



## Weekly Market Analysis December 12<sup>th</sup>, 2011

### Commentary at a glance:

- A European plan has emerged.
- The UK is growing more distant from the rest of Europe.
- Rating agencies have warned all of Europe about possible downgrades.
- Payroll tax cut extension has become a heated debate in Washington DC.
- The number of Initial Jobless Claims falls to 381,000 in the US.

**Market Wrap-Up:** Two weeks ago the US stock market indexes experienced one of the strongest moves of the past few years. Last week saw the markets take a much needed breather as investors weighed the potential outcomes in Europe. Despite some progress toward a deal to fix the ongoing situation in Europe, the US markets failed to make new highs last week and now look poised to stay range-bound for the next few weeks. As you can see in the chart below, the S&P 500 (green line) is now back above the trading range (red lines) where it was stuck from early August through mid October:

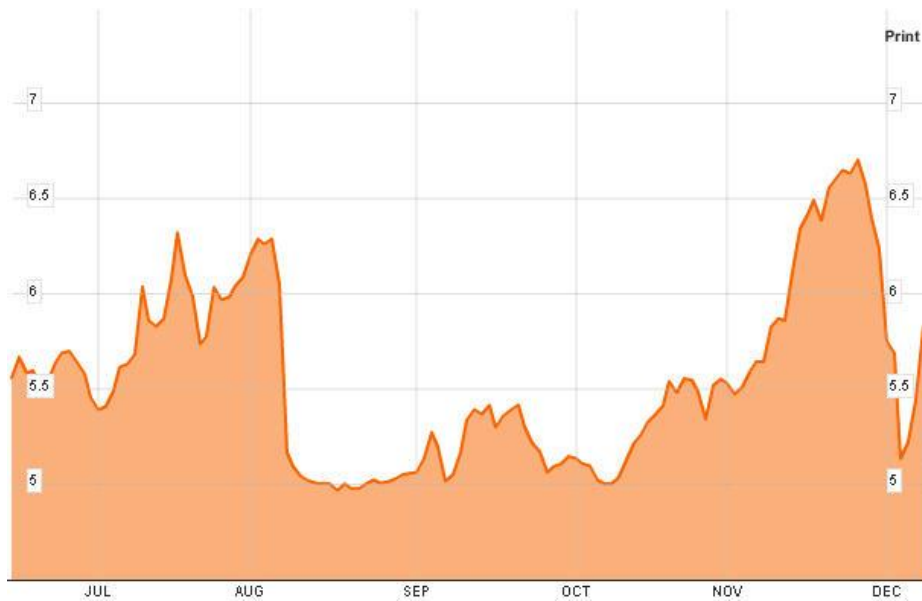


After weeks of speculation about what actions would be taken at the Euro zone summit that was held last week, the market seemed to shrug off the action as a non event. Maybe the plan was priced into the market two weeks ago when we saw the large rally or maybe there is little faith that the new plan will do enough to actually stem the problems, but for whatever reason, the world markets did not have a major positive reaction to last week's announcement. The plan that was outlined did have

an initial impact on the bond markets in several of the European countries that were in the “danger zone” as far as yields go, with Italy seeing rates move briefly back down below six percent before moving higher at the week’s end as depicted in the chart from Bloomberg below:



Spanish rates saw an even sharper decline last week before an end-of-the-week rally, with rates falling from over 6.5 percent down to 5.25 percent, and then increasing to approximately 5.5 percent as depicted in the Bloomberg chart below:



With the initial framework of a deal in place, does that mean that the US markets will continue to move higher in a year-end rally (which happens most years)? While it is true that the economy as a whole in the US looks like it is improving and the US consumer is spending money this holiday season at a higher rate than previous years, it still seems like we will see the market move in a sideways fashion through the end of the year. The reasons for the somewhat disappointing outlook

are that the market is trading on emotions and that between now and the end of the year we will likely see both positive and negative news out of the Europe and Washington DC. Investors will likely overreact to negative news because they generally fear losing money more than achieving a high return in a time of heightened volatility. Another indicator that the market will likely move sideways is the low trading volume we have seen; with the exception of the last day in November, volume on the whole, has been light and we have been seeing less and less participation on the days the market moves up. You would expect volume to slowly increase as the market moves higher if there was a lot of money behind the upward moves, but we have simply not seen that recently.

**International News:** International news focused last week on the summit that took place in Brussels on Thursday during which an agreement was discussed that has the potential to solve some of the issues that have plagued the Euro zone for the past two years. After weeks of negotiations, the plan that was reached during Thursday and Friday essentially laid the framework for a very different Euro zone – one in which countries will have to give up some of the sovereignty as they form a closer fiscal accord, in which European governing bodies will have much more control over the region. In a broad sense, this is what Germany has been pushing for all along and it took until last week for countries such as France and several others to realize that this was the only way to move forward. Other items that were also worked out at the summit include increasing the size of the European bailout fund by 200 billion Euros and outlining rules that provide for automatic penalties should a country run to budget deficits that are too high. All of this was done with one key country saying that they did not support what was taking place, and that was the United Kingdom. Playing from a hand that Prime Minister David Cameron thought was strong, the British PM pushed for having the ability to veto new financial regulations within the EU. While this move would have strengthened the UK's standing in the Euro zone by giving them some arbitrary power, Cameron's plan backfired as all of the 17 Euro currency member countries voted to move forward and all of the other EU member countries also moved against the UK. At this point, some members of the government in the UK are very proud of what PM Cameron did, but there is also a growing number that feel he performed very poorly in his negotiations. At risk for the UK is isolation from the rest of the Euro zone and no favored treatment, which they have been enjoying while they have been a part of the Euro zone. In the end, it looks like Cameron's move to try to sit at a more powerful seat at the table may have relegated him to sitting out in the hall with his ear pressed against the door.

Not all of the news coming out of Europe was positive last week, as the rating agencies wasted no time in criticizing the new plan and even went as far as issuing a thinly veiled threat to the region. After the deal was outlined, Moody's said that it would evaluate the credit-worthiness of all of the European nations as well as the AAA rating that had been previously assigned to the European bailout fund. Moody's was not the only rating agency to do so, as Stand and Poor's also indicated that they will reevaluate all of the credit ratings in the region in light of the new agreement. Turning an eye toward the banking sector, Moody's downgraded the three largest banks in France last week as they cited weaknesses in the economic outlook and the potential to find additional funding difficult going forward. This comes on the heels of a report about the latest round of stress tests performed by the European Banking Authority (this time there was a nine percent hurdle on the tier-one capital ratio) that found a shortfall of approximately 155 billion Euros in tier-one capital in the European banking sector should the crisis continue and get worse. Many of the very large banks had shortcomings with even the largest of the German banks being told that they need to raise additional funds. While the banks have several months to cover their shortfalls, the impact of the ongoing crisis is continuing to take a major psychological toll on the European banking system. In other news that has the potential to causing issues in the global markets this week, Italy is supposed to

have a week of strikes across the country as people take to the streets to protest Prime Minister Mario Monti's latest austerity package of 33 billion Euros. While the strikes are supposed to be orderly with different labor unions taking off at different times, it is easy to see how this could get out of hand. These types of austerity measures are likely to continue in many more countries than just Italy and Greece as countries such as Spain and Belgium will have to adjust the way they have run their governments in the past as well.

**National News:** National news last week was headlined by the political stalemate that seems to be taking place in Washington DC on an almost weekly basis. Last week the political football was the payroll tax cuts that are set to expire at the end of the year. Both sides of the aisle are claiming that they have the interest of the American people in mind and yet when both sides fight and get nothing done, the American people are sure to lose, as the payroll tax expiring would amount to an increase of money being taken out of workers' paychecks of approximately two percent. Right now the Democratic plan calls for an increase in the payroll tax cut from 2 percent up to 3.1 percent. While Republicans are looking for roughly the same figures, how they are paid for and the items that are being thrown into the debate are making the situation a real mess. An extension of long term unemployment benefits is a major sticking point between the two parties, as is adding the Keystone oil pipeline from Canada down to the Gulf of Mexico to the bill; something that President Obama has said he will veto. The situation is continuing to heat up in Washington DC as President Obama has signaled that he wants Congress to stay in session until a deal is reached and that they are not to go home for the holidays without passing a bill. President Obama is also canceling a Hawaiian vacation that he had planned in favor of staying in Washington DC to help along the negotiations.

While the political debate was raging last week there was also some interesting testimony taking place in Washington DC: the former MF Global CEO Jon Corzine was testifying before a Senate hearing looking into the collapse of his firm and the mysterious disappearance of about \$1.2 billion in client assets. While he maintains that he has no idea what happened to the money and he is just as upset as everyone else that it is missing, he made little attempt at admitting any wrongdoing on his part in anything at the firm. During the testimony, some light was shed on just how involved he was in the firm's trading operations and that he acted on his own against the advice of other executives and members of the board in his bets made on Europe. In the end, he did not do much for making himself look like a good guy and probably did damage his reputation with the American public, as he is now seen as just another Wall Street CEO that was paid too much money and made very bad judgment calls.

**Market Statistics:** In what turned out to be a lack luster week for Wall Street, all three of the major US indexes did manage to increase in value. The best-performing index was the primarily Blue Chip Mega-cap Dow, which increased in value by 1.37 percent. The more broadly based S&P 500 experienced an increase of 0.88 percent and the technology-heavy NASDAQ brought up the rear with an increase of 0.76 percent. The best-performing sector of the markets was the US Home Construction sector, which increased 3.12 percent as there was continued positive news about the US housing market. The worst-performing equity sector last week was the top-performing sector two weeks ago, the Oil and Gas Exploration sector, which decreased by 1.02 percent. Fixed-income investments had a mixed week as the long end ETFs saw a decline of more than one percent while the shorter term ETFs saw a slight increase in value. Commodities moved lower last week, with the GSCI Commodity Index declining by 1.37 percent as oil declined by 1.54 percent, while the overall energy sector saw an increase of 0.22 percent. Gold finally moved as one would expect with the market moving high as it lost 2.01 percent in value last week. The other two heavily traded metals,

copper and silver, also had negative weeks with Silver declining 1.01 percent and Copper sliding 0.67 percent. With the plan being announced in Europe with very few details of how it will actually work, the US dollar did not see much movement at all over the course of last week against a basket of international currencies. On the international investing front, Mexico had the index with the best performance with the main Mexican Index increasing by 1.91 percent. India was home to the worst performing index, with the Bombay based SENSEX Index experiencing a decline of 3.76 percent. The VIX had a pretty uneventful week, declining by 4.14 percent. The VIX (green line) briefly broke back into the recent trading range (red lines), but on Friday broke back down through the recent support level as depicted in the chart below:



For the trading week ending on 12/9/2011, 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	-0.18 %	-10.80 %	-11.50 %
Growth Model	-0.06 %	-9.09 %	-7.75 %
Moderate Model	0.12 %	-6.52 %	-2.51 %
Income Model	0.11 %	-3.87 %	(Insufficient Data)
S&P 500 (benchmark)	0.88 %	-0.19 %	-14.52 %
S&P 500 with Dividends	0.92 %	1.73 %	-6.90 %

We made a few changes to our models over the course of last week, but sold the new positions at the end of the week in light of the uncertainty surrounding Europe. In light of the recent market volatility I am looking at utilizing individual stock holdings going forward. Some of the criteria that I am using while looking for stocks include: low debt levels, strong and consistent earnings growth, consistent dividend payments and low volatility relative to the S&P 500. So far the list of stocks I am looking at is a "boring" list of names (consumer staple companies and utilities primarily) which

are exactly what you want to be invested in during these exciting (volatile) times in the market. More information about the stocks will be forthcoming as we get closer to implementing the new strategy. 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:**

<u>Economic Impact</u>	<u>Release</u>	<u>Economic News Release</u>	<u>Date Range</u>	<u>Actual</u>	<u>Expectation</u>
Neutral	12/5/2011	Factory Orders	October 2011	-0.40%	-0.40%
Slightly Negative	12/5/2011	ISM Services	November 2011	52	53.4
Positive	12/7/2011	Consumer Credit	October 2011	\$7.6B	\$7.0B
Very Positive	12/8/2011	Initial Claims	Previous Week	381,000	395,000
Positive	12/8/2011	Continuing Claims	Previous Week	3,583,000	3,700,000
Positive	12/9/2011	U of Mich Sentiment	December 2011 (Estimate)	67.7	65.1

Data for table from Econoday.com and Yahoo Finance

Last week was slow for economic news releases but it was a positive week for several indicators as they continued to signal a strengthening US economy. The week started off on Monday with the release of factory orders for the month of October, which came in at market expectations and therefore had very little overall impact on the markets. Later on Monday, the ISM Services index was released and it did not continue with the trend of two weeks ago when the overall ISM Index beat market expectations; instead the ISM Services Index missed market forecasts by a slight amount. On Wednesday, December 7<sup>th</sup>, consumer credit for the month of October was released and showed a better-than-expected reading as banks continue to lend to qualified borrowers. This release was positive because it indicates both that US consumers want to borrow money and that banks are willing to lend, something that the Federal Reserve has been attempting to increase for many months. On Thursday, the standard weekly jobs-related figures were released and much to everyone’s surprise initial jobless claims were shown to be 381,000, beating market expectations by 14,000. This was a very positive release as employment remains one of the key concerns in the US economy as we move into 2012. Continuing jobless claims also beat market expectations, but did so by a smaller percentage than initial jobless claims and were therefore overshadowed a bit. Initial jobless claims have been hovering around the 400,000 mark for several months now and this is the first print below 385,000 in a long time. The rate still needs to be lower to signal a strong economy. Most economists agree that 400,000 is the key level to keep the unemployment rate from ticking upward, but they also agree that 350,000 is the key level on the initial jobless claims rate to actually move the unemployment rate meaningfully lower. Only time will tell if the initial jobless rate will stay at these low levels in the future, but this is a good first step. Wrapping up the week on Friday, December 9<sup>th</sup>, the first estimate of the University of Michigan Consumer Sentiment index for the month of December was released and beat market expectations but did so by only a small amount, leading to little reaction from the market.

This week is a typical week for economic news releases, with a number of them having the potential to move the markets. The week starts off on Tuesday with the release of retail sales for the month of November, which is going to be watched very closely. Initial indications are that Black Friday and the ensuing weekend of sales saw very strong retail sales, which means that this release could see a

much better than expected reading. The market is expecting something around 0.6 percent but we could easily jump up to the one percent range. Later in on Tuesday, business inventories are set to be released for the month of October with expectations of a 0.9 percent increase over September's level; it would take something very different than expectations for this release to overshadow the retail sales figure. Wrapping up the day on Tuesday is the release of the FOMC rate decision, which in a sense has already been announced since the Fed has said that they will be keeping interest rates at their current levels until mid 2013. On Wednesday December 14<sup>th</sup> Import and export prices are set to be released with expectations that prices have remained pretty flat during the month, indicating that inflation is not currently an issue for the US economy. On Thursday, the standard weekly jobs-related figures are set to be released, and they will be watched very closely to see if the initial jobless claims figure can stay at such a low level. Currently the market expectation is for both initial and continuing claims to have increased slightly over the course of the previous week. Released at the same time as the jobs figures, is the Producer Price Index (PPI) for the month of November, with expectations of very little change over the price level seen in October. Later on Thursday, the Empire Manufacturing Index for the month of November is set to be released with expectations that it will show a slight increase of 3.0 up from the previous reading of 0.61 percent. The zero line is the crucial level at which an economy is either contracting or expanding, so this reading being above zero is greatly needed for the economy to continue moving along in the correct direction. Wrapping up the day on Thursday is the Philadelphia Federal Reserve's Index for the month of December which will also be closely watched since it is expected to post a reading of 4.5 up from the November level of 3.6. On Friday the 16<sup>th</sup> the Consumer Price Index (CPI) for the month of November will be released with expectations that prices will show that they rose by 0.1 percent over the course of the month. Overall it could be an exciting week for economic news releases, as a number of them could move the market.

Have a great week,

Peter Johnson

*Feel Free to forward this e-mail*

Financially Speaking, Inc.

5889 Greenwood Plaza Blvd. Suite 400

Greenwood Village, CO 80111

T 303.290.0702

T 800.228.9876

F 303.290.6581

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