



Weekly Market Analysis

November 28th, 2011

Commentary at a glance:

- Retail sales start out strong for the holiday season.
- Germany experiences a failed bond auction.
- Super committee turns out to be a super failure.
- Economic data comes in slightly weaker than expected.

Market Wrap-Up: Last week the US financial markets experienced their second week of declines in a row, as the failure by the super committee was made official and the situation in Europe deteriorated further. As you can see in the chart below, the S&P 500 is now solidly back in the trading range it was stuck in from early August through mid October. In the chart below the S&P 500 is the green line while the trading range is depicted with red lines:



The speed with which the market moved back into the trading range is perhaps the most alarming part about the move, as it would indicate that many investors were selling and moving their assets into non-equity holdings such as cash. Such a steep decline is typically followed by a bit of a recovery as bargain hunters move into the market looking to make quick returns due to overselling on the part of other investors, which push the prices temporarily downward. The current trend, however, is not one that exudes confidence for everyday investors and many people will be watching for the market's reaction as it nears the lower level of support (bottom red line). One aspect of the US economy that could get the market moving back in the correct direction is the holiday season and the amount of shopping that Americans do over the coming weeks. So far the

early figures for Black Friday sales seem encouraging as sales, according to ShopperTrak, increased by 6.6 percent over last year, to a whopping \$11.4 billion on Friday. In total, according the National Retail Federation, 152 million people braved hectic stores or sat in the comfort of their homes and shopped online on Black Friday. When the rest of the weekend shopping days and the all important Cyber Monday figures are tallied up, we will likely see an increase of about 7 percent in sales over the level seen last year. Spending by the US consumer can have the single largest impact on the overall economy so if this holiday season proves to be strong for retailers, it could be a very positive thing for the US economic recovery. With such strong news about sales over the weekend, it is likely that we will see the market react very positively on Monday after being closed last Thursday and having an abbreviated session on Friday.

International Politics: Germany made the biggest headlines in the international news last week after it experienced a very difficult bond auction. The continued fear of fallout from the ongoing debt situation in Europe hit potentially the strongest country in the region; Germany last week. In what was supposed to be a routine 10 year German Bond auction on Tuesday last week, investors decided not to participate fully in the auction. Prior to the auction Germany had planned on selling 6 billion Euros worth of bonds, but after all of the bids were made they only had interested buyers for 3.889 billion Euros worth of bonds and this interest came at a higher than expected interest rate. The rate chart below from Bloomberg shows the huge jump in yields seen last week and that the current rate being paid is the highest rate over the past three months.



The increase in German borrowing costs coupled with the continued upwards moves in yields on European debts, mainly Italy and Spain, are causing many investors to be concerned about the future of the Euro and the Euro zone as a whole. What started with Greece several years ago is quickly becoming an issue that may in fact be too large for the European government to contain without outside assistance. Outside assistance may come in the form of help from the IMF or even China, but it is looking more and more likely that help will be needed. The IMF announced last week that it was introducing a new lending facility for countries that are facing turmoil in light of the recent situation in the Euro zone. The new lending facility is called the Precautionary and Liquidity Line and is designed to help provide short-term cash to countries facing liquidity problems. The catch is that the total amount of funds that can be received by a country is capped by the country's contribution to the fund. In the end, this policy may help countries marginally but it is not enough to solve the bigger issue of countries spending more than they make. With Italian debt yields once again back over 7 percent and Spanish yields pushing very close to 7, the situation in Europe is gaining a sense of urgency and there is now more talk about issuing Euro bonds despite

Germany's rigid stance against such an action. Another proposal that is making the rounds in Europe is for the ECB to use the IMF to directly finance countries that are running into trouble. The reason that the ECB would have to use the IMF is because the ECB is allowed to make bond purchases in the open market but as an organization they are forbidden from financing individual countries directly. With the bond market purchases of recent weeks seeming not to have the desired effect on the market (interest rates keep going up), the Europeans are looking for ways to apply money to the root cause of the problems and not just try to contain the negative side effects of a free market economic system. Elsewhere in international politics, tensions are rising in Syria as more countries join in the call for President Assad to step down. Egypt has also made headlines as the country heads to a critical vote on Monday to install a government that will replace the military ruling the country, which has been in charge since the fall of President Mubarak. The situation in both Egypt and Syria will likely have the most impact in the oil market should the unrest continue much longer, but this impact on oil would be felt around the world as prices for gasoline would increase.

National Politics: The official word that no deal was reached by the super committee headlined national politics last week as many Americans watching the saga unfold felt that the failure highlighted what is wrong with the political system in Washington DC. Now that the debate is over and more information about the closed door meetings has started to emerge, it appears that the committee was actually making a little bit of progress until both sides' plans were leaked to the public about 4 weeks ago. After that point the negotiations seemed to break down. In the end the final sticking points were the same; taxes and cutting government spending. With neither side deciding that it was important to tackle the big issues at the current time, both sides started to blame the other for the failure while pointing to the 2012 elections as a day of reckoning for the other side. While the US markets did react somewhat negatively to the actual announcement that the committee was throwing in the towel, they did not decline as much as some people thought that they might. It seems like the market was already discounting the fact that nothing would be done by the group and therefore their indecision had little overall effect on the broad market. One of the main fears of the markets was partially put to rest later during the week last week as Moody's rating agency said that they would not be lowering the US's AAA credit rating as a result of the super committee's failure. While they still have the US on credit watch, at least for the time being, it appears our AAA rating with Moody's is intact. Fitch rating agency, on the other hand, has yet to make an announcement on any changes they may make to the US credit rating, but they will probably make an announcement early this week. Even if Fitch decides to downgrade the US from their top credit rating it will not have much of an immediate impact on the borrowing costs of the US because there would still be one of the major rating agencies holding the AAA rating. Most borrowing costs are determined by the highest rating given by any one of the three rating agencies, which means that until all three have lowered their credit rating borrowing costs for the US government, they should not increase by a large amount. In news about the 2012 presidential election, there is yet one more Republican contender that is now making headlines. Newt Gingrich is quickly moving up in the polls after winning the endorsement of New Hampshire's union leaders over Mitt Romney. This is the second Presidential election cycle that Mitt Romney has been passed over by the Unions leaders in New Hampshire and now has many Republicans questioning Mitt Romney's ability to win the Republican nomination. With both the US House of Representatives and the Senate back to work this week it should be an interesting week of continued finger pointing about the super committee's failure.

Market Statistics: Last week, the three US markets all experienced large declines for the second week in a row. The broadly based S&P 500 turned in the best performance of the week with a decline of 4.69 percent while the primarily Blue Chip Dow turned in the second best performance of the week after falling 4.78 percent. The NASDAQ had the toughest week, experiencing a decline of 5.09 percent. Over the course of the past two weeks all three of the major US indexes have lost in excess of 7.5 percent. The best-performing sector of the markets was Pharmaceuticals, which declined 1.57 percent. The worst-performing equity sector was Semiconductors, which decreased 8.01 percent. Fixed-income investments had a good week, with the long end of the Treasury curve (20+ years) increasing by 1.22 percent while the shorter end of the curve experienced a slight move upward. Commodities moved lower last week, with the GSCI Commodity Index declining by 2.29 percent as oil declined 0.36 percent, while the overall energy sector saw a decrease of 6.31 percent. Gold continued to move in a very strange way last week as it declined in value by 2.52 percent. Once again, the typical trade of investors adding to gold positions as uncertainty increased did not play out. The only speculation as to why Gold is falling with the market that I have come across is that investors appear to be selling assets indiscriminately to raise their cash positions, which could account for some of the move in gold prices but the movements still seem a little bit odd. Copper and Silver fared even worse than Gold as they fell 7.74 and 3.82 percent, respectively. With continued fear of contagion spreading in Europe, the markets saw a rush toward the US dollar as a safe-haven currency; for the week the US dollar gained 1.86 percent against a basket of international currencies with most of the gains coming from investors dumping Euros in favor of dollars. On the international investing front, there were no indexes that turned in a positive performance, so the best of the declining indexes was found in China with the Shanghai Index, which declined by 1.39 percent. With so many indexes experiencing a decline over the week, Taiwan ended up having the dubious honor of declining the most with the Taiwanese Index falling 8.17 percent. With the broad declines seen in the equity markets it comes as no surprise that the VIX increased over the course of last week. For the week, the VIX increased by 7.72 percent, giving it a two week gain of almost 15 percent. In the daily chart below of the VIX (green line) it is easy to see that we are now back up near the top of the recent trading range (red lines), a signal that volatility in the markets is probably going to continue through the end of the year.



For the shortened trading week ending on 11/25/2011, returns in FSI's models (gross of fees) were as follows:

	<u>Last Week</u>	<u>YTD</u>	<u>Since 12/31/07</u>
Aggressive Model	-1.59 %	-10.68 %	-11.39 %
Growth Model	-1.23 %	-9.13 %	-7.79 %
Moderate Model	-0.88 %	-6.76 %	-2.76 %
Income Model	-0.47 %	-4.10 %	(Insufficient Data)
S&P 500 (benchmark)	-4.69 %	-7.87 %	-21.09 %
S&P 500 with dividends	-4.65 %	-6.18 %	-14.13 %

With the heightened volatility and uncertainty surrounding Europe, early last week we decided to take some of the risk out of our models. We lowered our risk through the selling of our most volatile positions (equity positions) and our highest risk fixed income positions. We are now heavily invested in cash and other low volatility fixed income instruments and will be waiting for the market to settle down for us to move back to a fully invested positions. If you have any questions about how you are currently invested or would like more information about our models, please contact our office for more information.

Economic News: With last week being a shortened trading week, due to the Thanksgiving holiday, all of the economic news releases were crammed into the first three days of the week. The releases started on Monday with the existing homes sales figure for the month of October, which beat market expectations coming in at 4.97 million homes being sold during the month while the market had been expecting only 4.85 million. This release was a further positive development in the housing market, following on the heels of better than expected readings in building permits and housing starts that were released two weeks ago. On Tuesday, one of the major economic news releases of the week, the second estimate of GDP for the third quarter of 2011, was released and it was a lump of coal. The markets had been expecting to see no change from the first release of 2.5 percent growth but instead the release came in at 2.0 percent on an annualized basis. The market took this release very poorly as it means that we are closer than first thought to falling back into a technical economic recession. In fact, some economists put the odds at greater than 50 percent that we will see a technical recession to start off 2012. Later on Tuesday, the FOMC released the meeting minutes from the last meeting in which there were no major surprises, but they did provide some information on what QE3 may look like if it is going to be implemented by the Fed. On Wednesday, the standard weekly jobs-related figures were released a day early with both figures missing market expectations but doing so by a small enough amount that the releases did not have a meaningful impact on the overall markets. Also released on Wednesday were the figures for personal income and spending for the month of October, which ended up giving mixed signals. Personal Income increased by more than expected, 0.4 percent compared to expectations of 0.3 percent, but personal spending came in slightly below expectations at 0.1 percent while the market had been looking for 0.3 percent. This anomaly provided the market with a bit of hesitation as it seems to indicate that the US consumer, while they made more in October, were reluctant to spend out of uncertainty moving forward. Alternatively, it could just be that they chose to save their money in October so that they would have more to spend on holiday shopping in later months. Durable goods orders for the month of October were also released on Wednesday with both overall orders and orders minus transportation beating market expectations. Wrapping up the week for economic news releases on Wednesday was the University of Michigan Consumer Sentiment Index

for the month of November, which showed very little change over October's level and was in line with market expectations therefore making the release a non-impactful release.

This week makes up for the slowness of last week's releases as we have both the standard weekly economic news releases as well as the month-end releases for November. The week starts off on Monday with the release of new home sales for the month of October which are expected to show a slight increase over September levels, keeping with the momentum of the housing market that we have seen recently in previous releases. On Tuesday, the 29th of November, the Case-Shiller 20 city home price index for the month of September is set to be released with expectations of a year over year decline of about three percent. A decline of three percent would actually be seen as a positive development because it would indicate that prices are falling slower than they have been in recent months. Later on Tuesday the Consumer Confidence figure for the month of November is set to be released, and with the strong black Friday figures that have been released we could see a bit of a positive surprise out of this release. On Wednesday, the 30th, ADP releases their Employment change figure for the month of November and Challenger releases their job cuts expectations for November. Both of these releases will be watched very closely as they can be seen as precursors to what the government will be releasing on Friday for the official unemployment rate in the US for the month of November. Expectations on the ADP figures is for job creation of 125,000 jobs during the month of November, which if it turns out that way in the governments figures is unlikely to be enough to move the overall unemployment rate from 9.0 percent. Also released on Wednesday is the Chicago PMI which will be very closely watched as we have received conflicting manufacturing information out of other regions of the country over the past few weeks. Expectations are for the Index to show a decline from 58.4 down to 57.5, which means that the Chicago area is still well above the 50 figure that represents the inflection point between manufacturing expansion and contraction. Later on Wednesday, Pending Home Sales for the month of September are set to be released but the data is a bit stale as we already know more pertinent housing information from the month of October. Wrapping up the busy day on Wednesday is the release of the Fed's Beige Book, but as usual it should hold very few surprises and should therefore have little overall impact on the markets. On Thursday, December 1st, the standard weekly jobs related figures are set to be released with expectations that both will have moved lower over the course of the previous week. Later on Thursday the ISM index for the month of November is set to be released and it is going to be watched very closely as expectations are for a reading of only 51, meaning that we are very close to the inflection point of expansion versus contraction. Wrapping up the day on Thursday is the release of auto sales for November and construction spending for the month of October. Auto sales are expected to be fairly strong while construction spending is expected to be fairly timid, increasing by only 0.3 percent over September levels. On Friday the big release of the week is set to be announced, the official unemployment rate as measured by the government for the month of November. The rate is expected to not have changed from the 9.0 percent that we experienced during October, but strong job creation is expected to be seen in both the public and private payroll figures. The market will be watching the payroll figures much more so than the overall rate figure, so look for more movement on those figures if they either beat or fall short of expectations than the overall headline figure. This week has several economic news releases that could have an impact on the market. Couple those releases with the unknown announcements that may be coming out of the Euro zone, and we should be in for a pretty eventful week.

Have a great week,

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