer than previously expected. The component of gold as a hedge still is one of our favorites as it also counters a potential currency crisis in the dollar, euro and yen.

**Consumer Cyclical and Consumer Discretionary:** We see the progression of the jobs market and economic recovery as having a positive impact on an area that has been left for dead.

**Mid-Year Update:** *Perhaps the best barometer of the tale of two markets for the first half of 2010 is the chart for the S&P 500 consumer discretionary component. Starting at 285 at the beginning of the year, it rose 20% only to retreat back to nearly where it started at 278. As consumer's sentiment as measured by the University of Michigan started the year at 72.5, it to rose, retreated and now stands in quite a contrast to the consumer discretionary index as it stands at 76.*

*The trickiest of all economic and market prognostication is the measuring of the consumer as far as saving and spending. Both components are emotional in nature (understatement of the year) and leave a lot of room for interpretation. This challenge has only been heightened by the psychological state of the consumer following the greatest recession investors have faced, two equity bubbles bursting over the last decade and a housing decline not seen in the modern economic era. These increase the volatility and paranoia of an already nervous consumer who is keeping their fiscal head on a swivel.*

**Health Care:** With potential dynamic shifts arising from the political arena and an aging demographic, we see continued increases in spending in this sector for some time. There are a multitude of directions to go for the investor. Should one seek income, one could look at insurers on the taxable side and hospital related revenue issues in the municipal area for those seeking tax deferred investments. One could also look at the equity aspect in the form of UITS.

**Mid-Year Update:** *The resulting impact from the health care reform bill has been one that has caused anxiety over what is to come versus the immediate impact of the bill it self. It was signed in late March which at the time corresponded with the S&P 500 Health Care Index to be up 1.48%. The second quarter brought upon more of what the overall markets experienced with a drop of 12.29% in the health care component.*

*The negative reaction by a majority of centrist voters as evidenced by a small sampling of mid-term elections, combined with the lagging component of the largest impact of the bill itself, points us to a diluting impact of the bill in the longer term. Some components will remain, however it points to a continued opportunity in this sector based off of our original premise of large forces at work, in particular the aging demographic.*

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