Monthly Market Commentary

- Among the most critical issues impacting global growth is the European debt crisis.
- A clear difficulty facing Europe is the lack of fiscal coordination among the disparate European Union members.
- Though relinquishing at least some fiscal control at the national level may be necessary to maintain the Euro's existence, the process will take time and result in capital market volatility during periods of heightened uncertainty.

Investors continued to monitor the situation in Europe, as news on Spanish financials moved markets both down (poor Spanish bank audits) and up (support loans for Spanish banks). Up to this point, there is still no long-term remedy for European countries, with the expectation that they will continue to struggle over the next several years under austerity programs, diminished growth prospects, and waning confidence.

While economic data in the U.S. were generally weak, they were not weak enough to drive the Federal Reserve to introduce a new program. Instead, the Fed merely extended Operation Twist until at least late 2014. Morningstar economists doubt that the program will have much more than a symbolic effect on rates, given the already-low rates on long-term securities.

Employment: June saw a disappointing 84,000 jobs being added, mostly from sluggish private sector job gains. While the economy actually added 815,000 jobs, 731,000 were subtracted because of the seasonal adjustment factor. The good news is that in July, the seasonal adjustment factor will add, instead of subtract, more than 100,000 jobs to the total number, so that's something to look forward to. The unemployment rate remained at 8.2%.

Manufacturing: Manufacturing data in June fell sharply, mainly from a massive drop in new orders. This was the largest month-to-month decline since October 2001, and reversed 37 straight months of positive growth readings. Morningstar economists believe that many firms, faced with economic uncertainty in both developed and emerging economies, may have held back on new orders. However, at this stage of the recovery, the U.S. economy can tolerate some weakness in the manufacturing sector since it only represents 11% of overall employment. Month-to-month durable goods orders jumped 1.1%, but this was not enough to offset several previous months of decline. On a year-over-year basis, growth has slowed materially, falling to 4.6% from 6.9% in the prior month.

Auto: Auto sales have been a key driver in the economic recovery, and while they exploded upward in the beginning of the year because of favorable weather conditions, growth has tapered off from March through May. Fortunately, auto sales in June jumped back up to 14 million units from 13.7 million in May, which was 21% above last year's tsunami-blighted numbers, putting a stop to the downward trend.

Housing: Housing data in June have been highly optimistic, with uniformly positive pricing data, new home constructions trending upwards, existing home sales data driven up at least partially by a lack of quality inventory, and homebuilder-related financial data continuing to rise. Morningstar economists believe that the more predictive, earlier-in-the-cycle data is stronger than the more concurrent data, indicating more gains ahead. Furthermore, low rates, falling inventories, and higher sales levels should lead to better pricing results as well.

Quarter-end insights: It has become more clear that the U.S. is less dependent on exports than many other countries (U.S. exports represented only 13% of GDP according to 2010 data), and so a general slowing of the world economy would not drastically affect the U.S. economy. However, the U.S. economy is not the same as U.S. stocks, so S&P 500 companies that have substantial overseas exposure are still at risk. Stocks with lower overseas exposure, such as utilities, communications, and health-care stocks, were among the best performers in the second quarter. The relative U.S. strength showed up in country-level data as well, with U.S. indexes down only 5% near the end of the second quarter, while both European and emerging-market indexes were down 10-15% for the quarter. Overall, consumers continued to spend, fueled partially by falling gasoline prices. Unfortunately, low commodity prices were bad news for many basic material companies, as prices for their goods dropped while costs of production remained relatively high.