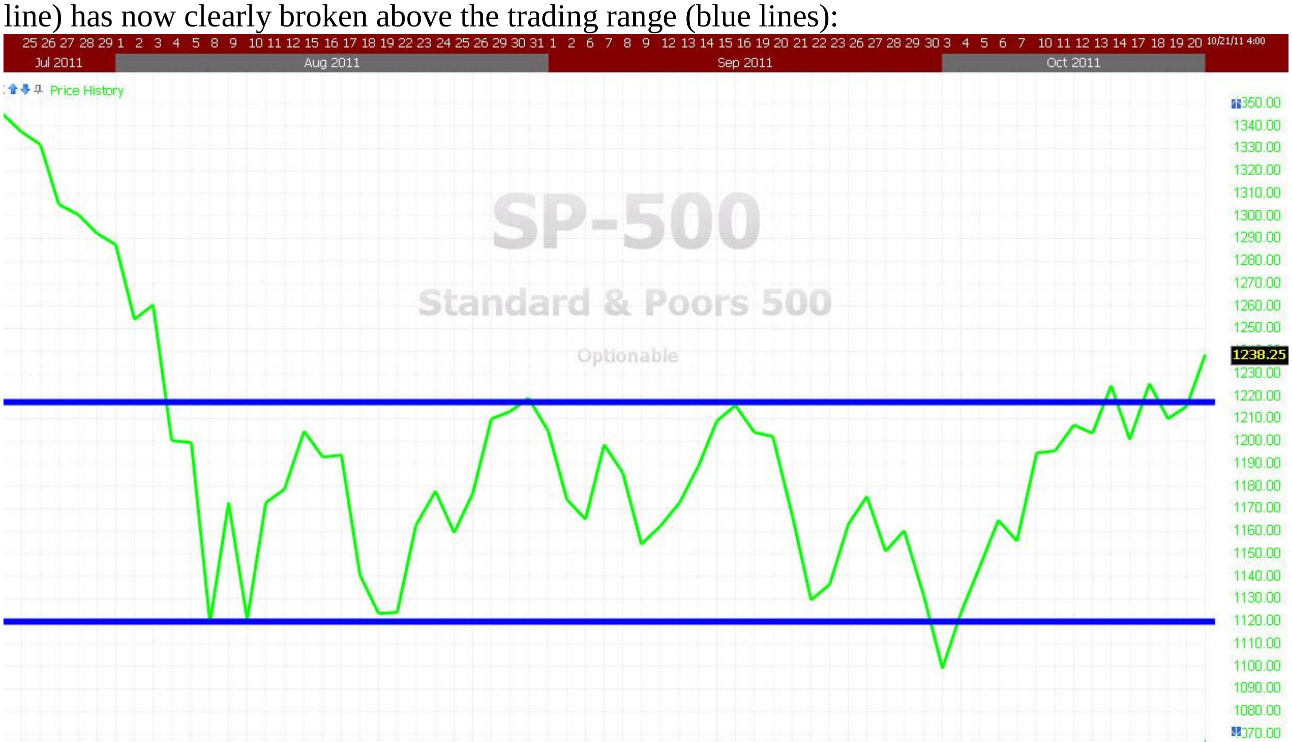
Weekly Market Analysis

October 24th, 2011

Commentary at a glance:

-Continued rumors of a plan for the Euro zone situation pushed markets slightly higher.
-Meeting of EU members to be held on Wednesday.
-Our signals indicated that it was time to move back into the markets and we started the process.
-Earnings season is going pretty well.

Market Wrap-Up: The US markets experienced a bit of volatility last week as rumors of a plan in Europe coming together over the weekend headlined news early in the week. That positive attitude was followed by disappointment during the middle of the week when it was announced that a deal would not be reached over the weekend. However, the week ended with a solid gain on Friday that took two of the three major US averages into positive territory for the week and pushed the indexes to new highs over the recent trading range. As you can see in the chart below, the S&P 500 (green line) has now clearly broken above the trading range (blue lines):



With the recent breakout timing almost perfectly with our models indicating that it is time to move back into the markets, we made a few changes to our models over the course of the previous week. We moved into investments such as high yield corporate debt, because it historically is less volatile than the equity market but has a higher yield than other forms of debt. We also moved into defensive equity positions such as utilities and consumer staples. We are utilizing mutual funds that we should have very little problems trading back out of should the market look like it is going to come apart. Right now, it looks like the current trend on the S&P 500 could continue as long as there is no blowout in Europe. It does seem like a plan is already being taken into account by the markets, so they are ripe for disappointment. Earnings on the whole for the third quarter of 2011 have been good, with a few notable companies missing expectations and a few beating expectations. Last week's big announcements included Apple missing market expectations on earnings while other companies such as Morgan Stanley, United Technologies, Yahoo and Abbott Labs all exceeded market expectations. While only a little over 26 percent of the S&P 500 companies have released earnings so far, on the whole it does not look like they will be negative going forward. This week some of the top companies releasing earnings include Amazon, Sprint, Caterpillar and Ford.

International Politics: The Greek saga continues to move forward but the pace is much slower than many participants in the region had hoped. With the 13th "emergency" summit of the past 21 months held in Brussels over the weekend there had been high hopes, that were dashed by Germany and France, that a deal would be finalized over the week that would end the financial turmoil in Europe. Before the weekend meeting even started, news came out that no deal would be reached until at least Wednesday, the 26th, and even then the deal will probably not be comprehensive or final. This type of uncertainty about a plan has come out before. If you remember, back in March the EU came up with a plan that would solve the situation—needless to say it did not work (but Greece was recently allowed to have access to the latest tranche of bailout funds). Then in July a second plan to supplement the first was released and the EFSF (the European version of TARP) was born and now it to is being shown to be completely inadequate. So will the third time do the trick, and this plan be the "final" plan that will actually fix the problems? The answer is probably not, because even if a plan is reached it will still require a massive amount of austerity from the countries that are in trouble and everything else falling into place exactly as planned. One of the major discrepancies lies in the taxation and or tax collection of some of the new measures. The plans all consider the taxes to be fully collected, but as we know, if tax rates go up people are more apt to find loopholes to dodge them and historically less taxes have actually been collected. Remember the "pool tax" that the citizens on Greece were supposed to pay if they had a swimming pool in their backyard? Hardly anyone paid it at all and when the government noticed that with Google Earth they could easily see who had a pool in their backyard, the Greek's quickly came up with the idea of covering their pools with tarps so that from above they looked like grass.

There is little solid information available about the current proposal that is being worked out but there are pieces that have made it to press. One of the major points in the plan is going to be the Greek debt haircuts (losses that bond holders will have to take). Estimates initially were in the 20 to 30 percent range, but that size haircut is inadequate and the number now is something along 50 to 60 percent. In the end, the changes that will need to be made to restructure the Greek debt will probably run higher than these figures, with the majority of the damage being borne by the private bond holders. Another hot topic at the meeting over the weekend was France's proposal to have the ECB take over the administration of the EFSF and pretty much turn it into a bank. This idea was strongly opposed by Germany, as there were numerous questions as to if the action would even be allowed under the current frame work on the ECB. In the end France ended up seeing it Germany's way and dropped the proposal. The last major talking point to come out of the meetings over the weekend was between Germany, France and Italy; with Germany and France somewhat bullying the Prime Minister of Italy Silvio Berlusconi into taking more action to boost Italian growth and lower the amount of debt that they are currently carrying (118 percent of GDP). In the end, we are not likely to see a final plan on Wednesday of this week but rather a framework for further discussion. In another part of the world, former Libyan President Muammar Gaddafi was killed last week by rebel forces and the new government officially liberated Libya on Saturday. Oil markets were watched particularly close after the announcement of his death, but there was little overall reaction in the form of price movement since for all intensive purposes he was already out of power.

National Politics: Last week, national politics once again seemed to focus on the upcoming elections and not dealing with the longer term US issues. The latest round of action on Capitol Hill was a second run at trying to pass the jobs bill that President Obama proposed several weeks ago. Despite a vote that did not pass less than two weeks ago, the Senate voted again last Thursday and once again it did not pass. While the bill makes a lot of sense, it is very difficult to fund, especially when there is a super committee working just across the hall trying to come up with ways that the government can cut spending and increase revenues. The latest bill was for $35 billion that would have gone to state and local governments to prevent payoffs, a much more manageable figure than the original $447 billion, but the bill carried a tax of 0.5 percent on people generating incomes of more than $1 million, so Republicans killed it. This latest defeat of a bill just adds to the thought that this congress really is stuck in partisan bickering that will not end until after the election next year and even then it could continue. The stock market took the latest defeat somewhat negatively as it is a sign that the Super Committee, in all likely hood, will not be able to come up with any sort of agreement by the late November deadline and that even if they did come up with something it is highly unlikely that it would garner enough support in the Senate and the House by late December to actually pass. The other major newsworthy political event last week came from President Obama as he announced that all US troops would be out of Iraq by the end of the year. This came as a bit of a surprise to some because initially there was a plan to leave some non-combat troops in Iraq so that they could further train Iraqi security forces.

Market Statistics: Last week was a mixed week for the US stock markets with two indexes advancing while the third declined. For the week, the best performing index was the primarily blue chip Dow which increased by 1.41 percent. The more broadly based S&P 500 turned in the second best performance of the week after advancing by 1.12 percent, on the heels of some of the component stocks turning in very strong third quarter earnings figures. The laggard of last week was the technology heavy NASDAQ, which declined by 1.14 percent. This is seen as a bit of a warning sign because typically the NASDAQ moves much faster than the other two indexes and is somewhat "ahead" of the others. If the NASDAQ was ahead of both the S&P and the Dow last week, we could see a bit of a decline throughout the course of next week as the indexes mean vert. The best-performing sector of the markets was Home Construction, which advanced 7.72 percent, driven by a few better than expected economic news releases. The worst-performing equity sector was in technology and was the Networking sector, which decreased by 2.87 percent. Fixed-income investments had a mixed week as operation twist continues. The long end of the yield curve saw a decline while the short to medium-term government fixed instruments saw a bit of upward movement in the fixed income ETFs. Commodities decreased, with the GSCI Commodity Index declining by 0.98 percent; oil advanced by 1.28 percent while the energy sector saw an advance of 2.85 percent. All of the common traded metals declined in value last week with Silver declining 2.74 percent, Gold down 2.37 percent and Copper falling 1.64 percent. On the international investing front, the best return outside of the US was found in the Netherlands with the Amsterdam Index increasing 1.09 percent. Globally, the worst-performing index was in China with the Shanghai SE Composite Index declining 4.69 percent. The VIX increased last week by almost eleven percent and after breaking through the resistance level to the down side two weeks ago moved back into the recent trading range and has now tested the trading range twice. Below is a chart of the daily VIX in green and the lower end of the trading range in red:

For the trading week ending on 10/21/11, returns in FSI's models were as follows:

	Last Week	YTD	Since 12/31/07
Aggressive Model	0.58 %	-7.18 %	-7.91 %
Growth Model	0.48 %	-6.60 %	-5.23 %
Moderate Model	0.35 %	-5.26 %	-1.20 %
Income Model	0.20 %	-3.30 %	(Insufficient Data)
S&P 500 (benchmark)	1.12 %	-1.54 %	-15.67 %

With the recent upward movement in the markets our overall signal for being either in or out of the market has moved from signaling to be out to signaling to move back into the market. In following with the signals last week, we started to move back into the market, purchasing a few different mutual funds that are defensive in nature while still participating in some of the upside market movements. Our first set of purchases included buying Rydex Utility Fund (RYUIX) and Mainstay High Yield Fund (MHCAX). Our second round of purchases included Pioneer High Yield Fund (TAHYX), Pioneer Floating Rate Fund (FLARX) and John Hancock Floating Rate Fund (JFIAX). Some of you may be wondering why we used two different funds in the same investment space in both high yield and floating rate. We used the different funds because while they are in the same investment space, they are invested very differently and have varying degrees of risk associated with each fund. In our more aggressive models we used the more aggressive fund while in our less aggressive models we utilized the less aggressive funds. Currently, we have between sixty and seventy percent remaining in cash, but we are actively looking for areas of the market that make sense for further investment. If you have any questions about our model positioning or would like more information about your specific accounts, please feel free to call our office.

Economic News: Last week was a pretty typical week for economic news releases, with the release split between positive and negative for the US economy. The week kicked off on Monday with the release of the Empire Manufacturing Index, which showed that manufacturing in the greater New York area during the month of October continued to contract. The market had been expecting the index to show a reading for -4.0 compared to -8.82 during September but the figure that was released showed -8.48. This would have been bad enough on its own but in looking at the release, the more negative aspect was the negative six month outlook (which fell from 13.04 in September down to 6.74 in October). This is the lowest six month outlook reading since the economic recovery started back in early 2009 and is seen as a very negative indicator as to what is going to happen in manufacturing in the future. Later in the day, on Monday, Industrial Production and Capacity Utilization were released, but they met market expectations leaving the market able to focus on the manufacturing data. On Tuesday, October 18th, the Producer Price Index (PPI) for the month of September was released and it showed a much higher reading than was expected. The PPI for the month of September came in at 0.8 percent when the market had been expecting 0.3 percent. This increase was seen as very negative for the overall markets because it indicates that inflation is running higher than expected at the producer level. The component of the PPI which increased the most was gasoline, which saw an increase of 4.2 percent during the month. Released at the same time at the PPI was the core PPI (core PPI is the PPI minus items that can fluctuate widely like fuel and food) which also came in higher (0.2 percent) than expected (0.1 percent) but the difference was small enough that the market did not pay it much attention.

On Wednesday, the Consumer Price Index (CPI) for the month of September was released and came in as expected with a 0.3 percent increase in consumer prices during the month. The main component of the CPI energy increased two percent while gas increased by 2.9 percent during the month. Core CPI came in one tenth of a percent under expectations at 0.1 percent for the month of September. Later in the day, on Wednesday, two key figures for the US housing market were released, housing starts and building permits for the month of September. Housing starts far exceeded market expectations coming in at 658,000 while the market had been looking for 595,000, but building permits had a bit of a dampening effect on the releases coming in at 594,000 while the market had been expecting 610,000. Even with the worse than expected permits figure, the housing market in the US looks like it is putting in a firm bottom as it has been moving in a horizontal pattern for the past several months. Now all the housing market needs to do is work through some of the inventory on the market (and sitting in the shadow market) and we could be on the road to a housing market recovery. The Fed's Beige Book was released at the end of the day on Wednesday and held no major new information. In general, the Beige Book described an economy that is not in a recession but remains very weak from an economic standpoint. Perhaps the most interesting bit of information in the Beige Book was the weaker outlook for business that was seen in many of the twelve Federal Reserve districts. On Thursday, the standard weekly jobs-related figures were released with initial jobless claims coming in at 403,000 and continuing claims coming in at 3,719,000. Initial claims is the figure that was most watched by the market as it stubbornly remained about the psychological 400,000 level and well above the 375,000 level which is what most economists agree is about the number of jobs that need to be created in a flat economy. The previous week's figures were both revised higher with initial claims at 409,000 and continuing claims at 3,694,000. A little bit later in the day on Thursday, the existing homes sales figure for the month of September came in at market expectations, leading the release to be a non-market moving event. The week wrapped up on Thursday with the release of the Philadelphia Fed Index for the month of October, which held a very positive surprise. After the poor Empire manufacturing figure earlier in the week many market participants were expecting a relatively weak showing out of the

Philadelphia Fed Index but the release was far better than expected. The market had been expecting an index reading of -8.8 down from -17.5 in September, but still indicating a contraction. Instead, the release came in at +8.7 indicating an expansion in manufacturing during the month. This was seen as very positive for the markets because it provided a bit of hope that US manufacturing was not all as bad as what is going on in the greater New York area. Overall the economic news releases last week held a bit of positive and negative indicators about the US economy.

This week's economic news releases start off on Tuesday with the release of the Case-Shiller 20 city home price index for the month of August, which is expected to show a year over year decline of 3.5 percent. While a decline is never a good thing, if the release comes in at -3.5 it will indicate that prices are starting to improve very slightly as prices in July showed a decline of 4.11 percent. Later in the day, on Tuesday, is the release of the US government's reading of consumer confidence for the month of October, which is expected to indicate that consumer confidence remained the same as it was in September. The market will be watching this release very closely and any deviation from expectations will likely lead to a strong market reaction. On Wednesday, October 26th, durable goods orders for the month of September as set to be released with market expectations of a decline of one percent during the month on overall orders and an increase in orders excluding transportation of 0.4 percent. Both of these figures seem a little bit low and we could see a nice surprise to the upside on these two releases. Later in the day on Wednesday, new home sales for the month of September are expected to show very little change over the August levels. On Thursday, the standard weekly jobs related figures are set to be released with expectations of no change on initial jobless claims at 403,000 and a slight dip of about 19,000 jobs on the continuing claims. If the number on initial jobless claims can somehow get below the 400,000 level it would be seen as very positive and could help boost people's feelings about the economic recovery. Released at the same time as the jobs figures, one of the most watched figures of the week will be released - the advanced estimate of third quarter GDP for the US. The market is looking for a reading of 2.2 percent but some estimates go as high as 2.5 percent; anything over 2 percent will likely be seen as positive since the final number for the second quarter was only 1.3 percent. On Friday, Personal Income and Spending for the month of September are set to be released with incomes expected to have risen by 0.3 percent and spending showing an increase of 0.6 percent. Wrapping up the week on Friday is the release of the University of Michigan consumer sentiment index for the month of October, which is expected to show no change over the level seen in September as consumers dealt with uncertainty over Europe and the economic recovery here in the US.

Have a great week,
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