



## Weekly Market Analysis

April 4<sup>th</sup>, 2011

**First quarter 2011 wrap up:** The first quarter of 2011 started off very much like the performance seen at the end of the fourth quarter of 2010. The three major US stock market averages continued to move higher during the first half of the quarter, then ran into a bit of a snag. During the last half of the quarter, the unrest in the Middle East led to various governments being overthrown in a wave of change that is still making sweeping changes throughout the region. The unrest seen in the Middle East had a dramatic effect on the price of oil, as it has now climbed up to a two and a half year high and has settled well above the \$100 per barrel level. While a price over \$100 per barrel is reason for concern, it is not quite high enough to cause a major dislocation in consumer spending. According to Clifford Krauss of the New York Times, “every one-cent increase in the pump price of gasoline takes more than \$1 billion out of consumer pockets over a year.” According to the US government data released in 2011 about the price of gasoline, we have seen prices move from \$3.052 per gallon (12/27/2010) to \$3.596 per gallon (3/28/2011), an increase of \$0.544 per gallon. Using the one cent rule of thumb mentioned above, the increase in gas prices that has occurred so far this year could potentially take \$54.4 billion out of the consumer’s pocket that would be otherwise spent on other goods and services. The majority of the increase in oil price is going to eventually make its way back to oil producing countries and regions of the world. For the first time ever, a recent International Energy Agency report puts OPECs revenues at \$1 trillion during 2011 if oil remains over \$100 per barrel. Despite the potential impacts on consumer spending from rising oil prices, the US markets turned in good first quarter numbers as seen in the table below:

Index	<u>1<sup>st</sup> Quarter 2011</u>
DJIA	6.41 %
S&P 500	5.42 %
NASDAQ	4.83 %

The Dow’s return of 6.41 percent for the quarter represents the best first quarter performance for the index since 1999, when it increased by 6.59 percent. Roughly the same is true of the S&P 500 which has not had a first quarter number better than 5.42 percent since 1998 when the index rocketed upward by 13.53 percent. The NASDAQ, turning in a return of 4.83 percent, was a much more standard happening for the first quarter of a given year. In 2010 the NASDAQ turned in a 5.68 percent first quarter figure and has been up more than five percent in first quarter four of the last eleven years. Looking back at the historical data, I found that after a move such as the one we had during the first quarter of this year, the Dow on average has a subsequent quarter performance of 3.30 percent (data back to 1915), the S&P 500 adds 4.33 percent the following quarter (data back to 1962) and the NASDAQ on average gains 3.35 percent the following quarter (data back to 1971). So, taking history into account, one would think that there is a chance of the upward trend in the market continuing during the second quarter of 2011, much like they have since fourth quarter

2010. The main problem with historical data is that at no point in the past was the US or any other country for that matter in the same spot economically as they currently are. Situations have been similar, but in general the world really is a different place now after the events of the past few years and we might be experiencing a “new normal.” Part of this new normal may include a prolonged period of high unemployment and low interest rates, as is currently being experienced by the US and many other developed countries. Another part of the new normal may be a change from the developed countries helping the developing countries growth, to the developing countries providing the financial life lines to the developed countries so that they can stay solvent. An example of this would be China stepping in and purchasing some of the sovereign debt issuances from struggling European countries.

Where I think the stock market will go in the second quarter and rest of the year is a question that I receive very frequently and have no concrete answer. In looking at historical market movements, the answer would be up somewhere around three to five percent during the quarter and then a slight dip back lower through the remainder of the year ending the year, very near longer term average returns of approximately seven to eight percent for the year. But there are numerous caveats to this very simple analysis, the first of which would be the price of oil. The price of oil could have a drastic impact on consumer spending and in turn US GDP for 2011, if it remains stubbornly elevated. Inflation is another area of concern for the longer-term outlook because the US will have to raise interest rates in the future to cope with inflation. With interest rates still near zero, the question is not if the Fed will raise rates, but when and how much. Most economists do not think there will be a need for an interest hike during 2011, but other countries and regions of the world have already begun moving rates. If more countries and central banks such as the ECB raise rates it could push the US’s hand and force a rate increase. While a rate increase is ultimately a correct and necessary action, the US stock market will probably not like such an action and move lower. Another caveat to the above mentioned stock market performance is the current high level of unemployment in the US. The headline unemployment rate is only part of the issue facing the US, the other is going to be workers who are forced into jobs that do not fit their skill set just so that they can make ends meet. This can lead to many underemployed workers that could be producing much more for society if they were fully utilized in another job. So while the headline unemployment rate going under nine percent and staying there for the past few months may be good psychologically, is it yet to be seen if the new jobs created are good paying jobs that use the workers skills. A few positive signs for the US economy are that consumer income and spending has been increasing (some of the spending is just covering the increased costs of food and fuel) and banks have increased lending to both businesses and consumers. GDP is also increasing in the US, helped by a strong increase in manufacturing and an increasing amount of money being spent on new technologies that will reduce our dependence on foreign oil. So, to wrap up where the market is headed, it really is anyone’s guess as the events that provide the largest moves in the stock market are almost always the unexpected, just look at the Middle East right now. Very few people thought that we would see the wave of changes that have toppled leaders that had been in power for decades or the earthquake and ensuing tsunami that hit Japan; yet those events have had the largest impact on the world’s financial markets during the first quarter of 2011.

For those of you who follow and are interested in the style box performance of various investments throughout the quarter, below is the standard style box performance for first quarter 2011. During the quarter the markets saw the continued outperformance of mid-cap companies over both small and large-cap companies. When looking at the style that was favored during the quarter, growth continued to outperform value in the mid and small-cap market spaces while value performed better

than growth in the large-cap market space, as investors were probably looking for dividends to make up lost income from the extremely low interest rate environment.

Style / Market Cap	<u>Value</u>	<u>Blend</u>	<u>Growth</u>
Large Cap	5.86 %	5.74 %	5.61 %
Mid Cap	8.48 %	8.84 %	9.56 %
Small Cap	6.04 %	7.58 %	9.06 %

The following tables give the performances for various sectors of the market as well as Commodities for the first quarter of 2011. The top performing sectors for the first quarter of 2011 are as follows:

Sector	<u>Value</u>
Oil and Gas Exploration	16.68 %
Energy	16.63 %
Health Care Providers	14.92 %
Natural Resources	12.38 %
Aerospace and Defense	9.14 %

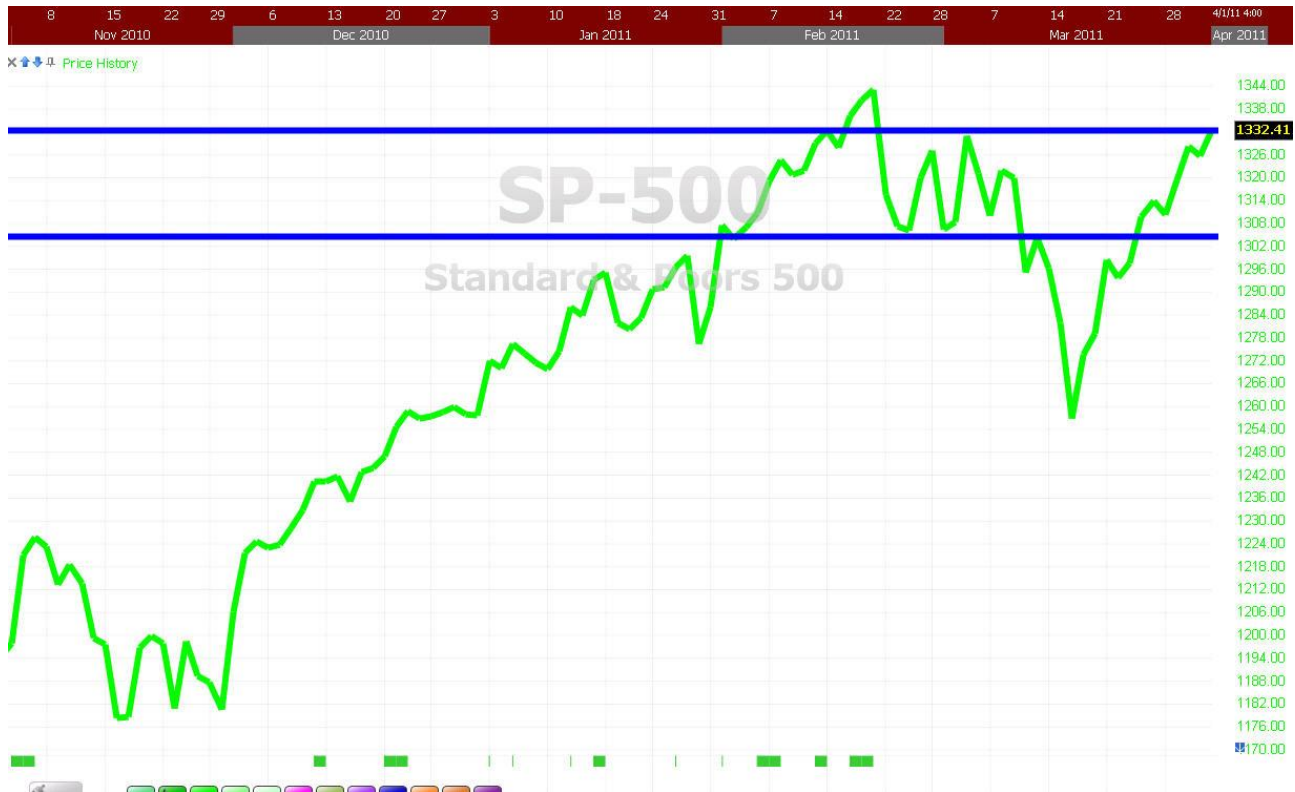
The bottom performing sectors for the first quarter of 2011 is as follows:

Sector	<u>Value</u>
Mortgage REITs	-2.63 %
Regional Banks	-1.21 %
Emerging Market Bonds	-0.42 %
Home Construction	0.53 %
Utilities	1.49 %

Commodity Performance for the first quarter of 2011 is as follows:

Commodities	<u>Value</u>
GSCI Commodity Index	9.53 %
Silver	21.84 %
Gold	0.82 %
Copper	-9.35 %
Oil	16.74 %

**Market Wrap-Up Week of 3-28-2010:** Last week the US markets finished out the first quarter of 2011 strong with a continued move higher as the week progressed, ending the week at the first level of resistance that I mentioned last week (1,332). As can be seen on the chart below, the S&P 500 (green line) is now touching the upper trading range (blue lines) that has been established for the past two months. With the resistance level being met, investors will be watching very closely on Monday to see if the resistance level can be broken or if the market will turn lower and bounce off of the resistance level.



If the market does move through the resistance level to the upside, the next point to watch is 1,344 since it was the previous high set back in the middle of February. Any move above this point would be seen as very bullish for the market. If the market does not pass through the resistance level and turns lower, the next major support level would be near 1,307, a decline of 1.8 percent from current level. One factor that is leaning towards a slight pull back at this point is that the market has gone up pretty much in a straight line since March 16<sup>th</sup> (the annualized return for the S&P 500 since 3/16 is 245 percent) and straight lines in investing do not last long in either direction.

**International Politics:** International politics focused primarily on the situation in Libya and the supposed hand-off of military operations to NATO from the US. After President Obama went on prime time television Monday night to explain the US involvement in Libya and outline the timeline going forward, the rest of the world was abuzz as to whether the hand-off would happen and if the rebels would ultimately succeed. After supporting the rebels with air support and seeing large gains in ground movements by the rebels they appear to have run into a bit of a wall, as Gaddafi's forces have now driven them all of the way back to where they started. With no US "boots" on the ground, (apparently covert CIA operatives do not wear boots) it is starting to be difficult to see how the rebels can actually take control of Libya and force President Gaddafi out of office. A more likely outcome is that all of Gaddafi's inner circle will abandon him as we saw with Mousa Kousa fleeing to the UK by way of Tunisia. Right now a stalemate looks like the most likely outcome of the

situation, with the conflict drawing out for a long time to come. The world market for oil has already adjusted prices to that effect, as the price of oil is now creeping toward \$110 per barrel. Elsewhere in the region, Yemen and Syria are now in the throes of civil unrest, putting further upward pressure on oil and exacerbating fears of contagion continuing to move across the region. Adding to the unrest in the Middle East is the violent reaction in Afghanistan to the Quran being burned by an extreme pastor in Florida. In reaction to the burning, a mob forced their way into a UN compound in Afghanistan and killed several of the foreign nationals that were inside. This type of reaction is what US General Petraeus warned about when the church's intentions were first made in September of last year. Further reaction to the Quran burning is yet to be seen but could easily make the situation for non-Muslims working in the Middle East very unsafe. On the European front, there was very little news about the situation in Portugal or any of the other countries that are having financial difficulties. Wrapping up international politics is Japan, which is still trying very hard to stop the flow of highly radioactive water into the sea from the damaged nuclear power plant as well as just starting to rebuild some of the areas that were hit by the earthquake and tsunami. The Japanese stock exchange, the Nikkei, has bounced back very strongly after the disaster and has now made up a little more than half of what was lost in the days following the earthquake.

**National Politics:** Congress came back to work last week after a weeklong recess and took up right where they left off—fighting about the US budget. Both sides are still pretty far apart and it appears that neither side is looking for another continuing resolution to kick the can down the road, which means that the deadline is this Friday to have a 2011 budget done or the government could be forced to shut down. Right now, it looks like the main fighting point is \$33 billion in spending cuts that the Republicans are holding fast to, and the Democrats are not willing to accept. Adding more fuel to the already hot budgetary fire is the fact that the Republican Party is supposed to come out with their own version of the 2012 budget on Tuesday (though it seems a little odd to be coming out with a 2012 budget before the 2011 one is finished). In the 2012 Republican budget, one of the main points of contention is going to be changes to the Medicare voucher plan (proposed earlier) and a cut in grants for Medicaid. Democrats will surely jump on the opportunity to skewer Republicans for making changes to Medicare and Medicaid, and Republicans will just counter with the rising costs of the programs leading to an even increase budget deficit. Overall, the market does not appear to be taking any of the budgetary fights as a negative sign for the economy, as we have not seen a selloff in medical stocks, which would be expected if there was a large change coming in the future. The market seems to be content thinking that nothing is going to come out of Congress that is going to have a large impact on the overall economy and that the gridlock is likely to continue to the foreseeable future. Another item that Congress looked at last week, and will continue to debate this week, is related to climate change regulation by the EPA and is actually attached to the Republican government funding bill. While this attachment was added to garner more support among Republicans for members of their own party, it appears that it is making the Democrats oppose the legislation even more. All of this comes on the heels of President Obama moving forward with a push to lower the US's reliance on foreign oil and the announcement that he has formally let the Federal Election Commission know that he intends to run for reelection in 2012. The debate about the dependence of the US on foreign oil is likely to create investment opportunities, as different forms of clean or alternative energy seem to be gaining a position above the others. Right now, natural gas looks like it is setting up for a large move since it is very readily available in the US and is a very clean form of technology. We are currently evaluating the best way to add exposure to natural gas in our models but are finding that establishing a position would entail some very unwanted tax ramifications.

**Market Statistics:** During the course of last week, all three of the Major US indexes turned in positive returns for the second week in a row. The technology-heavy NASDAQ experienced the largest advance, increasing 1.70. The broadly based S&P 500 increased by 1.42 percent during the week, while the primarily Blue Chip Dow brought up the rear, advancing 1.28 percent for the week. The best-performing sector of the US markets was the Biotechnology sector, which increased 4.48 percent. The worst-performing sector of the US market was the home construction sector, which declined by 1.41 percent on continued negative news releases about the housing market. Commodities had a good week, advancing by 1.72 percent, with Silver and Copper advancing 1.29 percent and 0.31 percent respectively; while Gold turned in a negative week declining by 0.04 percent as investors seemed to be moving out of the safety of gold and into more risky assets. Last week oil increased by 2.63 percent, as the unrest in the Middle East seemed to be reinvigorated by increasing news of issues in both Yemen and Syria as well as the ongoing conflict in Libya. The US dollar decreased in value by 0.50 percent against a basket of international currencies during the course of the week. On the international investing front, the best return was found in the Mexico, with the Mexico Index increasing by 4.57 percent. Globally, the worst-performing index was in China, with the Shanghai Se Composite Index decreasing by 0.38 percent. The VIX fell for the second week in a row last week, declining by 2.85 percent during the course of the week. After such a large decline two weeks ago (-26.7 percent) history was telling us that last week should have been an increase in the VIX of approximately five percent, it goes to show that history is many times not repeated as we might think.

For the trading week ending on 4/1/11, returns in FSI's models were as follows:

	<u>Last Week</u>	<u>YTD</u>	<u>Since 12/31/07</u>
Aggressive Model	3.33 %	2.17 %	1.36 %
Growth Model	2.92 %	1.12 %	2.60 %
Moderate Model	2.57 %	0.30 %	4.60 %
S&P 500 (benchmark)	1.44 %	6.29 %	-9.26 %

We made only two changes to our models over the course of last week, with the first being increasing our exposure to the Profunds Mid Cap Fund (UMPIX). To increase our exposure to mid-caps, we sold a portion of our holding in Sierra Core Retirement Fund (SIRIX). Our second move of the week was to initiate a position in Commodities through the use of the Goldman Sachs Commodity Fund (GSCAX), we initiated this position with either proceeds from the sale of Rydex Real Estate Fund (RYHRX) or from the sale of Sierra Core Retirement Fund (SIRIX) depending on model. Currently we are evaluating all of our positions to ensure that they are performing as expected and will be making adjustments as needed in the future.

**Economic News:** Last week was a big week for economic news releases. The week started off on Monday with the release of personal income and spending for the month of February. Personal income came in as expected with an increase of 0.3 percent but personal spending beat market expectations, coming in at 0.7 percent versus expectations of 0.5 percent. This better than expected figure for personal spending would normally be viewed as a positive thing, but since the increase in spending was directly attributable to the increased cost of both food and fuel, it can be viewed as slightly negative. Also released on Monday was the PCE Price Index for the month of February, which came in exactly as expected at 0.2 percent, as was therefore a non market moving announcement. Wrapping up the day on Monday was the release of the pending home sales figure

for the month of February and to many investors' surprise, the figure came in at a positive 2.1 percent over the level in January. This release was far better than the expected 0.2 percent and the previous reading of -2.8 percent and provided a glimmer of hope for the US housing market. On Tuesday, the excitement over a positive number out of the housing market was abruptly burst as the Case-Shiller 20 City home price index was released showing the sixth straight monthly decline in home value, this time dropping by one percent during the month. On a year-over-year basis, the decline is now at 3.06 percent and it appears to be trending in the wrong direction, leading some investors to question if the housing market is going to hit the economy once again. Also released on Tuesday was the official consumer confidence figure for the month of March, which missed expectations by 2.5 percent and came in at 63.4. This negative result was magnified a little as the February figure was revised upward from 70.4 to 72.0, leaving the current reading showing an even larger drop from the previous level. On Wednesday, March 30<sup>th</sup>, two important jobs related figures were released; the Challenger job cuts data and the ADP employment change, both for the month of March. The ADP Employment change showed a positive 201,000 jobs during the month but this was well below the expected 210,000. The Challenger Job Cuts figure came in surprisingly strong with 38.6 percent less planned job cuts coming than there were this time last year. This is a very positive sign for unemployment going forward, as it would take some unplanned event in order to make companies start to plan layoffs in the future. On Thursday, the 31<sup>st</sup> of March, the standard weekly jobs related figures were released, with both failing to meet expectations as both readings decreased over the previous week but did so at a slower rate than was expected. Later in the day, on Thursday, was the release of the Chicago PMI for the month of March and factory orders for the month of February. Much like many of the results of the past week this pair of releases was also split. The Chicago PMI for the month of March came in better than expected (70.6 versus expectations of 69.5) indicating that manufacturing continues to be strong in the greater Chicago area. Factory orders however, slipped by 0.1 percent during February after the market had been expecting an increase of 0.4 percent. Friday held numerous economic reports, the most important of which was the unemployment rate in the US for the month of March, which was shown to have declined to 8.8 percent from 8.9 percent. The decline in the unemployment rate was due to strong numbers from both nonfarm payrolls as well as nonfarm private payrolls, both of which were shown to have beaten expectations to the upside. Later in the day on Friday, the ISM Index for the month of March was released and came in as expected, leading to it being a non market moving event. Construction spending for the month of February was also released on Friday and to no one's surprise the figure was not good, -1.4 percent when compared to a really dismal January and while the market had been expecting a decline of 0.7 percent. This release, along with numerous other housing related releases over the past few weeks, indicates that the housing market in the US is very weak and could easily slip back into a downturn. This begs the question of how the Fed will react if there is another downturn in housing. Might they bring back the first time home buyer's credit or initiate some other new way to get people to purchase homes? We will just have to wait and see on that. Wrapping up last week was the release of auto sales for the month of March, and as expected the sales were very strong and seemed to be tilted toward the more fuel efficient models than the gas guzzlers.

This week is a very slow week for economic news releases with none of the major indicators planned for release. There are no major releases on Monday, but Fed Chairman Ben Bernanke is making a speech at the Atlanta Fed. There are some rumors that he may go hawk hunting during the speech and try to shoot down some of the reasoning being outlined by fellow Fed members that are hawkish on inflation. The economic news releases start off on Tuesday with the release of the ISM Services Index for the month of March. This release is a compliment to the overall ISM Index that

was released on Friday and came in as expected; expectations are for little change over the expected value. Released later in the day on Tuesday is the Federal Reserve meeting minutes from their March 15<sup>th</sup> meeting. The minutes are expected to hold very little new information. Making the rounds on the speaker circuit this week is the president of the Atlanta Federal Reserve, Dennis Lockhart, who will be speaking on Tuesday, Wednesday and Friday at various functions; towing the line of Fed Chairman Bernanke. The market will be watching the speeches by the various members of the Fed very closely and will be set to react to any changes that are mentioned as to the longevity of QE2 or the outlook for interest rates. On Thursday, the standard weekly jobs related figures are set to be released with expectations of initial jobless claims being higher than last week and continuing claims staying at the same level as last week. Wrapping up the week on Friday is the release of the level of consumer credit during the month of February as well as wholesale inventories for the month of February. Consumer credit is expected to have continued to expand during February by \$2.5 billion while wholesale inventories are expected to have increased by 1 percent. Overall the economic news that will move the market this week is not going to be the normal news releases, but rather the speeches by key members of the Federal Reserve Open Market Committee.

Have a great week,  
Peter Johnson

*Feel free to forward this email.*

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