



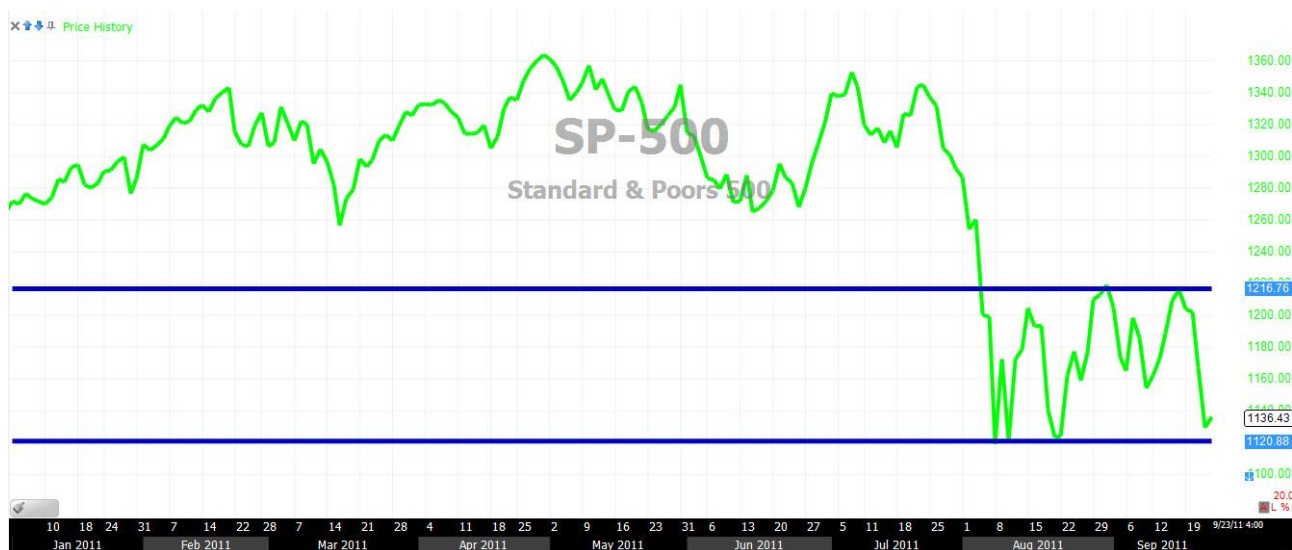
## Weekly Market Analysis

September 26, 2011

### Commentary at a glance:

The world financial markets remain in a very precarious position. Europe continues to drive emotional investing. Gold plummets along with all of the other major commodities. US financial markets have the worst week since October of 2008. Operation Twist is commencing with the Federal Reserve. We remain invested in cash and very low volatility mutual funds, in a wealth preservation mode.

**Market Wrap-Up:** Last week was very difficult for the US and global financial markets as the fear that the global economy is moving toward a double dip recession seemed to grip investors. Even asset classes such as gold fell as investors took profits out of trades and reduced exposure to all risk assets. The chart below shows the daily movements of the S&P 500 (green line) with the most recent trading range (blue lines) and gives a very good visual representation of the choppiness or volatility that the market has experienced since late July.



The main driving forces behind all of this volatility have been the same: global economic growth uncertainty, US fiscal uncertainty and the unknown conclusion to the European debt situation. Last week the primary force that shook the market came in the form of US government intervention into the bond market through “Operation Twist” as well as a strong statement from the Chairman of the Federal Reserve Ben Bernanke as to the risks facing the US economy. The markets reacted very negatively to the Chairman’s announcements; apparently the market expected Bernanke to announce another round of quantitative easing (QE3). When he did not do so, investors who had

been trying to time the bottom of the market decided to bail out to the sidelines. The other main reason for last week's decline was the news that the situation in the EU is quickly deteriorating and that action needs to be taken quickly in order to avoid an outright default by Greece and possible contagion to other European countries. In looking forward, I think that market volatility is here to stay as politicians in both the US and the Euro zone will do just enough to continue kicking the can down the road but will lack the political will to make necessary structural changes in the global economic system. We will likely continue to see large swings in the stock market as investors jump in with hopes of everything being solved and jump right back out when they realize that a solution is still in the distant future. In general, investors are very bearish about the next 10 years of equities returns as evidenced by the extremely low yield on the 10 year Treasury, which last week hit a 60 year low of 1.67 percent. With the markets likely stuck in a seven percent trading range, it is not advantageous to try to time the market by jumping in at perceived bottoms and selling at perceived tops, because undoubtedly the market will move erratically, leading to very high volatility in one's portfolio. It is best in this type of market environment to be defensively positioned; in our case we are utilizing a lot of cash and government-backed fixed-income investments in order to try to make a positive return while generating some income and, at the same time, taking on very little overall risk. At some point in the future, governments around the world will probably work out plans for fixing many of the global issues. At that point, investing in riskier assets should pay off in the long run as the market may enter yet another bull market—a bull market in which we fully expect to participate.

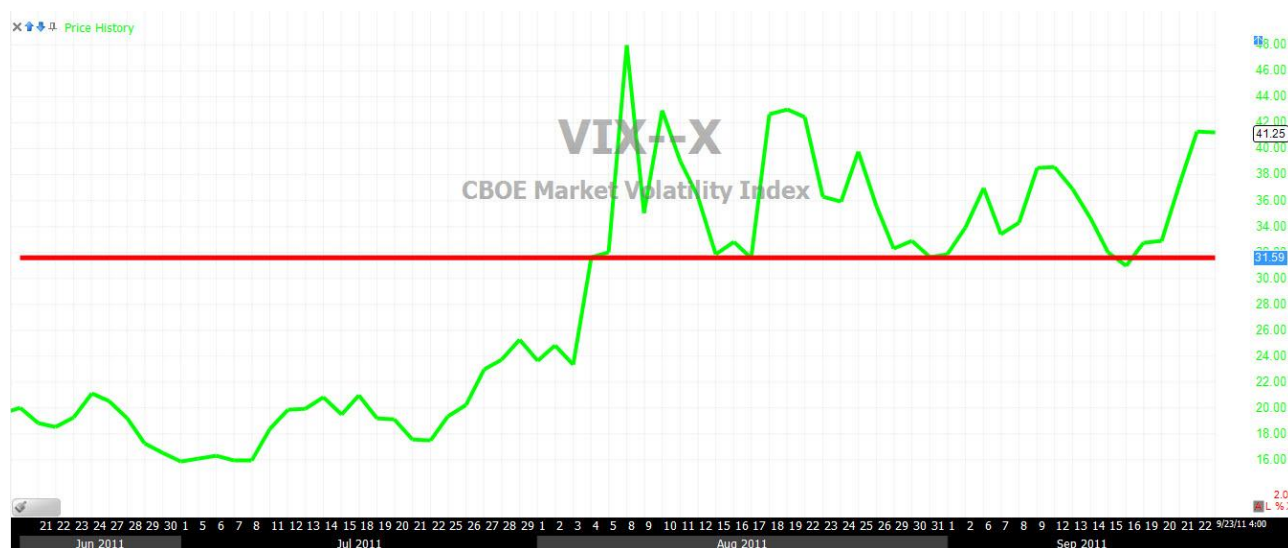
**International Politics:** International politics continue to be a main driving force for stock markets around the world as it now appears that time is running out to find a solution to the Euro zone problem. At a meeting of the IMF and the World Bank in Washington DC over the end of last week and over the weekend the main focus remained on solving the deteriorating Euro zone issues. At the core of the problem is how to handle an orderly restructuring of individual countries' debts without causing a banking system collapse or drastic currency changes. One theory that seems to be gaining some traction with several European leaders is the idea of building a firewall around Greek debt so that they can let Greece go while containing any fallout and stopping the contagion. Another idea being discussed at great length is that the European Central Bank (ECB) needs to take a more central role in the resolution of the situation. A more central role would allow for one policy to be set for the Euro zone as a whole, something that has eluded the region since its formation. The new ECB role would be modeled after the way the US Federal Reserve works with the US Treasury to fight periods of uncertainty in the US financial system.

One of the first steps that the ECB could take to put the world markets at ease would be to increase the size of the European Financial Stability Facility (EFSF) from its current \$440 billion level; the exact amount of the needed increase is unclear but many economists put the figure much closer to \$1 trillion. The EFSF is the European equivalent of TARP, which was used in the US during the crisis in 2008. US Treasury Secretary Geithner has been calling for an expanded EFSF for several weeks but now his voice has been joined by the other members of the G20. In a statement issued by the G20 in which they pledged “a strong and coordinated international response to address the renewed challenges facing the global economy, notably heightened downside risks from sovereign stresses, financial system fragility, market turbulence, weak economic growth and unacceptably high unemployment,” they too seemed to be calling for the EFSF to be expanded. The G20 will likely develop an outline of a potential plan for action to help world economic growth prior to their November meeting in France. As parts of the plan emerge, we could see drastic changes in the world markets as investors adjust their holdings for the potential changes.

**National Politics:** National politics last week once again focused on Congress's inability to accomplish anything, as there is yet another showdown looming on Capitol Hill about government spending. Up for debate is a very broad spending bill that funds a wide variety of government spending on things such as FEMA, space exploration and many other "non-essential" government actions. In total the bill is about a trillion dollars in total spending and the main sticking point is spending \$1.5 billion on electric vehicles, but the bill seems to be a chance for politicians to draw a line in the sand and show their true colors. If the bill is not funded and passed into law, the government would see many programs immediately run out of money, the largest of them being FEMA at a time when natural disasters seem to have run their course in the US and there is great need for government money to help with the cleanup. Late on Friday, members of Congress agreed to wait until Monday to take a vote hoping that "cooler heads would prevail" after a weekend to think about the consequences of their action or inactions. The markets will watch this debate very closely on Monday as it once again goes down to the wire (funding for some programs run out on Tuesday). The debate will likely be seen as an indication of the level of gridlock currently present in Washington. Also in national politics last week, Federal Reserve Chairman Ben Bernanke announced his latest attempt at jumpstarting the US economy through what is now being called Operation Twist. Operation Twist is when the Federal Reserve sells some of their holdings in short-term US government debt in order to purchase longer-term debt. The idea is that by selling the short end and buying the long end of the curve, the yields on longer-termed bonds will come down. This decrease in longer-term interest rates will then, in theory, lead to more people borrowing and spending money. The last time the government tried this type of action was over two decades ago and it did have the desired effect in the short term, but after less than a year of the program running, the long end of the interest rates had increased back to and above the level prior to the program being started. We will just have to wait and see if this latest round of action has the desired effect on rates. While Operation Twist was expected, the market also appeared to be looking for a little bit more to help the economic recovery continue. One aspect that was left out of the announcement that the market thought may be included was the lowering of the amount of interest that the Fed pays banks on their reserves. This would have given the banks more reason to loan on the money rather than just sitting on it and being paid by the government to do so. The markets also seemed to be expecting a third round of stimulus to be outlined despite Republicans on Capitol Hill sending the Chairman a letter expressing their concerns should the Federal Reserve take such action. With no mention of QE3 and Chairman Bernanke's changed statement language about "significant downside risks to the economic outlook," many investors decided to head to the sidelines, pushing the market substantially lower.

**Market Statistics:** Contrary to the strong stock market rally two weeks ago, last week was a bit of a reality and gut check for many investors. Last week saw all major market sectors decline in rapid fashion; even some of the typical hiding places such as gold took a beating. After the dust settled, the best-performing index in the US was the technology-heavy NASDAQ, which declined 5.30 percent. The next best-performing index of the three major US indexes was the primarily large-cap blue-chip Dow, which fell 6.41 percent. Bringing up the rear was the broadly-based S&P 500, which experienced a decline of 6.54 percent. The best-performing sector of the poor markets last week was utilities, which declined by 3.08 percent. The worst-performing sector of the markets was oil and gas exploration, which declined by 15.19 percent. To give people an idea of just how broad the decline was, of the 108 sectors that I watch, only 26 experienced a return last week that was better than a five percent decline. Thirteen of the 26 sectors that had good performance were sectors of the bond market. Fixed-income markets had a stellar week compared to equities, with many of

the fixed-income US government bond ETFs advancing—the long end of the curve in particular had a great week, advancing 7.65 percent. Commodities got clobbered last week with several key commodities experiencing declines in excess of ten percent. Silver had the largest decline, falling by almost 24 percent on fears of a global recession decimating the demand for the precious metal. Copper also had a wild ride, declining by 18 percent, while Gold experienced a decline of only 9 percent. Gold has now fallen from over \$1,900 per ounce all of the way down to under \$1,660 per ounce in less than a month. Oil was not spared last week as it too experienced a decline of more than 9 percent on fears that global demand will be much less than anticipated should the global economy move back into a recession. The US dollar advanced by 2.12 percent for the week against a basket of international currencies as investors grew very wary about the future of the Euro. The top performing and only positive index on the international investing front last week was found in China with the Shanghai Index advancing 1.43 percent. Globally, the worst-performing index was in Mexico with the Mexican stock exchange declining by 10.96 percent on continued drug-related violence that has gripped the country for the past few years. After looking like the VIX (green line below) may break through its trading range (red line below) to the downside two weeks ago, last week saw an abrupt reversal as fear once again took hold of the market.



As you can see from the chart above, we are now back near the upper end of the recent trading range with the VIX, an indication that volatility in the markets over the next 30 days will be much like it has been for the past 30 days (very elevated).

**Performance:** For the trading week ending on 9/23/11, returns in FSI's models were as follows:

|                     | <u>Last Week</u> | <u>YTD</u> | <u>Since 12/31/07</u> |
|---------------------|------------------|------------|-----------------------|
| Aggressive Model    | -0.08 %          | -7.56 %    | -8.28 %               |
| Growth Model        | -0.02 %          | -6.89 %    | -5.52 %               |
| Moderate Model      | 0.04 %           | -5.42 %    | -1.36 %               |
| Income Model        | 0.12 %           | -3.28 %    | (Insufficient Data)   |
| S&P 500 (benchmark) | -6.54 %          | -9.64 %    | -22.61 %              |

We made no changes to our models last week, remaining invested in very conservative holdings. Our only holdings are cash and US government-backed Ginnie Mae bonds through two different

mutual funds; Victory Fund for Income (IPFIX) and ING Ginnie Mae Income Fund (LEXNX). Prior to last week, we had several areas of the market that were starting to look attractive relative to the other sectors, but after the decline last week, even the best-looking sectors got hit pretty hard. Utilities is a sector that we are watching very closely as it has been performing well and is an industry that is highly regulated by the government (there are very few competitors within any given area, meaning that earnings are stable and the stocks typically fluctuate less than the market).

**Economic News:** Last week was slow for economic news releases with the majority coming in at or slightly worse than expected. The week started off Monday with the release of the NAHB housing Market Index for the month of September, which unexpectedly moved from 15 down to 14, indicating that the US housing market is still a long way from solid footing. On Tuesday the 20th, more housing-related figures were reported; the release of housing starts and building permits for the month of August showed that housing starts were lower than expected but building permits were unexpectedly strong, the two releases together washing each other out. On Wednesday the US housing market received a glimmer of hope as the Existing Home Sales figure for the month of August came in much stronger than expected at 5,030,000 homes sold while the market had been expecting only 4,700,000. Later on Wednesday, the FOMC released their interest rate decision keeping on track with holding rates between 0 and 0.25 percent. As mentioned above, the language in the statement was changed to “significant downside risks” when talking about the economic outlook, which gave the market a bit of a scare. This elevation of the risk language caught the market a bit by surprise and was a driving force in the market moving substantially lower over Wednesday and Thursday. On Thursday, the standard weekly jobs-related figures were released with initial jobless claims coming in 5,000 higher than expected while continuing jobless claims came in better than expected by 3,000 jobs. The big change in the weekly jobless figures came from the revision, which seemed to be largely ignored by the markets, in which initial jobless claims for the previous week were increased by 5,000 to 432,000 and continuing jobless claims were increased by 29,000 to 3,755,000. Wrapping up the week on Thursday was the release of the leading indicators for the month of August as compiled by the Conference Board, which slightly beat market expectations but was only half of what was seen in July.

This week is not too busy for economic news releases, but the releases that are being put out and the wide variety of speeches being made by Federal Reserve members could impact the overall market. The week starts off on Monday with the release of the new home sales figure for the month of August, which is expected to show a slight decline over the July level. On Tuesday the Case-Shiller 20-City Home Price Index for the month of July will be released with expectations that we will see a year-over-year decline in home values of approximately 4.5 percent (in line with what was shown in June). Later in the day on Tuesday one of the main releases of the week, the consumer confidence figure as measured by the US government will be announced for the month of September. The market expects the figure to show an increase of about 2 up to 46.7 for the month but with all of the turmoil in the markets and overseas it is pretty difficult to see how this release can do anything other than move lower; this could be a very disappointing release for the markets. At the same time as the consumer confidence figure is released, Atlanta Federal reserve Bank President Dennis Lockhart will be giving a speech about the US Economy which will probably overshadow the consumer confidence figure. On Wednesday the 28th durable goods orders for the month of August are set to be released, with expectations of zero change over the July level. This seems like a low target and we could see the release beat market expectations on this one. Ben Bernanke also makes a speech that evening in Cleveland on the topic of “Lessons from Emerging Market Economies on the Sources of Sustained Growth.” While nothing is expected to be

mentioned about upcoming actions, the market will likely take note of the speech. On Thursday, the standard weekly jobs-related figures are released with bull expectations that both figures moved lower over the course of last week, but initial jobless claims are still expected to be well above the psychological level of 400,000. Released at the same time as the jobs figures, the third estimate of GDP in the US for the second quarter of 2011 is set to be released with expectations that the second release will actually be revised upward from 1.0 percent up to 1.2 percent. This release seems like a bit of a stretch, and if GDP were revised upward, the market is going to look very closely at where the changes came from to ensure that they are real. Later in the day on Thursday, Pending Home Sales for the month of July is set to be released and will likely move in the same direction and with the same magnitude as the existing homes sales figure earlier in the week. On Friday, the last day of the third quarter of 2011, there is a slew of releases that could impact the overall markets. The day starts out with the release of personal income and spending for the month of August, which is expected to be pretty flat. Up next for release is the PCE Core Prices for the month of August, which is expected to show a slight increase in prices of 0.2 percent. If we receive a reading that is much higher than 0.2 percent, we could see the inflation hawks really start to show their concern for what the Fed is doing with monetary policy. Later in the day on Friday the Chicago PMI is going to be released for the month of September to expectations of a reading of 54.0. If this release goes anything like the other manufacturing data that has come out of various regions in the US, we could see the release miss to the downside in a big way. Wrapping up the week on Friday is the release of the University of Michigan Consumer Sentiment Index for the month of September, which is expected to show sentiments have remained essentially flat.

Have a great week,  
Peter Johnson

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