

May 10, 2010 - Market Update

On Thursday the stock market, as measured by the Dow Jones Industrial Average (DJIA), fell at one point 998 points, the largest point drop ever, before rallying to close down “only” 348 at 10,520. During the course of the day the DJIA had an extremely high intraday price move of 11.6%. In addition, the VIX, an option based volatility and fear index jumped from 22 to 40, the highest its been in over a year. The markets now stand off 7.3% from its April high, close to matching the 8.1% correction in February.

Recently, stocks have shown some weakness after rising for the previous 8 weeks in a row. The market has shown exceptional strength since last March’s low, growing almost 80% at the top in mid April after pausing only a few times over the past year to consolidate gains. During this time the market has climbed a “wall of worry” as investors have been skeptical of the nascent economic recovery that has taken root. Most notable of these concerns has lately been the worsening European debt crisis as the International Monetary Fund (IMF) and the European Union (EU) have struggled with the Greek Government to arrive at a rescue package. Scenes of rioting within Greece and infighting from other EU members has raised concerns that this bailout may not materialize, thus spreading the contagion to other overstretched EU members collectively know as the “PIIGS” (Portugal, Ireland, Italy, Greece and Spain) and by extension threaten the existence of the EU in its entirety. Adding to investor unease has been the Goldman Sachs investigation by the SEC and the Justice Department, impending financial reform, an unsuccessful terrorist bombing in New York City and the oil spill in the gulf. On Thursday market volatility either through an erroneous trade or through the systemic stress induced by high frequency trading resulted in an extremely low price of \$39 for a share of Procter & Gamble that traded at \$60 per share just moments before. Accenture and a number of other stocks also traded for a fraction of their actual market value. Observing these indicators, and the resultant negative effect on market indices, it is believed that quantitative based market trading algorithms jumped into the fray, selling off securities into what was until then a low volume day, briefly creating a panic situation. As the market stabilized from the actions of circuit breakers and human market maker intervention, the market then rallied from the rapid sell off to close the day off a relatively better 3.2%. The Dollar & Treasuries soared in value as a flight to quality took place – ominous signs for the economy, deflation and the US export market.

Friday, a much stronger than expected employment number was announced of 290 thousand jobs being created in April as confirmation of the economic rebound taking place. While this recovery may be weaker than the average, we are coming out of no ordinary recession. However, a profound difference between now and the fall of 2008 is the fact that the US and the global economies are on balance improving. The economy is growing and corporate earnings have been strong. The Federal Reserve is poised to keep rates low for what appears to be a long time and has felt confident enough in the US economy to recently begin to remove its liquidity facilities such as TALF. In fact, the market still remains positive for the year with the S&P 500 up 4.43% as of this writing. We are concerned with the increasing investor appetite for risk assets such as low rated C&D stocks, small cap stocks and emerging market stocks. The extremely high valuations in these areas, coupled with the huge drop in high yield and corporate bond spreads along with below average volatility exposed an investor complacency that made the markets extremely vulnerable to a confluence of bad news.



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Over the weekend the IMF approved the \$140 billion rescue package for Greece as well as, more importantly, the creation of a \$1 Trillion liquidity fund to speed aid to any European Union country in need. The EU, Euro zone and the IMF have all participated in the funding and policy of this plan. The US markets have rallied strongly on this news and are up around 4% from Friday's close.

Our Investment Policy Committee remains neutral to the equity markets, meaning that we advocate an equity exposure equal to our client's investment objective. The markets will remain under greater than normal stress and investor skepticism for a long time to come. The inherent volatility will create investment opportunities and potential pitfalls. While there may be a time that we will quickly change investment positions, most often the disciplined use of asset allocation around client risk parameters will be the best plan of action. We have encouraged use of high quality stocks, not only within the proprietary growth products but as an equity style as well; high dividend, high quality stocks should fare well in this volatile environment. For those clients who further wish to reduce their risk profile we can offer products like the Prudent Bear Fund or tactical moves across asset classes to increase their fixed income or cash positions. We will continue to remain vigilant in monitoring the markets and will notify all if our position changes.



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