

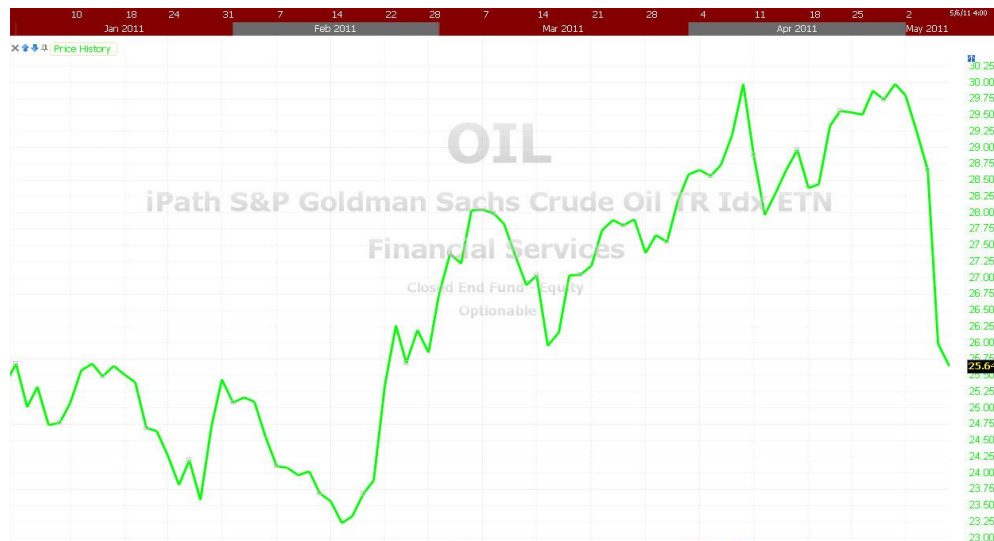


## Weekly Market Analysis May 9<sup>th</sup>, 2011

**Market Wrap-Up:** Last week was an interesting week from a trading standpoint because several unusual things happened. The event that had the greatest impact on the market last week was the dramatic selloff of many of the commodities, as investors seemed to be fleeing them at a very fast pace. The amplitude of the selloff was best seen in the price of Silver, represented by the green line in the chart below, as it fell by more than 25 percent in three short days:



Crude oil (green line below) saw similar decline to Silver, but the drop was much less in relative terms:

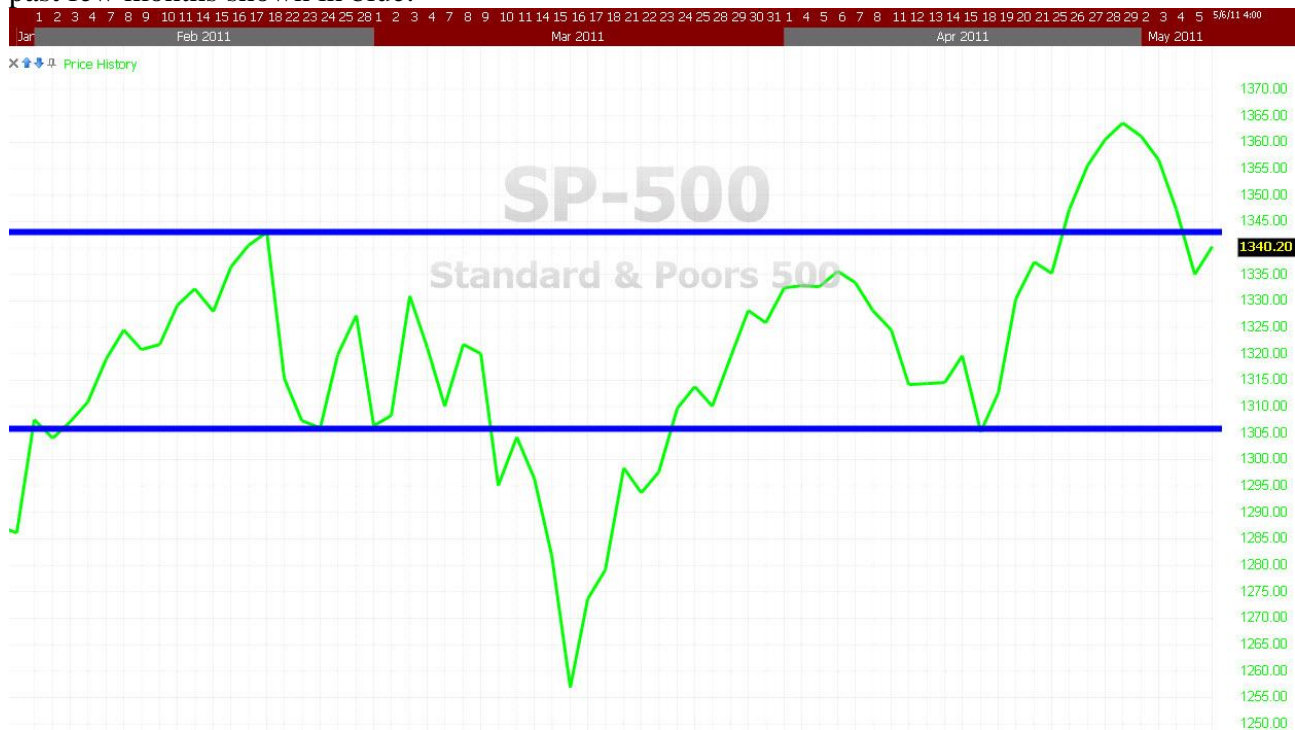


The reasons for the sharp selloff on commodities are numerous, with all of the theories probably having some impact on the overall decline. A few of the more prominent theories are as follows:

- **India raised interest rates**—On May 3<sup>rd</sup> the Central Bank of India raised their interest rate by one half of one percent, from 6.75 to 7.25 percent, as they are battling very persistent and high inflation. The increase in rates was the ninth such increase in the last 15 months. The increase in the interest rate was also accompanied by the bank indicating that they thought the economy would now grow by only eight percent during 2011, down from earlier expectations of 8.6 percent. This slower growth in India could potentially have a meaningful impact on slowing the demand for commodities worldwide, thus leading to the selloff over subsequent days.
- **ECB Announcement**—ECB President Jean-Claude Trichet left the ECB interest rate alone this month, as expected, but he changed the language of his statement by taking out the use of the term “strong vigilance”. The markets seemed to be interpreting this term to mean an interest rate hike was coming at the next meeting. After that language was removed from the statement the world market reacted to the possibility that there is not an interest rate hike coming from the ECB at the next meeting. As a result, we saw the Euro fall by a large amount against the US dollar.
- **US Dollar Movement**—The US dollar increasing in value against a basket of international currencies will naturally force dollar denominated commodities to move lower if all else is equal. Against an international basket of world currencies the US dollar moved up by 1.48 percent on Thursday making it the third largest single day move since December of 2009. The US dollar continued to rally on Friday as commodities moved lower making the US dollar move up, against a basket of international currencies, the 10<sup>th</sup> largest two day move (+2.24 percent) since February of 2007.
- **US Margin Requirements**—The final major theory as to the force behind the decline in commodities last week was that it was simple a function of margin calls to speculators who could not put up the money to cover the margin requirements and were forced to sell their positions by the exchanges in order to pay their debts. The increases in margin requirements started back at the end of April and were initiated by the exchange operators in order to try to manage the volatility that could potentially accompany the very fast rise in the price of Silver. By changing the reserve requirements the various commodities exchanges were hoping to get large speculative investors to think more about the size of their positions and what would happen if a decline started. The operators were also trying to help businesses that rely on semi stable commodity prices for their everyday business, primarily companies that use a large amount of commodities and hedge their prices in the future so short term changes in prices have less of an impact on their bottom line.
- **Combination**— The most likely cause of the decline in commodity prices is a combination of the above theories as well as numerous other unmentioned factors that culminated in the slide.

With commodities having such a wild ride over the course of last week the stock market followed as it, too, moved lower. Two weeks ago there was much excitement that the trading range the markets

had been stuck in was finally broken to the upside, but now it looks like the upward move was simply an expansionary move of the trading range and a very transitory phenomenon. The chart below shows the S&P 500 in green with the recent trading range that it has been stuck in for the past few months shown in blue:



As you can see from the chart, the S&P 500 has clear now moved back into the trading range after breaking above and staying above for several days. Where does that leave us now? Our theory that the markets are going to remain range bound for the foreseeable future has not changed and the factors that led to this conclusion have not changed, as there are still many dark clouds on the horizon and many uncertainties before us. Accompanying the dark clouds are a few bright spots that include strong earnings, stabilizing and decreasing unemployment in the US, low inflation and manufacturing remains high. On the whole, earnings season has been positive for the first quarter of 2011 but with a cautionary note moving forward about the rising costs of inputs for production as well as rising costs of fuel. The employment situation in the US has been getting better, albeit very slowly, and it is heading in the correct direction. Inflation as measured by both the PPI and the CPI has remained relatively stable, even as prices of food and fuel have been increasing, leading the Fed to maintain their loose money policy. Lastly manufacturing has picked up and has remained heightened levels in many parts of the US compared to where they were in early 2009, indicating that the recovery has some strength to continue.

**International Politics:** Aside from the fallout from the situation surrounding the death of Osama Bin Laden, last week's international politics focused on the Euro zone and what should be done with Greece. Greece received a bailout back when the situation in the Euro zone first started and it was contingent on them following some very well laid out goals, goals that it currently looks like they may not be able to meet. So now the big question is what to do about Greece. Should they either not make the goals or stop trying to meet the goals all together? Can they be kicked out of the Euro zone? Can they be forced off the Euro onto another currency? Should the EU continue to bail them out when they ask for money? All of these questions were hot button issues at a meeting held late last week by the EU finance ministers to discuss Greece, among other things. Immediately after

and even during the meeting, there were rumors swirling that Greece wanted to leave the Euro zone voluntarily and move back onto the drachma, a rumor than was vehemently denied by all parties at the meeting and by Greece itself. The rumor was enough, however, to get some investors to start moving money out of the Euro and into other currencies around the world, with some investors worried about the bailout debt repayments if Greece were to actually leave the common currency. The EU finance ministers have a very dicey situation on their hands as they must balance Greece in light of other countries that could potentially run into the same problems. Portugal and Ireland are both running into their own issues and they are not unlike those of Greece, so how the region handles Greece may have a large impact on further bailout funds and other countries that fall on hard times in the future. Meanwhile, the US appears to be perfectly willing to stay out of the economic mess in the Euro zone as they are potentially the largest beneficiary to investors around the world losing confidence in the Euro, as the money would have to find another safe haven currency - most likely the US dollar.

**National Politics:** National news and politics were a buzz last week with commentary and analysis about Osama Bin Laden having been killed in Pakistan the week prior, with the main questions being who knew that he was there and was Pakistan helping to harbor him. With tensions already strained between Pakistan and the United States, the finger pointing and congressional hearings on the subject should be pretty entertaining to watch. Elsewhere in national politics, the main focus of both the House of Representatives and the Senate remains the budget for 2012, with both sides fighting over how the budget should be dealt with in 2012. On the Democratic side of the isle, both Senator Baucus and Senator Conrad have either already proposed bills or will do so very shortly to combat the Republican led Ryan Plan that was put forth a few weeks ago by Representative Paul Ryan from Wisconsin. All of the budget plans that have made it into general circulation have both good and bad aspects to them, with a compromise potentially very difficult to find as the bills focus on areas that each side knows that the other will not give in on. All of this debate about the 2012 budget comes at the same time as the debate around increasing the debt ceiling of the United States and/or doing away with the debt ceiling all together, as some have called for. While the 2012 budget is very important, it is small potatoes when compared to the situation for the US if the debt ceiling is not lifted and the US is forced by law to stop issuing debt. One event that Wall Street will be watching very closely this week is Federal Reserve Chairman Ben Bernanke's testimony before the Senate Banking Committee about the implementation of the Dodd-Frank legislation. Chairman Bernanke will be testifying along with FDIC Chairwoman Sheila Bair, SEC Chairwoman Mary Schapiro, CFCT Chairman Gary Gensler and Deputy Treasury Secretary Neal Wolin. With this lineup, it is hard to see a way that some exciting sound bites cannot come out of the session.

**Market Statistics:** Last week all three of the major US stock market indexes decreased in value, and did so with relatively high volume. The best performer of the negative week in the US was the large blue chip heavy Dow which decreased by 1.34 percent, while the technology heavy NASDAQ decreased by 1.60 percent and the more broadly based S&P 500 decreased by 1.71 percent. The best-performing sector of the US markets was US Healthcare Providers sector, which increased 0.58 percent. The worst-performing sector of the US market was the Global Energy sector, which declined by 7.44 percent on the massive selloff in commodities. Commodities turned in a week unlike most as there was a major selloff, sending commodities down 11.20 percent, with Gold and Silver declining 4.64 percent and 26.45 percent respectively, while the more industrially used Copper declined 5.26 percent, energy declined by 7.24 percent and oil fell by 14.66 percent. Silver finally broke down last week in a very big way, giving up the previous six weeks of advances in just one week and ending the week back under \$35 per ounce. The US dollar increased in value by 2.29

percent against a basket of international currencies for the first time in the past six weeks, as uncertainty about the Euro zone predominated throughout the currency market. On the international investing front, the best return for last week was found in Japan, with the Tokyo based Nikkei Index increasing by 0.10 percent. Globally, the worst-performing index was in Mexico, with the Mexico Index decreasing by 4.62 percent. The VIX skyrocketed higher last week by 26.45 percent as it moved back into the lower end of the trading range that has been in place for more than a year. This move in the VIX was very large and indicates that as commodities remain volatile in the near future the stock market will as well.

For the trading week ending on 5/6/11, returns in FSI's models were as follows:

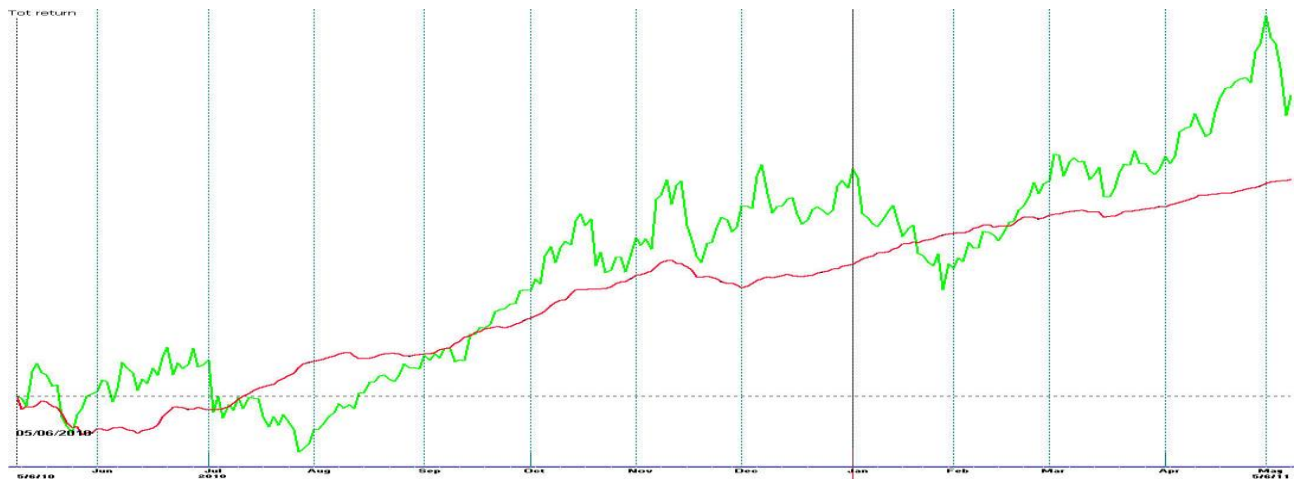
	<u>Last Week</u>	<u>YTD</u>	<u>Since 12/31/07</u>
Aggressive Model	-3.43 %	-2.74 %	-3.51 %
Growth Model	-2.06 %	-2.41 %	-0.98 %
Moderate Model	-0.49 %	-1.49 %	2.74 %
Income Model	0.00 %	0.66 %	(Insufficient Data)
S&P 500 (benchmark)	-1.71 %	6.55 %	-8.74 %

We made no changes to our models during the course of the week, as will be the case most weeks.

**Fund Spotlight:** This week's fund spotlight focuses on the Calvert High Yield Fund (CYBAX) that is used in our Growth, Moderate and Income portfolio models. CYBAX is a mutual fund that invests primarily in high yielding debt instruments of both US and non-US based companies. The fund seeks high current income and capital appreciation and has demonstrated proficiency in both goals through a variety of market cycles through the funds very active approach to managing high yielding investment instruments. The fund is currently being used in our models because as the stock market moves sideways this fund being invested in securities that have a fixed interest rate associated with them should continue to pay a monthly dividend while participating in more market movements than higher grade fixed income investments. CYBAX pays out a dividend every month and the current trailing twelve month distribution yield on the fund is 6.22 percent. The sector breakdown of the fund holdings as of 3/31/2011 is as follows:

Industrial 69 %  
 Finance 6 %  
 Utility 6 %  
 Industrial/Finance 4 %  
 Transportation 1 %  
 Other 4 %  
 Cash 9 %

The one year performance of CYBAX (red line) below shows the strong investment return (16.3 percent during the past one year) while at the same time illustrating the lower volatility (chopping around) experienced by the fund compared to the S&P 500 (green line):



**Economic News:** Last week was a fairly slow week for economic news releases with the information that was released split between positive and negative for the markets. The week started off on Monday with the release of construction spending for the month of March and the ISM Index for the month of April. Construction spending was shown to have unexpectedly increased by 1.4 percent over the level seen in February while the market had been expecting no change; this was seen as a very positive sign for the US housing market. The ISM Index for the month of April was also positive, as the reading beat market expectations (60.4 versus expectations of 59.7) but it was a reading that was lower than the March level, giving investors slight reason for pause. On Tuesday, US auto sales for the month of April were released and they were strong, with sales rising 18 percent since April of 2010. Much of the increase was in the smaller, more fuel efficient cars. Consumers appear to be changing their choice in cars as the bigger, less fuel efficient cars become increasingly more expensive to fill up at the pump. Japanese auto makers, Toyota in particular, indicated that sales were being hindered by the earthquake and tsunami that hit Japan last month. Also released on Tuesday was the US factory orders change for the month of March, and once again the market was surprised by the much stronger than expected increase seen during the month (3 percent versus expectations of 1.8 percent) as the US economy looks like it is rumbling along. On Wednesday, May 4<sup>th</sup>, the ADP Employment change figure for the month of April was released and it was the first employment related figure of the week to miss market expectations as it was shown to have increased by only 179,000 while the market had been expecting 200,000 new jobs. The number was not that large of a miss but it was enough to signal to the market that the government's release on Friday may not be very strong. Later in the day, on Wednesday, the ISM Services Index for the month of April was released, also missing its mark. The ISM Services Index had been expected to have increased very slightly to 57.4 from the March reading of 57.3 but instead the index was shown to have decreased to 52.8. On Thursday, along with the standard weekly jobs related figures the government released the productivity figure for the US during the first quarter of 2011. The weekly jobs related figures both missed their mark by wide margins with initial jobless claims coming in at 474,000 while expectations had been for 400,000 and continuing jobless claims came in at 3,733,000 while expectations had been for 3,638,000. These releases, combined with the falling commodities prices, led the markets to have a very wide and negative trading range throughout the day. The increase in the two jobs related figures is being blamed on the way the government seasonally adjusts the figures. The preliminary Productivity report for the first quarter of 2011, however, was a slight bright spot as it released to show productivity increased on 1.6 percent during the first quarter higher than expected but lower than the increase seen during the fourth quarter of 2010. On Friday, the long awaited unemployment rate according to the US

government was released to show a slight uptick to 9.0 percent up from 8.8 percent during March. This slight increase did not have the impact on the market that it would have had, had the ADP figures earlier in the week not set the market up for the possibility that this release could show the rate increasing. The releases also had limited impact because nonfarm payrolls and nonfarm private payrolls both were shown to be higher than expected with nonfarm payrolls increasing by 244,000 while private payrolls were shown to have increased by 268,000. Both of these releases were very positive despite the overall unemployment rate increasing during the month. Wrapping up the week on Friday was a late day release of consumer credit for the month of March which indicated that consumer credit expanded by \$6 billion during the month.

This week is the second fairly slow week in a row for economic news releases, as the majority of the releases should not have a major impact on the overall markets (provided they do not miss their mark by a large amount). The week starts off on Tuesday with the release of both import and export prices for the month of April. This release could be skewed a bit with the impact of the falling US dollar throughout the month, but the figures should not indicate any real amount of inflation creeping into the US economic system. Later in the day, on Tuesday, the wholesale inventories figure for the month of March is set to be released with expectations of a one percent change over the level seen in February. If this release goes the same way as factory orders did last week, we could see a bit of an upward surprise out of this release. On Wednesday, the 11<sup>th</sup>, the US balance of trade for the month of March is released and, as always, it will show that the US imported much more than we exported - something along the lines of \$47 billion during the month. After we see just how much more we spent than we took in, the Treasury Department is going to release their balance sheet for the month of April and the figure is expected to be along the same lines as the balance of trade, a negative \$41 billion during the month. On Thursday, the 12<sup>th</sup>, there are high hopes that the unexpected increase in the initial jobless claims and continuing jobless claims seen last week was a onetime event, and that this week both figures will show that a decline occurred over the previous week. Released at the same time as the jobs figures, the most important economic news release of the week will be unveiled, the retail sales figure for the month of April. Expectations are for an increase of around 0.6 percent for the month but the majority of the increase in spending is going to be pinned on higher food and energy costs, making it much less meaningful to the overall economy. Also released on Thursday is the Producer Price Index (PPI) for the month of April which is expected to show prices remained relatively flat (+0.5 percent), indicating that inflation is yet to become a problem for the US. On Friday, the Consumer Price Index (CPI) for the month of April is going to be released with expectations of no major change in the level of prices that consumers are paying, further allowing the Federal Reserve to justify lose monetary policy as the economic recovery continues. Wrapping up the week on Friday is the release of the University of Michigan Consumer Sentiment Index for the month of April. Expectations are for no change over the level seen in March; therefore the release should be a non market moving event. Overall, there are few releases this week that should move the market meaningfully but there are a few that could create such a move.

Have a great week,  
Peter Johnson

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