FINANCIALLY SPEAKING

# Weekly Market Analysis

January 24th, 2011

**Market Wrap-Up:** Last week, the US markets experienced a very interesting trading week. There was a large dislocation between what had previously been happening in the markets and what happened last week. Prior to last week, both the small and mid-cap market sectors had been turning in the best performance, then last week we saw a dramatic selloff in the two market caps as investors appeared to have been taking profits out of long-term trades. There was no particular economic news that would normally have driven such a decline, but the decline is a little troubling because the small-cap stocks are typically a forbearer of what is to come in the broader markets. At this point in the market cycle, earnings announcements are likely to drive the market going forward and there are a number of them set to be released this week. The earnings week kicks off with McDonalds reporting earnings before the market opens on Monday, quickly followed by earnings announcements by American Express and CSX. On Tuesday, Johnson and Johnson is the largest name to release earnings, and combined with 3M's announcement could drive the market direction. On Wednesday, investors will look to announcements from Boeing, Xerox and Netflix for direction, with Netflix expected to report a very strong 4th quarter and give upbeat guidance for 2011. On Thursday, heavyweights Microsoft, Caterpillar and AT&T all release their earnings and should be the driving force for the markets. In total, 14 of the Dow 30 components, 19 of the NASDAQ 100 and 122 of the S&P 500 are scheduled to report earnings this week. With several of the market sectors showing the start of what could become weakness, we are watching all of our holdings very closely and have the ability to move very quickly toward the sidelines if needed.

**International Politics:** Chinese President Hu Jintao's visit to the US was a focal point of international politics last week. His trip to the US, an attempt to stop further deterioration in China's relationship with the US, was viewed largely as a success. As a result of the trip, the US has agreed to a new trade deal with China that some analysts value at over $45 billion in value. The US has been allowed to keep two Chinese Pandas at the national zoo for an additional five years. During the Chinese President's meeting with many of the top business executives, he invited their businesses to expand into China and said that China would not discriminate against the foreign companies. While this list may seem small at first glance, it is a major step forward in a relationship that has been under stress for the past few years. The President's visit was not without a few awkward moments, mostly around human rights violations in China and calls for a free moving Yuan against the US dollar. Toward the end of last week, China announced that during the fourth quarter of 2010 their GDP grew by 9.8 percent after growing by 9.6 percent during the third quarter. This continued growth in GDP at an unexpectedly high rate presents an interesting problem for much of the investing community and for China itself. The problem is that China seems to be well on its way to inflation and a possible overheating of their economy. The unknown is what China is going to do about it and the concern is that they may overreact. With the Chinese economy growing very quickly, there is speculation that China will continue to enact more fiscal and monetary policies that attempt to cool off the economy. Recent actions taken by China, such as raising the reserve requirements on their banks or increasing their interest rates, do not appear to have worked. Every time China does take action we see a worldwide selloff in areas of the market like commodities, as many investors fear that China will overreact and hurt production and demand for raw materials in the country. At this point, China will either continue to move interest rates higher or they will have to come up with some new technique for combating the excess growth that they have been experiencing. Any action is going to lead to worldwide uncertainty in the financial markets and could create a very volatile market environment.

**National Politics:** National politics heated up last week as the Republicans in the US House of Representatives voted on and passed a healthcare repeal. While the repeal holds little weight, since Democrats hold a majority in the US Senate and will most likely not even bring the bill to the floor for a vote, the Republican Party is calling the passage a victory and is currently trying to craft changes to the bill in order to make it more appealing to the Democrats. Even if the bill did somehow make it to the US Senate and pass, it is highly unlikely that President Obama would ever sign it into law. With President Obama's State of the Union address on Tuesday evening, we will have to wait and see if he makes any reference to the House of Representatives' first major piece of legislation. During the State of the Union address, President Obama is going to focus on jobs. The President is likely to point out key successes in the fight on unemployment, such as the turnaround in a few areas of Michigan and other parts of the US, but also that these successes are only a start to what needs to get done. Other key talking points on Tuesday night will be spending, the growing US deficit and the ever increasing amount of debt that is being issued by the government. We may see items such as a national power grid or high speed rail network once again brought up, but funding for such initiatives is going to be very hard to get approved with a gridlock on Capitol Hill. From an investment standpoint, if the President mentions any specific industries as they relate to major areas of expansion, typically the stocks in that industry see a nice move upward the following day, and at some point give up the gains as politicians fight over funding. After the State of the Union, the following days in national politics are spent finding members of congress that agree or disagree with statements the President made and televising the ensuing arguments on the news. After all of the points of the address have been extrapolated on, business in Washington DC will get back to work, with many members of congress trying to figure out how they can work together and get something done during the next two years. During the State of the Union address, many Democrats and Republicans are going to cross the aisle and sit with members of the opposite party as a sign of unity and bilateral cooperation.

**Market Statistics:** The US markets saw a wide divergence in performance as earnings seemed to drive much of the performance. The largely blue chip Dow turned in the best performance of the week, advancing 0.72 percent while the more broadly based S&P 500 declined by 0.76 percent. The technology heavy NASDAQ (on the back of some negative earnings announcements) sank by 2.39 percent on very heavy volume. To give a little more perspective on the disparity of returns, the Russell 2000 index (an index of 2000 small capitalization stocks) fell by 4.16 percent during the four trading days last week. The best performing sector of the US markets last week was the US Aerospace and Defense sector, which increased by 0.55 percent. The worst-performing sector last week was the high technology networking sector, which declined by 5.67 percent, due largely to a miss on earnings by F5 Networks, accompanied by a lowering of their outlook for 2011. Commodities turned in weak performance last week as the GSCI Commodity Index declined by 0.98 percent. Uncertainty about Chinese demand for commodities was a main driving force behind the decline. Leading the decline in commodities were some of the industrial metals that the previous week were the largest winners, including copper (-5.96 percent) and oil which decreased by 2.65

percent. The more precious metals, gold and silver, were also down for the week with Gold turning in a -1.25 percent return and Silver -3.28 percent. The US dollar declined sharply for the second week in a row against a basket of international currencies, dropping by 1.23 percent over the course of the week. On the international investing front, the best return of last week was found in France for the second week in a row, with the CAC-40 index advancing 0.86 percent, while the worst performing index globally last week was the Shanghai Composite Index which declined by 2.68 percent, on uncertainty about government actions going forward. The VIX saw its largest weekly move in a long time, advancing by almost 20 percent as uncertainty around the upcoming earnings and the emotional state of the average investor continued to wreak havoc on the volatility being seen in the markets. The VIX is currently at its highest level of the past month but it is well below even the average volatility level we saw during the months of September through October of 2010.

For the shortened trading week, ending on 1/21/11, returns in FSI's models were as follows:

| | Last Week | YTD | Since 12/31/07 |
|---|---|---|---|
| Aggressive Model | -3.58 % | -1.05 % | -1.83 % |
| Growth Model | -3.39 % | -1.49 % | -0.04 % |
| Moderate Model | -2.89 % | -0.79 % | 3.47 % |
| S&P 500 (benchmark) | -0.75 % | 2.02 % | -12.60 % |

Over the course of the previous week, we made a few changes to our models as we adjusted for a continued upward movement in the markets and then readjusted for the weakness we saw in the latter half of the week. The week started off with the selling of our large-cap position in Profunds Large Cap Growth (LGPIX), as it was underperforming the more broadly based S&P 500. We used the proceeds of the sale to move into both small-cap (DXRLX) and a NASDAQ fund (UOPIX) as well as a small allocation to natural resources through the use of either US global Natural Resources (PSPFX) or Jennison National Resources (PGNAX). Once we saw the turning over in both the small and technology sectors of the market, we moved half of our positions in both DXRXL and UOPIX to cash so that we greatly lighten our exposure to the markets. We continue to look for investment opportunities while at the same time being cognizant of the risk of a broad market decline in the near future, this type of market leads us to use more tradable index funds than would otherwise be utilized because of their inherent tradability.

**Economic News:** Last week was a slow week for economic news releases since Monday was a market holiday. The week kicked off on Tuesday, the 18th, with the release of the empire manufacturing index. It came in as expected, at11.92 up from a December level of 9.89, indicating a good amount of growth in manufacturing in the New York area. Later in the day, on Tuesday, the government released their housing market index for the month of January and it was no surprise that the figure showed no change over the December figure. While this may seem like a slightly negative announcement for the housing market, the financial markets seemed to take this as a sort of "at least it was not down" announcement and did not really react. On Wednesday, housing starts and building permits for the month of December were released with the building permits coming in much better than expected at 635,000, versus expectations of only 560,000. The good news was somewhat dampened by a lower than expected reading from housing starts (529,000 versus expected 550,000). The US housing market got a very positive surprise on Thursday when it was released that existing home sales for the month of December had come in at 5.28 million while the market had only been looking for 4.8 million. This unexpected jump in existing home sales was a very pleasant surprise for the markets and seems to indicate that the US could be starting to work through the inventory of unsold homes in the US. The surprise in housing was enough to offset some negative earnings announcements, as well as the unexpectedly high growth rate in China and helped turn around the US markets prior to their opening for trading on Thursday. Adding to the good news on Thursday was the release of the initial jobless claims, which came in at 404,000 for the prior week while the market had been expecting 425,000 (this point will probably be brought up in the State of the Union address on Tuesday night). Continuing jobless claims for the previous week were shown to be 3.8 million, while the market had been looking for 3.9 million, further adding to the positive news of the day. Wrapping up the week later in the day on Thursday, the Philadelphia Federal Reserve index for the month of January was released and missed expectations, but not by enough that it was a cause for concern. Overall, much of the economic news released last week pointed to positive developments for the US economy and seem to be indicating a continuation in the rally of the stock market.

This week is a bit busier than last for economic news releases, with the release of the Case-Shiller 20 City Home Price Index for the month of November on Tuesday. Expectations are for a decline of 1.5 percent on a year-over-year basis for the index. While this may seem very negative, the data is a bit stale with the more current information about the housing market seeming more positive than it was back in November. Later in the day, on Tuesday, is the release of the Consumer confidence index for the month of January, with hopes that the index increased slightly over December levels. Also released on Tuesday is the government's version of the Housing Price Index for the month of November. Normally the two housing price indexes are not released on the same day so it will be interesting to see how the market reacts to any of the differences between the two releases. After last week's positive news about home sales, this week's release of new home sales for the month of December is expected to be positive as well registering a reading near 300,000 for the month. Later in the day, the Federal Reserve will end its two day meeting with an interest rate decision that is expected to be the same as it has been for a while; interest rates between zero and 0.25 percent. The language of the release will be scrutinized and investors will be watching very closely for any changes in the wording as it regards the second round of quantitative easing. On Thursday, the weekly jobs related figures are set to be released with the markets hopeful that last week's declines will become the start of a new trend in the unemployment figures. Later in the day, on Thursday, durable goods orders for the month of December are set to be released with expectations being for an increase of 1.5 percent on overall orders and around 0.5 percent on durable goods orders when transportation is excluded. A reading of 1.5 percent on overall durable goods orders would be a drastic improvement over the previous months reading of -0.3 percent and would be a very good signal for the US economy. Late in the day, on Thursday, pending home sales for the month of November are set to be released with expectations of a decline. The market would not need too much good information to have this release become a very positive announcement if it does beat expectations and come in positive. On Friday, one of the highly anticipated news releases of the week is set to come out, the announcement of the advanced 4$^{th}$ quarter GDP figure for the fourth quarter of 2010. Expectations are for a reading between 3.4 and 3.7 percent. While the release is only an advance release, it does provide the market with some insight into what the final outcome for GDP in the fourth quarter is likely to be. Along with the GDP figure, the government also releases both the Chain Deflator and the Employment Cost Index both for fourth quarter of 2010, both are expected to have remained very close to the levels seen during the third quarter of 2010. Wrapping up the week on Friday is the release of the University of Michigan Consumer Sentiment Index for the month of January, and it is expected to have increased slightly over the level seen during December. This increase in consumer confidence would be a key signal that the US consumer has not lost faith in the recovery and that they are still behind a continued recovery.

Have a great week,
Peter Johnson

*Feel free to forward this email.*

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