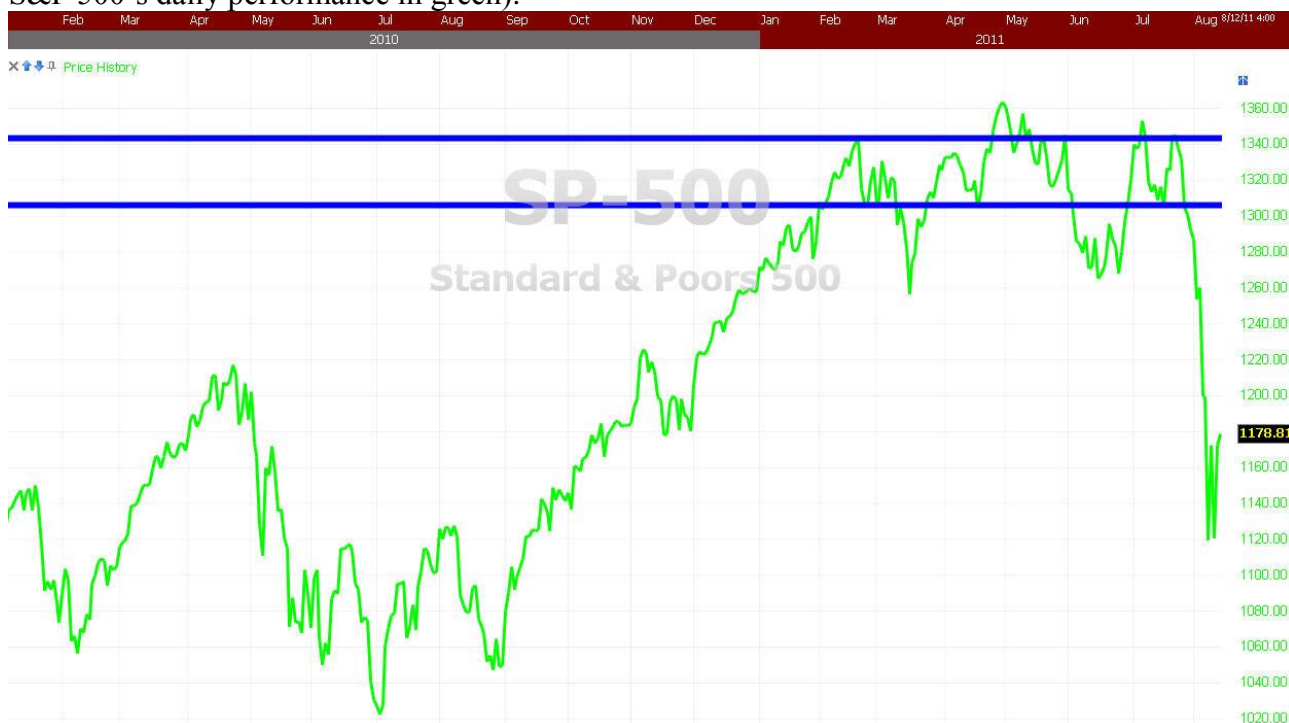




## Weekly Market Analysis

August 15<sup>th</sup>, 2011

**Market Wrap-Up:** Following the decline that the markets saw two week ago, last week was *very* volatile. The chart below keeps with the expanded timeframe I started last week to give some perspective on where the markets have fallen back to (most recent trading range is the blue lines, S&P 500's daily performance in green):



One of the most concerning aspects to last week's market movement was the amount of volume across the board. Volume was more than double the 30 day average of volume on four out of the five trading days last week, indicating that either there was a lot of market participation in the movement or something else was going on. Market participation does not look like it was the reason because the overall movement of retail money, according to reports last week, pulled approximately \$50 billion out of equity mutual funds and moved it into money markets. With the money moving to the sidelines, market participation does not explain the large up days that we saw throughout the week. The other school of thought is that much of the volume and market movement was due to high frequency computer trading models that were running free in the markets. High frequency trading normally makes up a good portion of the market volume but in extreme cases it can make up pretty much all of it. When the markets have a day like they did on Monday—a fourth standard deviation event—many trading programs “wake up” and search for deals because prices are so cheap compared to where they were a very short time ago. The computers are non-emotional and typically only look at prices and nothing else, like that which gives human investors that gut

wrenching feeling, so the computers jumped into the market on Tuesday after Monday's decline. They jumped in and followed several technical indicators up to a very precise selling point at which they sold the stock. The prices were hit late in the day on Tuesday, hence the sell-off after the 400 plus point move earlier in the day. The selling continued on Wednesday as the systems jumped out with their gains. Markets pulled back enough on Wednesday that the computers once again saw the market as cheap and jumped back in, causing yet another large point gain on Thursday. On Friday the game was over as there was nothing to really push the market enough to initiate the computers to sell and nothing to make them want to buy. This was confirmed by the volume on Friday falling right back down to the 30 day moving average. Adding to the thought that last week was largely computer driven is the fact that many asset managers and traders in Europe are out on holiday, leaving the reins to junior members of the firms. Those junior members running the high-frequency trading algorithms probably lack the confidence that the true managers would have had in overriding their system when strange things started to happen in the markets, so they just let the systems do what they are programmed to do.

With all of the money that seems to have moved to the sidelines over the last few weeks, this market seems ripe for continued emotional and/or volatile trading. Even if the high-frequency trading has ended or mostly slowed down, the US economy does seem to be hitting a bit of a slowdown and the market will likely have a hard time climbing back to its July highs. On the other hand, with the downgrade of the US debt and many of the economic indicators being negative, this market is in a very fragile state that could break down and move lower. It is the unusually heightened downward uncertainty that makes the current prudent investment cash. As an example, it does not pay off to run across a busy highway to pick up money blowing down the road; yes the money is there but the consequences of not making it to the other side far outweigh the benefits of the money.

**International Politics:** International politics was largely quiet last week as the ECB grapples with how to save countries from falling prey to rising interest rates. Last week the ECB stepped in and purchased Italian and Spanish bonds on the open market, knocking down interest rates from well over six percent to near five percent. While this temporary fix appears to have worked, it is only temporary. In the long run the ECB cannot just print money and use it to purchase bonds—at some point this action would lead to inflation increasing and the value of the Euro declining. For right now the situation in Europe seems to be contained, but the markets in Europe have yet to make back what was lost as the situation unfolded. This means that either the markets think that more is to come and they will move lower or they feel that enough has been done to stem the bleeding but not enough to push the markets back up to old levels. One of the major wild cards in the region is what affect, if any, a downgrade of France's AAA rating would have on the overall situation. Elsewhere in the world, the situation in Syria seems to be deteriorating as the armed forces are now being used to help try and put down the uprising that looks like it is starting to gain steam again. The latest news out of the region is that the Syrian navy shelled a port city that was having large demonstrations against the current government. The impact on the world markets by unrest in Syria should be minimal, but it does bring back into focus oil producing countries in the region that could see uprisings much like what swept across the region in the spring of this year.

**National Politics:** National politics was largely quiet last week with both the US House of Representatives and the Senate enjoying their summer recess. There were, however, a few newsworthy events on the national political scale, the first being the naming of the "super committee"

that was formed by the debt ceiling bill that was signed into law just before the deadline two weeks ago. The following members of Congress will make up this committee:

Rep. James Clyburn of South Carolina (D)  
Rep. Xavier Becerra of California (D)  
Rep. Chris Van Hollen of Maryland (D)  
Rep. Fred Upton of Michigan (R)  
Rep. Dave Camp of Michigan (R)  
Rep. Jeb Hensarling of Texas (R)  
Sen. Rob Portman of Ohio (R)  
Sen. Pat Toomey of Pennsylvania (R)  
Sen. Jon Kyl of Arizona (R)  
Sen. John Kerry of Massachusetts (D)  
Sen. Patty Murray of Washington (D)  
Sen. Max Baucus of Montana (D)

The goal of the super committee is to come up with a reasonable plan before Christmas that puts the US fiscal house in order through cuts in spending, tax reform and adjustments to entitlement programs such as social security and Medicare. If the committee fails to come up with a plan by the deadline, then an automatic \$1.2 trillion cut will be made that chops evenly between defense and non-defense spending. While this idea of forcing a committee to come up with a plan seems like it will probably work, the people that was chosen for the committee seem like they will have a very difficult time coming to agreement on the terms of the cuts.

Elsewhere in national politics, the Federal Reserve made headlines last week as they announced their interest rate decision. The decision, as expected, made no change in the federal funds rate, leaving it at between zero and 0.25 percent. The changes were in the language that followed the decision. The major change was that the Fed changed the time period for which rates will remain low from “an indefinite period of time” to “through mid-2013.” The market took this as a positive development since now there is a set date for when rates will increase. However, the announcement last week was not all positive as there was new language that said that the economic recovery has deteriorated more than was previously expected, leading the Fed to look at options they have to keep the economy moving forward. While the options were not specifically outlined, the fact that they said the economy was weaker than expected spooked some investors. The other interesting factor in the release was that the decision was not unanimous, like it has been in the past. This time, about three members of the voting committee voted against the new policy, a very unusual occurrence under Chairman Bernanke’s tenure. This divide amongst voting members may make any major policy shift much harder in the future than if the chairman had a consensus opinion among voting members. The last bit of national politics that took place over the last week was the Iowa straw poll that took place over the weekend that saw Michele Bachmann win the vote and Tim Pawlenty drop out of the running for President in 2012 due to a poor showing in the vote. Republican contender Mitt Romney chose to skip the straw poll and focus his efforts on the US in general and not just one small area in Iowa.

**Market Statistics:** Following the move two weeks ago, markets wasted no time last week getting right back on the downward trend, with Monday seeing one the largest single-day point declines ever for the Dow. Following the massive sell off on Monday, many investors thought that we would see a bit of a rally on Tuesday, which ended up coming to fruition. But the market tanked off again

on Wednesday, with many investments declining by more than they had increased on Tuesday. Thursday followed with another 400 plus point move on the Dow and Friday seemed like a day when nothing was going on, with only a meager 100+ point move on the Dow. After all was said and done, the NASDAQ turned in the best performance of the week declining 0.96 percent while the Dow declined 1.53 percent. Turning in the lowest performance for the week was the broadly based S&P 500, which decreased 1.72 percent. Including last week's move, the three major US indexes are now down in excess of eleven percent for the past three weeks. The best-performing sector of the markets was real estate, which advanced 2.01 percent. The worst-performing sector of the markets was regional banks, which declined 9.39 percent. Fixed-income markets saw a good week with many of the fixed-income US government bond ETFs advancing despite the S&P credit rating downgrade. Both of the commonly followed precious metals had a pretty good week with gold advancing 5.08 percent and silver moving up 2.14 percent as investors moved toward safe haven assets. The more industrially used Copper had a rough week, with its prices declining by 3.31 percent as traders worried about slower demand from manufacturing for the metal. Oil continued to slide last week, dropping by 1.73 percent as global demand seems to be drying up as the US recovery continues to be called into question. Despite the US debt downgrade, there was no movement in the US dollar versus a basket of international currencies when last week came to a close. Much of this is due to currency manipulation that is being done by many of the "safe" currency countries as they try to contain their skyrocketing currencies. On the international investing front, the best return was found in Brazil with the Sao Paulo based BOVESPA Index advancing 8.20 percent. Globally, the worst-performing index was in South Korea with the KOSPI Index declining 7.74 percent. Volatility was in full force again last week with the VIX rocketing higher by 13.63 percent. The VIX blew right through its highest point so far this year, and the highest point seen during 2010, and closed the week at a level not seen since early 2009 in the depths of the recession. The following is a daily chart of the VIX in green with last week's closing level being the red line:



**Performance:** For the trading week ending on 8/12/11, returns in FSI's models were as follows:

	<u>Last Week</u>	<u>YTD</u>	<u>Since 12/31/07</u>
Aggressive Model	-1.75 %	-7.50 %	-8.23 %
Growth Model	-1.90 %	-6.88 %	-5.51 %
Moderate Model	-2.05 %	-5.46 %	-1.40 %
Income Model	-1.93 %	-3.41 %	(Insufficient Data)
S&P 500 (benchmark)	-1.72 %	-6.27 %	-19.72 %

Being fully in cash as of Tuesday last week, we experienced very little overall volatility relative to the market, despite finishing the week at roughly the same level as the market. I received a few questions about moving to cash and why the equities were sold prior to the fixed-income assets in our models. We run two different models to indicate to us that it is time to pull out of the market, one that is only for the equity side of the market and one that is for fixed-income investments. The equity model trigger tripped on Friday last week, hence the selling of our positions and moving to cash. The fixed-income triggers did not get tripped until Monday's market movement, during which many of the safe haven assets we had been hiding in were hit very hard. The assets we were in fell by a very unusual amount, indicating to us that cash really would be the only hiding spot for the time being. If you have any questions, please feel free to give our office a call.

**Economic News:** Last week was very slow for economic news releases with the majority of the releases meeting market expectations. However, there were a few concerning releases that were largely ignored by the markets. The week started off with the government's productivity figure for the second quarter of 2011 in the US which was shown to have declined by 0.3 percent while the market had been expecting a decline of 0.6 percent. While the figure was much better than expectations, it does indicate that unemployment will not get much help from workers already working as hard as they can and, therefore, companies will not need to hire extra workers to get the work done. Productivity has to be very high and either increasing or remaining level for companies to be willing to hire people; if business production can be picked up just by raising productivity, companies almost always will choose that over hiring new workers. Later in the day, on Tuesday, the FOMC rate decision was released and there were actually some meaningful changes. The statement's main change was to include a time frame during which interest rates will remain very low; rather than using "an extended period of time," as has become the norm, the Fed changed the wording to say that rates will remain at the current low levels through mid-2013. The markets took this change as a positive development; since uncertainty is greatly disliked by the markets, having a definitive time line for the lower interest rates is now one less uncertainty. Other changes to the statement included the acknowledgment that economic growth in the US is weaker than the Fed had expected and that the Fed was evaluating various ways to further stimulate the US economy. The final interesting piece of news out of the Fed statement was that Chairman Bernanke now has a rather divided Fed, so much so that three voting members actually dissented on the vote this time around. While more reasoning about the dissention will be known later once the minutes are released in a couple weeks, the fact that three went on record against the chairman sends the message that Ben Bernanke may not have as easy a time pushing through policy changes as he had with the previous set of voting members. On Wednesday, August 10<sup>th</sup>, the wholesale inventories change for the month of June was released but came in at 0.6 percent while the market had been looking for 1 percent, therefore creating a non market moving event since the numbers were relatively close together. Later in the day, on Wednesday, the Treasury Budget for the month of July

was released and came in at market expectations showing a decline from the June level of -\$165 billion down to -\$130 billion in July. On Thursday the standard weekly jobs figures were released, both initial jobless claims and continuing claims beating market expectations. On a very positive note, initial jobless claims have once again fallen below the psychological 400,000 level and now rest at 395,000 jobs. While some pundits are saying that the reason for the decline this month has to do with seasonality smoothing and a trend will have to be seen in the next couple of weeks to be meaningful to the markets, this is at least a step in the correct direction. On Friday retail sales for the month of July were released with the overall retail figures meeting market expectations of a 0.5 percent increase. Retail sales minus autos beat market expectations, as consumers are still purchasing cars (albeit mostly due to large incentives that car manufactures are starting to run). Wrapping up the week on Friday was the release of the University of Michigan Consumer Sentiment Index for the month of July, which was the largest negative sign for the overall US economy of the week. The Consumer Sentiment Index was expected to be down to 62.5 from the June level of 63.7 which is only a very slight decline, but in reality the number was shown to be 54.9 which is a very large miss to the downside. This release is cause for concern because it seems to indicate that the US consumer is losing some faith in the US economic growth and is getting very uncomfortable. If the US consumer becomes uncomfortable enough to pull back on spending, it could have a very large negative impact on the overall economy.

This week is a busy one for economic news releases with several releases having the potential to impact the overall movement of the markets. The week starts out on Monday with the release of the Empire Manufacturing Index for the month of August, which is expected to have increased from last month's poor reading of -3.76 to -0.4. Should the move occur, this would indicate that manufacturing is rebounding a little bit from the past few months of declining readings (this would be good for the US economy). Later on Monday, the NAHB Housing Market Index for the month of August is set to be released with no expected change from the July level. On Tuesday August 16<sup>th</sup> Housing starts, building permits and Industrial Production (all for the month of July) are set to be released. Housing starts are expected to have declined slightly down to 608,000 from 629,000, an indication of a very soft housing market that is trying to work off already existing homes rather than construct new ones. Building permits are also expected to show a decline during July from the levels seen in June for the same reason as housing starts and Industrial production is expected to show very little change occurred during the month of July. On Wednesday, the 17<sup>th</sup> of August, the Producer Price Index (PPI) for the month of July is set to be released and is expected to show no change in prices at the producer level. No change in prices at the producer level is a good thing because it indicates that prices will not rise in the US any time soon due to inflation. On Thursday the standard weekly jobs figures are set to be released, with an expectation that both of them will see a tick back upward, ending last week's declining trend at just one week. Also on Thursday, the Consumer Price Index (CPI) for the month of July is set to be released and is expected to show a very slight increase of 0.2 percent during the month. Later on Thursday, the existing homes sales figure for the month of July is set to be released, with expectations of an increase of approximately 100,000 homes sold during the month when compared to the June level. Wrapping up the day and week on Thursday is the release of Philadelphia Federal Reserve Index for the month of August, which is expected to show a decline from 3.2 down to 1.0; the market will watch this release very closely as the expected figure is very close to going from expansion (a positive number) into contraction (a negative number). If the figure goes negative to indicate a manufacturing contraction in the region, it would be seen as a very bad sign for the US economy as we would then have multiple manufacturing regions in contractionary mode. Overall this week, if the market is trading wildly like it was last week, any one of these releases that either misses or beats expectations could

send the market jumping. On the other hand, if cooler heads prevail in the markets this week, it would take one of the major releases either drastically beating or missing expectations to send the market moving.

Have a great week,

Peter Johnson

*Feel free to forward this email.*

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