DVI
DAVID VAUGHAN INVESTMENTS

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The Economic Headwinds

The strength and stamina of the U.S. economic expansion that began in the late summer of 2009 is now being called into question as certain indicators such as job growth, the housing market, consumer confidence and spending have all softened in recent months. The negative impact to the stock market and its individual constituents has been noticeable as the S&P 500 Index has experienced a 15.7 percent peak to trough decline since late April of this year and has registered a year-to-date loss of 6.8 percent. It is not particularly noteworthy to experience a market decline during the early stages of an economic recovery, in fact according to Ned Davis Research; we have experienced nine such market corrections of 10 percent or more since World War II [1]. After the 80 percent increase of the S&P 500 Index over the past 12 months, it was likely that a market correction was right around the corner. However, one can never anticipate the timing and severity of a pullback. The notable aspects of this market decline has been both the swiftness of the retreat (just 46 trading days) and the seemingly endless list of fundamentals that have provided investors cause for concern.

The Worry List

- Euro-Zone Debt Crisis
- Size of U.S. Budget Deficit and U.S. Federal Debt
- Fiscal Austerity Plans and Tax Hikes in both Europe & the United States
- Continued instability in the U.S. housing market and future ramifications to both Fannie Mae & Freddie Mac
- Developing Countries' (i.e. China and India) ongoing ability to lift the economies of Developed Countries
- The cost and regulatory ramifications of Healthcare Reform
- U.S. Energy Policy in light of the Deepwater Horizon oil spill

Double Dip Recession?

Despite an economic recovery that is less than one year old, many market forecasters are already talking about a "Double Dip Recession." They are anticipating future economic weakness and at least two consecutive quarters of negative GDP growth. As the table on page four illustrates, save that of the short lived expansion in the early 1980s, most growth cycles tend to last at minimum a few years, with the average duration around five years in length.

[1] Ned Davis Research & the Wall Street Journal, June 2010.

| Continued on Page 4

Route To:
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The Dodd-Frank Wall Street Reform and Consumer Protection Act

Brian Christensen, CFA
Senior Vice President

The name sounds impressive and the length of this legislation is clearly impressive at over 2,300 pages. A casual review might suggest positive change is ahead in the area of financial regulation and reform. Below the surface, it appears this bill is as much show as substance. The good intentions of Congress appear to again be diluted.

A few highlights of the legislation:

1. Creates the Consumer Financial Protection Bureau to be housed at the Federal Reserve, established to ensure consumers get the clear, accurate information they need to shop for mortgages, credit cards, and other financial products.

This is largely positive but requires the Fed to become familiar with payday loans, check cashers and other non-bank finance companies. It falls short by exempting auto dealers and what is typically the second largest financial decision for most households.

2. Creates the Financial Stability Oversight Council consisting of ten voting members from various regulatory agencies. The hope is to end too big to fail bailouts by creating a safe way to liquidate failed financial firms.

While the concept is good, the proposed powers of this new Council are nearly unlimited. Using $50 billion in assets as the threshold for determining "too big", the universe today is 184 banks. Once the Council determines a bank "poses a grave threat to the financial stability of the United States" they are able to essentially direct the bank's business activities in any manner deemed to be more conservative and stable. Some analysts have suggested this provision simply creates quasi-government sponsored entities out of the already "too big" banks by default. One other problem, Fannie Mae and Freddie Mac are exempt from financial reform. Considering Fannie and Freddie received nearly $150 billion in bailout money this is a serious failure. Apparently the six-figure campaign contributions to Senator Christopher Dodd and President Barack Obama are paying off.

3. The Volcker Rule seeks to limit proprietary trading at large financial firms and to restrict investment in and sponsorship of hedge funds and private equity funds, and seeks to limit relationships with hedge funds and private equity funds.

Clearly a good idea particularly for those financial firms with FDIC insured deposits. After considerable negotiation, the bill's current form would limit banks to no more than three percent of Tier I Capital as opposed to an outright prohibition. Let's hope this doesn't get diluted further before final passage.

4. Policies designed to create greater transparency and accountability in the derivatives market will be enacted. This will allow both the Securities and Exchange Commission and Commodity Futures Trading Commission authority to regulate over-the-counter markets previously not monitored. Also proposed is the creation of a central clearinghouse and exchange for derivatives trades.

In concept, this is a good idea but in the current proposal limits participation in the transparency and accountability to banks. It seems short sighted to not consider a broader business spectrum. Past experience shows the insurance company AIG would have been well served by greater transparency and accountability in its derivatives trading business.

5. Gives the SEC authority to impose a fiduciary duty on brokers who give investment advice requiring that the advice must be in the best interest of their customers.

Staggering to think this is something that has to be legislated.......

As I write, the Dodd-Frank Act has passed the House vote and now waits for a post Independence Day vote in the Senate. There continues to be great concern about the cost to the economy and the consumer if the bill becomes law. Early indications are that the bill will become law. As Senator Christopher Dodd closed the conference sessions early the morning of June 26th he said, "No one will know until this is actually in place how it works."Not exactly a ringing endorsement but certainly correct.

SEC Circuit Breaker Rule 101

Meghan Jackson
Financial Analyst

On May 6, 2010, investors grappled with several unsettling pieces of political and economic news, most significantly the unfolding saga of the European Debt Crisis, all events placing downward pressure on the equity markets. The overall decline suddenly accelerated at an alarming pace shortly after 2:30 pm ET. In the next several minutes, there was an additional decline of more than five percent in both the cash equity and futures markets. Thirty of the stocks in the S&P 500 Index plunged at least ten percent with some stocks trading as low as a penny. This *"flash crash"* was quickly followed by a similarly hasty recovery. The extreme volatility in this short fifteen minute period of time and irrational pricing of individual stocks clearly suggests that there was a temporary lapse in the supply of liquidity on the various equity exchanges.

In an effort to prevent this kind of extreme volatility in the future, the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA) and other self-regulatory organizations have come together to construct a new circuit breaker rule. This rule applies between 9:45 am and 3:35 pm ET and will be triggered in all markets when a ten percent price change occurs over rolling five-minute intervals for any stock included in the S&P 500 Index. Once the circuit breaker is triggered, all markets will be required to wait until the stock's primary listing market has resumed trading after an initial five-minute pause before they can begin trading again. If for some reason the primary listing market is unable to open the stock after the initial five-minute pause because of an issue such as an order imbalance or a system problem, other markets will be able to resume trading after an additional five-minute pause. According to the SEC, this temporary pause in trading should allow the markets the opportunity to draw new trading interest in an affected stock, re-establish a rational market price and resume trading in a fair and logical fashion. The circuit breaker rule has been implemented on a pilot basis through December 10, 2010 to allow time to evaluate whether the rule is meeting its intended goals and whether additional securities, such as exchange traded funds, need to be added.

Regulators are still unsure as to what specific actions caused the *"flash crash"*, but are moving ahead with ways to prevent it from happening again in the future. According to the SEC, investigators have been focusing on a possible link between the steep decline in prices of indexes and simultaneous waves of selling in individual stocks. SEC Chairman Mary Schapiro said in a statement, "By establishing a set of circuit breakers that uniformly pauses trading in a given security across all venues, these new rules will ensure that all markets pause simultaneously and provide time for buyers and sellers to trade at rational prices." The circuit breaker rule that has been put in place should limit significant volatility, increase market transparency and bring consistency to decisions regarding trading halts in individual securities.

DVI In the Community

Save the date the morning of August 21, 2010 for the fourth annual DVI Hike for Hunger. All proceeds of this event will benefit the food ministries of South Side Mission to help feed the less fortunate in our community. It will be a morning of energetic hiking and fun filled games and activities for the entire family, held on the premises of DVI and the Forest Park Nature Center. To pre-register for this great event, please visit www.southsidemission.org or call Lisa Proctor at 685-0033.

In addition, from September 17, 2010 to January 9, 2011 DVI will continue its commitment to the environment by underwriting the Lakeview Museum of Arts & Sciences John James Audubon: American Artist and Naturalist Exhibit that touches on the disciplines of art, history, biology, natural science, literature and environmental studies. Audubon's art and aesthetic legacy continue to amaze and inspire and DVI is delighted to support this exhibit for our community.

The Economic Headwinds

Continued from Page 1

With this historical perspective in mind, one would reasonably expect continued but possibly slower growth through the balance of 2010. Economic headwinds do exist, but there are also several potential catalysts for future economic growth.

1. Interest Rates remain at historical lows.
2. Corporate Balance Sheets are conservatively positioned with an abundance of cash.
3. The inventory rebuild in many industries is still in the early recovery stage.
4. Capital Expenditures by Corporate America have been deferred and are long overdue.

"**We are confronted with insurmountable opportunities.**" Pogo

History of U.S. Economic Expansions

	Trough	Peak	# of Months
1	Nov-27	Aug-29	21
2	Mar-33	May-37	50
3	Jun-38	Feb-45	80
4	Oct-45	Nov-48	37
5	Oct-49	Jul-53	45
6	May-54	Aug-57	39
7	Apr-58	Apr-60	24
8	Feb-61	Dec-69	106
9	Nov-70	Nov-73	36
10	Mar-75	Jan-80	58
11	Jul-80	Jul-81	12
12	Nov-82	Jul-90	92
13	Mar-91	Mar-01	120
14	Nov-01	Dec-07	73
		Ave:	56.64
15	Jul-09	-	11

Source: National Bureau of Economic Research

Traditional long-term investors continue to avoid the U.S. equity market, preferring asset classes that provide a greater sense of emotional comfort. This herd mentality does provide opportunity for a contrarian *if* the economy provides stable growth and corporate earnings continue to rebound from their Post-Recession lows. Those are big *ifs* and we recognize the high degree of uncertainty. However, disciplined and unemotional investing leads you to ponds of opportunity that others don't dare to fish. Market valuations are once again most attractive and many large multinational companies with global franchises trade at 11 times forward 2011 earnings or less. Unfortunately, to be a value investor, you have to be a long-term investor and suffer through these moments in time in which your natural instinct is to bury cash in a galvanized steel bucket in your back yard.

Will Williams

President

DVI Website Enhancements

Over the past several months a team of DVI associates has spent a great deal of time enhancing and improving our website. We are pleased to announce the roll out of the new site, still located at www.dviinc.com. In addition to the aesthetic changes, we have added educational content, including a new white paper entitled "The DVI Approach to Asset Allocation", as well as made enhancements to the client secure portion of the site.

If you haven't recently visited our website, we encourage you to take a look as well as visit periodically to see the ongoing updates as new material is added. Additionally, if you are a client and would like to gain on-line access to this secure site, please contact Denice Soda or Jim Sinclair at 685-0033.

David Vaughan Investments, Inc. • Peoria, IL • Winter Park, FL • www.dviinc.com