



Weekly Market Analysis September 19th, 2011

Market Wrap-Up: Last week was a very strong week for the US stock market indexes with the three indexes all turning in one of the best weeks of the year. However, the indexes remain stuck in the trading range that has been established since early August. Below is a daily chart of the S&P 500 (green line) with the current trading range (blue lines) clearly showing last week's move from the middle of the range to the upper edge of the range:



Last week's strong advance was based on speculation that Greece would not default on its debts because of a variety of plans that are being drawn up by various committees in different countries in Europe. The leading factor in the rally last week was an announcement by several of the central banks from around the world that they would back the Europeans with US dollars should they need increased liquidity. Also French President Sarkozy and German Chancellor Merkel announced that they felt that Greece should remain a member of the Euro zone (an indication that they do not want to kick them out). As time passes the situation is quickly coming to a turning point, as is evidenced by US Treasury Secretary Tim Geithner attending a meeting of European Finance ministers and actually making a statement while there. While his visit is not unprecedented, it is very unusual and shows just how much of a problem the US believes the situation in Europe could be for the global economy. The entire developed world has an interest in the outcome of the crisis and some pundits are even saying that if Greece were to default, the global economy would enter a period of time much more devastating than what followed the Lehman Brothers collapse. Our current thinking is that the situation will probably get worse before it gets better but the major issues will be temporarily kicked down the road. While a Greek default is likely to happen, in the coming months

it looks like a short term fix will be put in place. As for the US markets, it would take a lot of positive news for the major indexes to break out of their current trading ranges, which has not happened. With the uncertainty surrounding the super committee, the upcoming election, Federal Reserve Action and the health of our overall economy; we are likely to see the market continue to wonder aimlessly in a sideways direction for the foreseeable future. With the market moving sideways and the potential for a large downward movement, we remain invested predominantly in cash along with very low volatility income-bearing fixed income instruments.

International Politics: International politics once again focused on the situation unfolding in Europe, though during the course of the last week there was more positive news about possible ways to save Greece from default than negative, so the markets all moved higher. The European situation is still very fluid with no certainty that anything concrete has been agreed and things that have been agreed to in principal may not be able to be implemented. Currently the most pressing issue is whether Greece has implemented enough of the austerity measures so that they can continue to receive funds from the ECB, IMF and other Euro zone countries. Greece is up for a cash injection of about \$11 billion on October 4th. If they receive this, it would enable them to pay their bills for a few more months. The problem is, not everyone agrees that Greece is making enough changes to make them eligible for the payment. If they do not receive the payment they will likely quickly move into default and touch off what could be a very hard time for financial institutions around the world, as the fallout of Greek debt hits the balance sheets of the world's largest financial institutions. The main concern in the Euro zone, should a default occur, is the domino effect and what role a default by a lesser European country may have on some of the larger countries—Italy and Spain in particular. If there is a contagion effect in the Euro zone stemming from a default, the markets are going to be in for a bit of a wild ride as investors weigh the very real potential of the Euro declining sharply and possibly even disappearing as a currency. China made headlines last week as they, too, weighed in on the situation in Europe, offering to step in with a cash infusion of their own to “help” the situation. The money came with a few conditions, the most important being that China will give the money with the contingency that China be recognized by the World Trade Organization as a full market economy. China being recognized as a full market economy is not supposed to take place until 2016 and would provide China with all of the trade benefits of being a full member. This is just the latest example showing that China is very much out for themselves and will do a wide variety of things that are in its best interest while at the same time trying to look like the white knight of global finance. At first glance, there are enough European countries that will staunchly oppose the cash infusion from China in exchange for the recognition that the plan will probably go largely unconsidered.

National Politics: National politics were abuzz last week after President Obama delivered the American Jobs Act to Congress for immediate approval and implementation. As expected, his plan is pretty much a non-starter on Capitol Hill with many member of congress having major problems with various aspects of the bill. One of the main sticking points is going to be the funding of the bill, which will rely on increases in government revenues in the form of increased taxes on the wealthiest Americans; which is being dubbed the “Buffett Tax” by news pundits. It earned this name because of Warren Buffett's very outspoken stance on US taxes and the injustice he sees in his secretary paying a higher effective tax rate on her income than he pays on his. This lower tax rate for wealthy Americans is achieved through a variety of tax loopholes, which is the basis of the tax increase (closing the loopholes). While the current proposal is for families that make more than \$250,000 per year to pay more in the form of taxes, it is highly unlikely that House Republicans will go along with any changes that would amount to a tax increase for any of their constituents.

Another aspect of the changes being suggested is the closing of yet more loopholes, this time in the corporate tax code, so that companies based in the US and companies doing business in the US pay their fair share of the taxes which are owed. This plan again flies in the face of what Republicans staunchly believe in and will probably not get passed through the House. In the end, all of the proposals are about increasing revenues to the government so that they can, in turn, spend more on trying to create jobs and getting more Americans out of the unemployment lines and back to work. Both sides in Congress would like to see this outcome achieved, but the differences in how to get it done are likely to cause gridlock in the Capitol so that very little is actually passed and implemented. Gridlock is something that people in Washington DC are certainly getting used to, just look at the super committee and the work they have done so far.

The super committee, which was formed as a compromise in the debt ceiling debate, brings together 12 members of Congress in the hopes that they will be able to devise a plan to come up with \$1.5 trillion in deficit reduction measures. After taking the summer recess to work amongst themselves, both sides came together over the past few weeks to see if they have anything that they agree on. So far the news has been grim coming out of the committee as it looks like they will be unable to get the necessary measures in place by the deadline of November 23rd. Should the committee not come to an agreement, there are a set of automatic cuts that will be implemented on the debt ceiling bill that has already been signed into law. One of the provisions of the cuts is that they cut both defense and non defense programs equally. Last week US Defense Secretary Leon Panetta testified before congress that should the automatic cuts be implemented (\$1 trillion over the next 10 years), the effects would be very bad for the US economy as a whole. He mentioned that there would have to be a round of layoffs that would amount to adding a full one percent to the already high unemployment rate of 9.1 percent, in addition to the size of the US military being diminished. The resulting spending cuts by the department of defense would have a large impact on defense contractors such as Boeing, Northrop Grumman and Lockheed Martin; all of which have seen their stock prices move lower on uncertainty about future government contracts. As aspects of plans being devised emerge, the stock market in the US is going to jump on every word and in many cases react with large movements either up or down. In the end, this is only going to add additional volatility to a very volatile time and help very few investors.

Market Statistics: Last week saw one of the strongest moves of the year on a weekly gain basis as all three of the major US averages moved from the middle of the recent trading range up to the top of the range. The best-performing index last week in the US was the technology heavy NASDAQ, which advanced by 6.25 percent. The second best performing index of the three major US indexes was the broadly based S&P 500, which advanced by 5.35 percent. Bringing up the rear was the primarily large cap blue chip Dow, which experienced an increase of 4.70 percent during the week. The best-performing sector of the markets last week was the technology related semiconductor sector, which advanced by 9.50 percent. The worst-performing sector of the markets was the global real estate sector, which advanced by 0.46 percent. Fixed-income markets had a poor week last week with many of the fixed-income US government bond ETFs declining, thanks in large part to investors jumping back into the Euro on the hopes that the situation has been fixed and Greece will not be defaulting. Commodities moved lower for the second week in a row as global demand for the industrially used commodities was seen as further deteriorating as the global economy slows. Oil was the sole commodity that increased over the course of last week, gaining 0.83 percent. Leading the move lower in the other commodities was Silver, which declined by 2.79 percent and Gold, which slid 2.58 percent. Copper moved lower by 1.79 percent while overall the commodity related index fell by 0.60 percent. The US dollar fell by 0.78 percent for the week against a basket of

international currencies as investors continue to have a hard time trying to figure out which currencies are going to come out on top with all of the turmoil. The top performing index on the international investing front was found in Germany's Frankfurt Index, which advanced 7.39 percent on hopes that the German banks would not be hit hard by Greek debt (since they assume that a default will not happen). Globally, the worst-performing index was in Hong Kong, with the Hang Seng Index declining by 2.07 percent. After advancing by almost 14 percent two weeks ago, last week the VIX gave up all of the upward movement and then some, falling by 19.57 percent. Last week's move represents the largest single week move down by the VIX so far this year, but even taking into account the movement we are still at a very elevated level. In looking at the chart of the VIX (green line) below and the current resistance level (red line), you can easily see that we are at the low end of the recent trading range but we are not meaningfully lower.



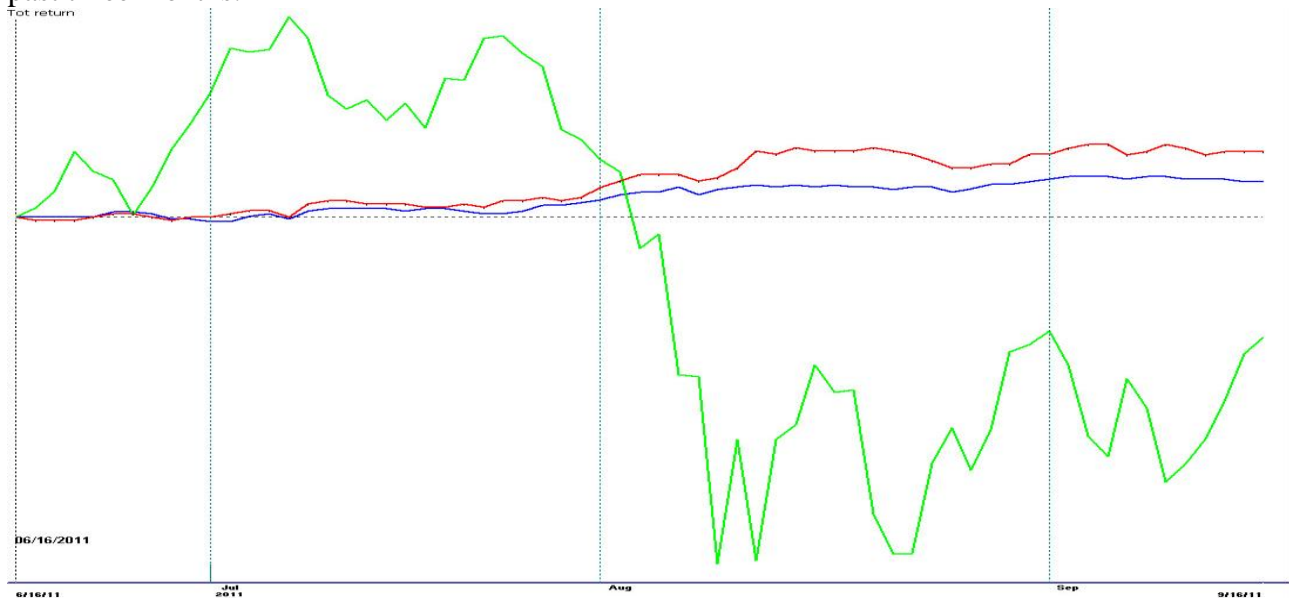
If the VIX continues to move lower then we would say that a trend may be forming and that it broke through its previous level of resistance. If on the other hand the VIX moves back upward last week's move will be seen as nothing more than bouncing around in a trading range.

Performance: For the trading week ending on 9/16/11, returns in FSI's models were as follows:

	<u>Last Week</u>	<u>YTD</u>	<u>Since 12/31/07</u>
Aggressive Model	-0.06 %	-7.49 %	-8.21 %
Growth Model	-0.06 %	-6.87 %	-5.50 %
Moderate Model	-0.06 %	-5.46 %	-1.40 %
Income Model	-0.07 %	-3.40 %	(Insufficient Data)
S&P 500 (benchmark)	5.35 %	-3.31 %	-17.19 %

We made two changes to our models over the course of last week, but remain invested in cash and investments that do not have much volatility at all. Our new holdings in our models include ING GNMA Income Fund (LEXNX) and Victory Fund for Income (IPFIX). Both of the new funds were found because of their extremely low volatility during the recent turbulent times and the income which they throw off on a monthly basis, the current distribution yield of IPFIX is 5.40 percent while the yield of LEXNX 3.7 percent. Both of the funds invest in GNMA certificates (mortgage backed securities) which are backed by the US government and provide rates of return that are higher than other low risk fixed income instruments. Below is a chart of the performance of the two

mutual funds (LEXNX red line, IPFIX Blue line) compared to the S&P 500 (Green line) over the past three months:



Additionally, the two mutual funds that were purchased are tradable funds, meaning there is no penalty for us to trade out of them should the funds break from their recent trends and start to move lower. Both of the funds were purchased on the load-waived platform, therefore no sales charge or commissions were incurred through the purchases. If you have any questions please feel free to give our office a call and we would be happy to walk you through more information about our exciting two new funds.

Economic News: Last week there were several key economic news releases that were weaker than first expected, but the market rallied higher ignoring the warning signs on the hopes of a Greek debt solution. The week started off on Tuesday with the release of both Export and Import prices for the month of August which were higher than the market was expecting, but not high enough to cause alarm. On Wednesday, September 14th, the Producer Price Index (PPI) and the Core PPI for the month of August were released with both figures coming in one tenth of a percent below market expectations, but still at zero or above. This PPI reading is a good indication that prices, at least at the producer level, are not experiencing any upward push from inflation. This is mostly due to falling commodities prices. Later in the day, on Wednesday, the retail sales figure for the month of August was released and came in weaker than expected, showing no growth in retail sales during the month. This release is an early warning that the consumer is losing confidence in the economic recovery and showing that mood by a lack of using their wallets. Poor readings on retail sales typically have a negative impact on the overall stock market but the release on Wednesday seemed to be largely ignored, as the market's focus was much more on Greece. On Thursday, the standard weekly jobs related figures were released with both missing market expectations as unemployment remains stubbornly elevated. Initial jobless claims came in at 428,000 while continuing jobless claims came in at 3,726,000; unemployment is something that needs to be brought down and quickly, as it is one of main indicators that everyday Americans watch as a sign of how the US economy is doing. The government is currently coming up with all sorts of plans and gimmicks that try to get companies to hire new employees, but in the end companies are not going to hire more employees if they do not need the extra workforce to get the job done. Later in the day, on Thursday, the Consumer Price Index (CPI) figures for the month of August were released and

indicated an unexpected increase with the CPI reading being double what was expected while the core CPI came in as expected. Continued increases in the CPI would lead to increased prices at the consumer level and therefore fewer purchases. It could also have a large impact on the overall economy so the Federal Reserve, in particular, will be watching the CPI in the coming months very closely. At the same time as the CPI release on Thursday, the Empire Manufacturing Index for the month of September was announced and it came in well below expectations. The market had been looking for a reading of -4, indicating a contraction, but a contraction that was less than the one in August when the index was at -7.7. Instead of a slower contraction the September reading came in at -8.8, indicating that manufacturing the greater New York region is contracting and doing so quickly. Much like the Empire Manufacturing Index, the Philadelphia Fed Index which was released at the end of the day on Thursday also showed a worse than expected contraction in the region (-17.5 versus expectations of -10.0). Both of these releases should be taken as warning signs that the manufacturing sector is expecting a slowdown later this year and they are adjusting production now to account for the coming change. Wrapping up the week on Friday was the release of the University of Michigan Consumer Sentiment index for the month of September, which came in better than expected (57.8 versus expectations of 56.3) but failed to provide the markets with much of a boost. The latest reading from the University of Michigan Consumer Sentiment index seems to be at odds with all of the other data about the US consumer, but if the reading turns out to be correct we may just be seeing a case of consumers being confident in words (poll questions) and not in actions (spending money).

This week is a slow week for economic news, which is a good thing because there will probably be a number of key developments out of Greece. This week starts off on Monday with the release of the NAHB housing Market Index for the month of September, which is not expected to show any change from the August level. On Tuesday, the 20th, more housing related figures are set to be released with the release of Housing starts and building permits for the month of August, both of which are expected to show a slight decline compared to July levels. If there is going to be a surprise on these two releases it will likely be to the downside, with the blame being put on the natural disasters that hit the US late in the month. Wrapping up the day on Tuesday is the release of the FOMC rate decision from their meeting. This should be a non-market moving event since we have already been told that rates will stay very low for an extended period of time (through mid 2013). On Thursday, the standard weekly jobs related figures are released and as is typical, both of the figures are expected to be better than they were last week, but much like last week these two releases have the potential to disappoint to the downside. Wrapping up the week on Thursday is the release of the leading indicators as compiled by the Conference Board. While this release rarely has much of an impact on the market since all of the figures used to calculate it have been previously released, the release will give a good overall reading of how our economy is currently doing. Much like last week, this week will likely be driven by events unfolding in Europe and not by anything that is either done in Washington DC or released as economic news releases.

Have a great week,

Peter Johnson

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