FINANCIALLY SPEAKING

# **Weekly Market Analysis**

August 8th, 2011

**Market Wrap-Up:** Last week was a very bad week for US stocks. After breaking through the lower support level two weeks ago (represented by the lower blue line below), US stocks proceeded to freefall last week. The decline affected almost every asset class with the exception of Gold, which was seen as a safe haven asset that investors could flee to for protection. The chart below is an expanded timeframe from the previous week because we have broken through the previous trading range and had to go back to 2010 to see the same level we are currently maintaining (trading range in blue, S&P 500's daily performance in green):


There are numerous reasons for the decline last week but the most compelling seems to be the negative effect that European countries had on the world economy as a whole. After getting the debt ceiling passed at the very last possible moment, the markets appeared to shift their focus to other areas that had been largely hidden behind the debt ceiling debate. With the negative economic data largely out of the public eye, due to the news demand drawn by the debt ceiling debate, investors all of a sudden last week seemed to wake up and say "Hey this is worse than we were expecting, I think I am going to sell." This opinion must have resonated with lots of investors because volume saw the fourth highest weekly reading of the past two years. As for the decline of more than seven percent on the S&P, while not unheard of, it is very rare. Since 12/31/1999 there have been only six weekly declines that are larger than the one experienced last week, with the worst being in October of 2008 when the US financial system was literally falling apart and the S&P tanked off 18 percent. Other notable declines occurred during the technology bubble burst, which hold the second and third spot on the list followed by three other very bad weeks that occurred in 2008. Is last week's index performance and outlier? The answer from standard statistics is yes; last week's decline was a three standard deviation event, hence it should almost never occur. Where does such an event leave us? Under normal circumstances one would expect at least a short term buying rally to take place this week as investors jump back into the market and scoop up stocks that have become more attractive as they have declined. I do not think that this will be the case this week, as there has been a "black swan" event that is sure to rile the market - the downgrade of US debt by Standard and Poor's rating agency that took place last Friday evening. With the US long-term debt being knocked from AAA down to AA+ it is anyone's guess as to what to expect for this week. One thing is for sure; it is going to be a wild ride. Volatility will probably spike upward, US bonds will surely fall, the US dollar will also likely decline, the Fed will probably make some sort of statement and the ECB will be purchasing Italian and Spanish debts in a fruitless attempt at propping up their financial markets. In all of this upheaval our models here at Financially Speaking have indicated that we need to move fully into cash, an action that has been in the works for the past few weeks as we have been selling off the highest volatility funds that we owned. Our sole exception to being fully in cash is the very actively managed Sierra Core Retirement fund (SIRIX), as it is a fund that manages the downside very well through the use to trailing stops on positions as well attempting to capitalize on a downward moving market.

**International Politics:** International politics was very busy last week and especially so over the weekend. Last week the main focus surrounded the ECB and their stepping into the European bond markets and helping through the purchase of bonds to keep rates down. Initially the markets took this as a good sign, but the excitement quickly turned sour as investors realized that the ECB announced that they would be helping some countries while not helping others. The big concern was that Italy and Spain were not on the initial list of countries' bonds that the ECB would be purchasing. This sent the markets into a bit of a panic as it seemed at first glance that the ECB was going to let the Italian and Spanish bonds continue to get hammered and their yields continue to move well above six percent. There was fear in the European markets that both Italy and Spain could end up in the same situation as Greece and that there was little that could be done because Italy alone is simply to large to bail out. After seeing the fallout of their statement earlier in the week and the downgrade of the US debt rating, the ECB smartly announced over the weekend that they would support Italian and Spanish bonds on the open market. This initially seems to have worked at calming the market as yields have come back down under 5.5 percent, but can the ECB really save Italian and Spanish bonds? Chances are that they have done nothing more than kick the can down the road and that more decisive action will need to be taken. In their statement that said they would help the ECB, they already stated that there need to be drastic changes in the country in order for them to remain fiscally viable. This is eerily similar to where Greece was not too many years ago and so far that has not turned out very well at all. Added to the mix is the lingering uncertainty of sovereign credit ratings; France has already been warned and the UK now seems to be thrown into the mix for a possible rate cut. On top of the European situation there were some pretty unprecedented actions taken in the currency markets by countries that have largely been quiet during the upheaval. Switzerland, Turkey, Brazil and Japan all took action last week to try to slow the ascent of their currencies against others such as the US dollar, as they have been driven up far too fast by investors looking for alternatives to the US dollar. The outcome of such action initially had the desired effect of lowering their currencies, but with the US downgrade I think it is only a matter of time before the action taken is absorbed by the markets and the increases in the currencies once against start.

**National Politics:** National politics started out on what most investors thought would be the right foot last week with the news that a bill had been passed by President Obama and leaders of congress about the debt ceiling. While the bill is far from perfect and both sides would have liked a much different bill, the fact remains that a bill was passed and signed into law that prevented an outright default on US debts. One of the main points in the bill is the creation of a new "super committee" made up of twelve members of congress that will have the very tough job of coming up with cuts in spending as well as many other changes in Washington DC such as taxes and entitlement programs in order to stay on the path to increasing the debt ceiling outlined in the bill. Failure by the committee to work together and come up with plans would incite immediate and painful cuts across the board totaling approximately $1.2 trillion. While this seems to be just one more committee in a city that is full of unproductive committees, this group may actually have the teeth to get things done, if for no other reason than the consequences of not getting the job done. Following the default being averted, politics shifted focus once again to the stagnant US economy and in particular the high rate of unemployment. Unemployment has remained a thorn in the side of politicians throughout this economic recovery because no matter what action is taken it remains stubbornly elevated from its historical level.

National politics showed its ugly side over the weekend as the reaction to S&P's downgrade of US debt was vehemently opposed by almost all politicians. It seemed like most people in Washington DC thought that with the debt ceiling passed we were past the chance of seeing our debt downgraded, but they were wrong. Standard and Poor's came out on Friday evening with the announcement that the US was being downgraded from AAA down to AA+ for their long term debt; they also reaffirmed various other ratings that the US carries including leaving short term ratings at their highest level. Immediately the effects of the downgrade were felt throughout the world as people speculated about the worldwide ripple that would move through the financial system. Meetings were held and phone calls were made throughout the weekend between government officials and in the end most countries decided to take a wait and see approach to what happens to the world's financial markets. The markets that were open on Sunday (mainly in the Middle East) saw their values all decline, as was expected, but not by enough that central bankers felt the need to step into the mix and make an announcement. Australia and the Asian markets all opened during what was Sunday evening here in the US and as expected, they also declined but did not see a waterfall decline as some had predicted. All of the relatively good performance so far has been waiting to see the reaction that the US market has on Monday, so far today things are not nearly as bad as they could have been and are a far cry from an outright panic. In the long run the downgrade to AA+ may be somewhat meaningless as the US dollar and US government debts are still viewed as one of the very few safe investments in the world. Could the US coming back from the AA+ rating and regain AAA status? Yes, in theory the US could once against achieve an AAA rating but more often than not countries do not move back up. Two notable exceptions are Canada and Australia, which have successfully moved up to AAA credit ratings in the past.

**Market Statistics:** "Blowout" would be a good word for describing the market movement last week, as the markets in the US and around the world all moved lower and did so with speed. After having stayed in or close to the trading range of the past six months all of the US markets broke down through the range last week. Not surprisingly, in the downward moving market the Dow turned in the best performance of the week declining by 5.75 percent. The second-best performance was the broadly based S&P 500, which decreased 7.19 percent; bringing up the rear for the week was the technology heavy NASDAQ, which decreased by 8.13 percent. With the declines last week all three of the major US indexes are now in negative territory for 2011. It seems a little bit futile in such a negative week but the best-performing sector of the markets was consumer staples sector, which declined by 2.92 percent. The worst-performing sector of the markets was the biotechnology sector, which declined by 13.04 percent. Fixed-income markets saw a good week with many of the fixed-income US government bond ETFs advancing on fears about the global recovery being questioned (these advances were prior to the downgrade and I expect to see a lot of volatility on Monday). With the US markets falling sharply, it was not surprising to see that gold had a strong week as the scare trade was fully implemented; gold increased by 2.19 percent for the week and set an all time high. More industrially used silver and copper did not fare as well as gold as they both lost ground with silver sliding 3.94 percent and copper tumbling 12.99 percent. Oil got hit very hard, dropping by 9.22 percent as global demand seems to be drying up as the US recovery is being called into question. Despite all of the negative news the US dollar did increase in value over the past week (+0.90 percent) and in early trading on Monday it looked to be advancing. On the international investing front there were no major indexes that increase in value last week, the best return was found in China with the Shanghai Se Composite Index declining by 0.83 percent. Globally, the worst-performing index was in Germany with the Frankfurt based DAX Index declining by 12.89 percent. Volatility was in full force last week with the VIX rocketing higher by 26.73 percent last week. The VIX blew right through its second highest point so far this year and closed the week higher than it has been since June of 2010. The following is a daily chart of the VIX:

**Performance:** For the trading week ending on 8/5/11, returns in FSI's models were as follows:

| | Last Week | YTD | Since 12/31/07 |
|---|---|---|---|
| Aggressive Model | -2.49 % | -5.85 % | -6.59 % |
| Growth Model | -2.22 % | -5.08 % | -3.68 % |
| Moderate Model | -1.58 % | -3.48 % | 0.66 % |
| Income Model | -1.44 % | -1.51 % | (Insufficient Data) |
| S&P 500 (benchmark) | -7.19 % | -4.63 % | -18.32 % |

As mentioned before, our models have flipped indicating that it is time to be in cash and wait this market out. We started to move to cash more than two weeks ago and have been progressively selling as the market has deteriorated. You may notice an unusual amount of movement in our income model; this is due to a wild swing in the fixed income market prior to the S&P debt rating downgrade (there is some debate about if the downgrade was leaked leading some market participants adjust their allocations to take advantage of the impending downgrade). With the models now having moved to cash, we will take the wait and see approach to the markets, typically the models remain in cash for approximately 30 days once the move is initiated, but they could signal to move back in either faster or slower and will adjust for market movements. If you have any questions or would like more information please feel free to give our office a call.

**Economic News:** Last week was a light week for economic news releases with the majority of the news meeting market expectations. The week started off on Monday, August 1st, with the release of the ISM Index for the month of July which came in slightly lower than expected at 50.9 versus expectations of 54, but remained above the all important 50 line. 50 is the inflection point that signals expansion versus contraction. Any reading above 50 is an expansion while any reading below is a contraction. Also released on Monday was construction spending which came in better than expected at 0.2 percent while expectations had been for zero. This slight beat was not enough to lift the spirits of the housing market as there are still many structural changes that will need to be made. On August 2nd, personal income and spending for the month of June were released with income meeting expectations while spending missed slightly. The miss in the spending reading is being attributed to people saving rather than spending as the economic recovery becomes less certain. Later in the day on Tuesday, PCE prices were shown to have increased by only one tenth of a percent, which is lower than expected and a good sign that inflation remains to be seen in the US economy. Throughout the day on Tuesday auto manufacturers were coming out with their figures for the month of July. In aggregate auto sales increased by about eight percent for the month but this is well below what many analysts had been expecting. If you have not bought a car recently, waiting might be the prudent thing to do as the auto manufacturers will probably start to run good incentives in the coming weeks and months as they try to move 2011 inventory off the lots to make room for the 2012 models. On Wednesday, the 3rd, the ADP employment figure for the month of July was released and to many people's surprise the figure beat market expectations. Expectations had been for a reading of 100,000 new jobs during the month but with all of the uncertainty many economists were predicting a reading much lower. With a reading of 114,000 new jobs, the market got a little bit of relief, but the relief was very short lived as another report released at the same time indicated that planned layoffs had spiked higher. Factory orders figures were released later in the day, met market expectations and the release was a non-market moving event. The ISM services index for the month of July posted well above the 50 level at 52.7. On Thursday, the standard weekly employment figures were released with initial jobless claims beating market expectations by 5,000 jobs while continuing jobless claims missed market expectations by 30,000; therefore the two releases had a bit of a wash effect on each other. Despite reasonable good news from the employment figures Thursday proved to be a brutal day for the markets as it was the height of the Euro zone concerns. On Friday the biggest release of the week, the official government unemployment rate for the US, was released and showed a slight decrease in the overall rate from 9.2 down to 9.1 percent. This was seen as very positive for the markets and they quickly shook off the fears in Europe and recovered much of the losses of the day. Both non-farm public and private payrolls came in better than expected adding further belief in the overall unemployment figure moving lower. This week's employment related information seems to be indicating that it is at least moving in the correct direction, now the only problem is how slowly unemployment is improving. Wrapping up the week on Friday was the release of consumer credit for the month of June, which came in much better than expected at $15.5 billion while the market had been looking for only $5 billion. This expansion of credit should help the economy stay on its feet if it continues, but credit is something that banks can pull back on very quickly so it should not be heavily relied upon.

This week is a very slow week for economic news releases with very few releases that have any chance at moving the market and no releases that will have as large an effect as the US debt rating downgrade. The week kicks off on August 9th with the release of productivity for the second quarter of 2011 which is expected to show a decline of 0.6 percent during the quarter. Later in the day, on Tuesday, the FOMC rate decision is going to be released and Fed Chairman Ben Bernanke will hold his press conference. The press conference should be very interesting because it is going to be all about what the Fed is considering doing and what they think is going to happen with the US economy (Wall Street will be watching the conference very closely). On Wednesday, August 10th, the wholesale inventories change for the month of June is set to be released with expectations of an advance of about one percent. Later in the day, on Wednesday, the Treasury Budget for the month of July is set to be released with the expectation of a decline in the budget from -$165 billion all of the way down to -$132 billion. On Thursday the standard weekly jobs figures are set to be released with expectations of a slight increase in initial jobless claims while continuing claims are expected to have declined. On Friday retail sales for the month of July are set to be released with high expectations that retail sales including and excluding autos will show an increase during the month. Wrapping up the week on Friday is the release of the University of Michigan Consumer Sentiment index for the month of July, which is expected to be virtually unchanged over the level seen during June. Overall, this week the US downgrade and the world's reaction are going to clobber any economic news releases. The only possible exception will be Chairman Bernanke's press conference on Tuesday afternoon.

Have a great week,

Peter Johnson

*Feel free to forward this email.*

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