

## Weekly Market Analysis

February 28<sup>th</sup>, 2011

**Market Wrap-Up:** During last week's shortened trading week, the US markets saw a slight decline due to the unrest in Libya and the uncertainty surrounding the price of oil. Oil remains one of the catalysts that could provide a bump in the road for the economic recovery currently being experienced in the US. One of the key resistance levels that I was watching on oil (red line below at \$92 per barrel) was decisively broken through last week as Light Sweet Crude oil soared through \$100 per barrel, as shown by the green line on the chart below (oil price movement since 12/31/2009). In addition to the resistance line on the price chart below, this week I have added the lines which show the range oil has been trading in for the past six months. As you can see, oil moved decisively higher after having broken through the lower trend line (normally a technical sign that oil would continue to move lower). Following the breakout to the upside, oil pulled back slightly and retested the upper trend line, proceeding to bounce higher after testing, a further indication that the price of Light Sweet Crude may continue to move higher in the near term.



With oil being so vital to the continuation of the world's economic recovery, Saudi Arabia stepped forward and said that they would increase production to fill any shortfalls that the market may experience due to Libya's unrest. Initially, the market reacted positively to this news with the price of oil declining, but this fix is ultimately not going to work as many people expect. Saudi Arabia's oil is very heavy and has to be refined by refineries specifically designed for that type of oil. The oil that is pumped out of Libya is Light Sweet Crude, which requires a different refining process. So even if the Saudi oil makes it to the same ports that Libyan oil used to be shipped to, the refineries would not be able to do anything with it. The dislocation in types of oil can be seen in the price

difference between Brent Crude and WTI oil (Light Sweet Crude). Brent crude is primarily used in Europe, which also happens to be where more than 80 percent of Libyan oil (light sweet) was sent, so with a shortage from Libya, the main oil Europe uses has moved up in price, as they will need to replace lost supply from Libya with Brent crude. Ultimately the recent upward movements in oil are going to have a dampening effect on consumer spending around the world. The cost to move both people and goods will increase due to increased costs of oil. According to Tom Kloza, chief oil analyst at the Oil Price Information Service, a 25 cent increase in the price of gas in the US leads to Americans spending an extra \$3 billion to fill up. That is \$3 billion that would otherwise be put back into the economy, helping to keep the recovery moving forward but instead it is being used to just keep us moving. A sustained oil spike remains the single largest threat to the economic recovery as can be seen by the correlating spikes in volatility when oil moves higher.

**International Politics:** Last week international politics were once again focused on the unrest in the Middle East, with the primary focus remaining on Libya. The world seems to have come together and denounced the actions that Gaddafi has been taking against his own people in a desperate attempt to hold on to power, but so far there has been little direct intervention in Libya by outside countries. Sanctions have been applied by the United Nations Security Council and diplomatic ties with Gaddafi's regime and foreign countries have been severed, but this has done little to oust Gaddafi and his supporters in Tripoli. The world stock markets are not so much concerned about the Libyan situation as they are about the continued spread of the unrest to either Algeria or Saudi Arabia. The "domino effect," as many pundits call it, could have a profound effect on the oil supply around the world and could ultimately force developed countries off of their addiction to foreign oil. This would be a very positive development for the alternative energy sector in particular, as more money would be spent on research and development, thus leading to technology evolving faster than if cheap oil remains the main form of energy used by developed countries. Elsewhere in the world Chinese Premier Wen Jaibao said over the weekend that China is lowering their target GDP growth rate from eight percent to 7 percent for 2011 through 2015. This is quite a change from the nearly 10 percent annual growth rates that have been experienced since 2000. The reason for the change, according to Wen Jaibao, was because China wants "to raise the quality and efficiency of economic growth." With China being willing to accept a lower GDP growth rate, many market participants feel that they will continue to apply the brakes on their economy as they continue to struggle with high levels of inflation.

**National Politics:** National politics were pretty quiet last week since the majority of the headlines were focused on Libya. The main story coming out of Washington DC is the budget, and trying to get something passed by midnight on Friday, March 4<sup>th</sup> (and rightfully so, since a government shutdown could have long term negative effects on the economy). As the time draws near, we will be assessing the risk of a government shutdown on the specific holdings in our models and we will take the necessary actions to mitigate risk in our models. The United States has not experienced a federal government shutdown since 1995, when President Clinton and the Republican Party could not agree on the budget. During that time, the stock market did not really react adversely to the shutdown. In the present day, however, with spending already being so tight and energy costs rising, a prolonged shutdown (during which non-essential government employees are not paid) could have a large impact on spending and ultimately the stock market. The deal currently being considered involves Republicans agreeing to a two week extension of the budget deadline in exchange for \$4 billion in budget cuts. The fighting among Congress is being mimicked across the country by state legislatures as the states try to come up with their own budgets. The most vocal and obvious of these is the state of Wisconsin, which is trying to work through its own budgetary issues. One of the

hotly contested issues popping up in many states is the collective bargaining rights of unions, as governors want to make budget cuts and want to hand some unions their share of the cuts. If compromises are not reached, states may be forced to lay off workers in order to close the budget gaps. This would add negatively to the economy in much the same way as furloughs to federal employees would if a national budget is not agreed to. One big difference is that states must have a balanced budget, whereas the federal government can keep passing continuing resolutions which would keep the federal government running without formally adopting a budget.

**Market Statistics:** All three of the major US markets broke their trends last week, and they all experienced a decline. The broad based S&P 500 decreased by 1.72 percent, while the technology heavy NASDAQ moved down 1.87 percent and the blue chip Dow declined by 2.10 percent. The best performing sector of the US markets last week was the Energy sector, which increased by 1.09 percent, thanks in large part to unrest in the Middle East. The worst performing sector for the week was the US Home Construction sector, which declined 4.29 percent. Commodities turned in stellar performance last week, with the GSCI Commodity Index increasing by 4.20 percent. Within commodities last week, Oil saw the largest increase advancing by 13.55 percent. This was the largest weekly gain for oil since 2008. Precious metals also had a strong week, with silver increasing by 2.42 percent while gold advanced 1.45 percent. There was uncertainty about the US equity market last week as was seen in the fixed income markets, which had their best week in a long time. Long end US Treasuries gained 3.12 percent followed by TIPs increasing 1.86 percent. Despite the uncertainty surrounding oil, the US dollar did not advance last week. It actually fell by 0.51 percent against a basket of international currencies. This decline was counter intuitive since most people expect investors to move toward dollars when there is a lot of uncertainty in the world. On the international investing front, none of the major world indexes turned in positive performance last week. The best return came out of China, with the Shanghai Index declining by only 0.01 percent. Globally, the worst performing index was in Japan, with the Nikkei average declining by 3.60 percent. The VIX had a great week, advancing by 16.98 percent, even after a decline of 9.85 percent on Friday. The VIX briefly touched a new high for 2010 on Wednesday, indicating that there is more uncertainty about the equity markets right now than there has been this year. However, there is a bit of a silver lining in the VIX reading. Currently the VIX is below the average that was experienced during 2010, a sign that despite the uncertainty it is still better than the average amount of uncertainty in 2010.

For the shortened trading week ending on 2/25/11, returns in FSI's models were as follows:

	<u>Last Week</u>	<u>YTD</u>	<u>Since 12/31/07</u>
Aggressive Model	-3.00 %	2.73 %	1.92 %
Growth Model	-3.16 %	2.13 %	3.63 %
Moderate Model	-3.08 %	1.71 %	6.07 %
S&P 500 (benchmark)	-1.72 %	4.95 %	-10.11 %

With the increase in volatility in the stock market last week we decided to take some of the profits we had made in a few of our holdings out of the market. We did so by selling our holdings in Semiconductors (SMPIX), NASDAQ (UOPIX), Basic Materials (BMPIX) and Industrials (IDPIX). With the proceeds from the sales we doubled our position in Real Estate (REPIX) and initiated a position in precious metals (RYPMX), as well as a position in Sierra Core Retirement Fund (SIRIX). In order to lower our overall volatility we also decided to hedge our long mid cap growth

holding (SMCSX) with an inverse mid cap mutual fund (UIPIX). We did this, rather than sell our position in mid cap, because if the market turns around and continues to move higher, we still want to have our managed mid cap growth fund. With our current model allocation we are well positioned to ride out volatility in the equity markets and will continue to make adjustments as needed.

**Economic News:** Last week was a mixed bag for economic news releases with a few surprises that were positive and a few negative. Since Monday was a market holiday, the week started off on Tuesday with the release of the Case-Shiller 20 City Home Index for the month of December. The reading came in as the market expected, -2.38 percent versus expectations of a -2.4 percent, giving the announcement very little impact on the markets and indicating that the housing market is still pretty weak in the US. Later in the day, on Tuesday, the Consumer Confidence Index for the month of February was released and was shown to have beaten market expectations by nearly five percent, settling at 70.4 (an almost three year high). Despite this very positive announcement about consumer confidence, on Tuesday the stock market experienced the largest single day decline of 2011, due to a spike in oil prices. On Wednesday, the 23<sup>rd</sup>, existing home sales for the month of January were released and came in better than the market had been expecting. This news release provided some positive information about the housing market, despite the somewhat weaker announcement on housing prices the previous day. Thursday, the 24<sup>th</sup>, held positive surprises from both of the employment related figures as well as a very negative surprise out of durable goods orders. The day started off with both initial jobless claims and continuing jobless claims beating market expectations, and doing so by a fairly wide margin. The positive attitude about the jobs figures was quickly erased by the market after news broke that durable goods orders were in line with expectations on the whole, but durable goods order ex-transportation missed the mark badly. Overall, durable goods orders came in with a positive 2.7 percent increase during January, but durable goods order ex-transportation came in with a decline of 3.6 percent while the market had been expecting an increase of 0.6 percent. This rise in overall orders and a decline when orders are looked at without transportation indicates that auto sales were very strong during January but that other durable goods were not selling. Later in the day, on Thursday, the new home sales figure for the month of January was released and came in worse than expected. This slightly negative figure from the housing market was overlooked by the market because it appears that buyers during January were just in the mood for purchasing existing homes and not for new homes. On Friday, the week's most meaningful economic news release came out, the second estimate of the fourth quarter GDP figure for the US. The release was disappointing, showing that GDP grew by only 2.8 percent while the first estimate had been 3.3 percent and was what the market was expecting out of the second release. The reason for the decline is that state and local government spending was lower than expected while consumer spending did not grow as quickly as initially expected. With the potential state government shutdown looming, we may see more of this type of dislocation in the future, leading to potentially lower GDP readings. However, the day was not lost on Friday because the University of Michigan Consumer Sentiment Index for the month of February was released and came in better than expected, much like the consumer confidence figures released by the government earlier in the week.

With the month of February coming to a close, this week is going to be a busy week for economic news releases. The week kicks off on Monday with the release of personal income and spending for the month of January, both of which are expected to have increased by approximately three tenths of a percent. The income and spending report is followed by the PCE Core Price Index, also for the month of January, in which prices are expected to show little change over the December level.

Monday wraps up with the release of the Chicago PMI for the month of February and the Pending homes sales in the US for the month of December. The Chicago PMI figure is going to be watched very closely to see if there is any carry over from the poor durable goods orders last week on the manufacturing base around Chicago. The pending homes sales figure for December is a bit of a stale dated figure, since we already know that actual sales were strong in January as shown by the two housing related releases last week. On Tuesday, March 1<sup>st</sup>, Construction Spending for the month of January is set to be announced, with expectations for a decline of between 0.6 and 1 percent. At the same time construction spending is released, the ISM Index for the month of February is expected to be released with expectations of no change over the January level. Later in the day, on Tuesday, auto sales figures for the month of February are set to be released and if durable goods orders are any indication, it seems like consumers are purchasing a lot of vehicles and this release could be very positive. On Wednesday, an important jobs related figure, the ADP Employment change for the month of February, is set to be released with expectations of an increase in jobs of approximately 163,000. The key to watch for here is how the employment change is arrived at. For example, we want to see private payrolls picking up and not just government jobs being created. Later in the day, on Wednesday, the Federal Reserve releases its beige book for March, but there is little expectation for any changes. On Thursday, the standard weekly jobs related figures are set to be released with expectations for a slight increase in both initial and continuing jobless claims. Later in the day, on Thursday, the ISM Services Index is released for the month of February, with expectations of no change over the January level. On Friday, potentially the largest economic news release of the week comes out - the official unemployment rate in the US for the month of February. January saw a pleasant surprise downward to 9.0 percent but this month expectations are for a slight move upward to 9.1 percent. If somehow the figure is shown to be less than 9 percent, the market could react very positively. On the other hand, if the rate goes over 9.3 percent, we could see a negative reaction by the market. Much like the ADP figure, the market will be paying more attention to how the number is achieved over the figure itself, higher nonfarm private payrolls than nonfarm payrolls is what the market is looking for. Wrapping up the week on Friday is the release of factory orders for the month of January, which is expected to be about 2 percent higher than they were in December. Overall, there are a few economic news releases that could really send the market moving this week, but the majority of the markets' energy is going to be spent assessing the situation in Libya and the US 2011 budget.

Have a great week,  
Peter Johnson

*Feel free to forward this email.*

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