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Registered Investment Advisor

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"Investors who have longer time horizons need to ignore the volatility and concentrate on investing for when they need the money ..."

Perspectives

The US economy is in a low growth phase with a lot of uncertainty. Investors are unsure of what is to come over the next few months (if not years) out of Europe, Asia and also from within the US. This tends to lead to a stagnant market without a lot of upside potential or downside risk. The difference between now and what was the typical market behavior is the increasingly strong influence of programmed high frequency trading. Price swings are quicker and bigger with trading that is run by computer models instead of human decision making. These large price movements come from orders that are triggered when certain prices are met, typically based on technical analysis. Each order pushes stocks further in the direction they were already moving which triggers more orders in larger quantities. These trades are triggered over fractions of seconds and are the reason the markets move in such extremes lately. After a slew of selling finishes its cycle, the number of trades diminishes and value investors have the opportunity to buy the stocks they believe were caught in the broad based selling unfairly. New buy orders are triggered as the buying of undervalued stocks pulls indexes higher and the cycle continues in the other direction.

These large price swings can run through a full cycle in a matter of hours, days or sometimes weeks and appears to have no rhyme or reason to those who value stocks on fundamentals alone. Investors who have longer time horizons need to ignore the volatility and concentrate on investing for when they need the money they are investing, not when the next headline is due. Prices may dip lower before they go much higher, but investing for the long term at today's valuations offers less risk than at most other periods in history. The price to earnings ratio (P/E) for the S&P 500's trailing 12 months of earnings was 15.20 recently compared to 16.28 a year ago while the index is up only slightly. This means as companies have grown their earnings, their stock prices have not benefited. Based on forward earnings estimates, the S&P 500 has a P/E ratio of 12.95. This leaves room for either 15-20% upside in the S&P 500 or a 15% earnings miss for S&P 500 companies if the P/E ratio is to be the same a year from now.

The likely outcome will be a result somewhere in the middle. Interest rates are at record lows so corporations can borrow money cheaply which will continue to prop up earnings for the foreseeable future. The euro has fallen to a two year low which has strengthened the dollar and helped to push oil prices lower (along with weakening energy demand worldwide). Lower oil prices gives consumers more discretionary income. This increase in discretionary income creates a stronger consumer who will spend more and support companies within the S&P 500. Were it not for the feared fiscal cliff at the beginning of 2013 and the ongoing worries out of Europe, stocks would likely overshoot the 15-20% upside range. However, with such uncertainty overshadowing Wall Street, investors are more likely to let the P/E ratio contract a little further while companies build up their cash stock piles even more.

Trading volume has been consistently low for most of this year as institutional traders take smaller positions outside of their programmed trading models. Retail investors are waiting out the uncertainty and continue to move more heavily into bonds, even with the risks of a severe bond correction looming. At some point the hoards of cash will come off the sidelines and out of bonds and shift back into stocks. This is a cycle that repeats with regularity. The catalyst is unlikely to come from earnings season starting next week, but could see a quick change if a third round of quantitative easing (QE3) is announced this fall. The likelihood of such an announcement increased with the disappointing employment report released on Friday. With an election at hand in only a few months, politicians will be ready to push forward on more stimulus if they believe it will help them get reelected.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average TR	7/6/2012	4.54	1.16	15.34	-1.26
NASDAQ Composite PR	7/6/2012	12.75	3.65	18.01	1.95
Russell 2000 TR	7/6/2012	9.73	-3.09	19.35	0.31
S&P 500	7/6/2012	8.96	3.43	17.08	-0.25
S&P MidCap 400	7/6/2012	8.57	-4.00	20.74	2.20
Global Stock Indexes					
Developed World (Ex-US)	7/5/2012	4.04	-13.83	8.51	-5.06
Emerging Markets	7/5/2012	4.79	-17.59	9.39	0.42
Bond Indexes					
Core Bond	7/5/2012	2.89	8.10	6.76	7.28
Intermediate Core Bond	7/5/2012	2.85	6.63	6.35	7.34
Long-Term Core Bond	7/5/2012	5.58	20.34	12.87	11.01
Short-Term Core Bond	7/5/2012	0.97	1.70	2.84	4.24

Market Movers

- Spain formally requested 100 billion euros to recapitalize its banks.
- Ahead of Greece's election, the world's major economic monetary authorities said they would keep the banking system liquid with a flood of cash. This planned stability eased contagion fears and allowed for a bounce in stocks.
- The Fed lowered real GDP growth expectations for 2012 down a half percentage point to 1.9% to 2.4% and raised unemployment forecasts 0.2% to a range from 8.0%-8.2%. The announcement reinforced the theory held by many investors that the economy's growth rate is slowing substantially.
- China cut interest rates for the second time in a month, the Bank of England expanded its asset purchase program and the European Central Bank (ECB) cut rates by 0.25%. These efforts came in attempts to avoid further economic slowing. All of the moves were expected by traders.
- The selloff in the euro subsided in June (which helped US stocks have a better than average June), but renewed pressure emerged when ECB President Draghi lowered growth outlook.
- The FOMC announced it would extend "Operation Twist" through the end of 2012. This was a smaller form of fiscal stimulus than many traders hoped for and markets sold off on the news.
- UK regulators announced an investigation is underway of Barclays for manipulation for Libor, the London Interbank Offered Rate, which is used as the average interest rate banks lend to each other. Mortgage lenders and credit card issuers set their rates using Libor also.

Fundamentals & Indicators

- Producer price data came in mixed. Overall producer prices declined during May by 1.0%, which is steeper than the 0.7% decline that had been anticipated, but core producer prices experienced an in-line increase of 0.2%.
- Housing starts hit an annualized rate of 708,000 units during May, below expectations for an annual rate closer to 719,000. However, April figures were revised upward to reflect an annual rate of 744,000 housing starts.
- Building permits rose April's upwardly revised rate of 723,000 to 780,000 for May. That is much better than the pace of 725,000 building permits that had been expected.
- Existing home sales set an annualized rate of 4.55 million units during May. The pace for May is down from the April rate of 4.62 million units.

- The Philadelphia Fed Survey fell to -16.6 for June. That comes after a reading of -5.8 for May. Economists had expected that the survey would improve to a near flat reading for June.
- Leading Indicators for May increased by 0.3%, which is better than the flat reading economists forecasted to follow the 0.1% decline in April.
- The latest Housing Price Index from the FHFA for April increased by 0.8%, which follows a 1.8% increase in March.
- New home sales in May hit an annualized rate of 369,000, which is up from April's unrevised rate of 343,000, and better than the rate of 350,000 that had anticipated.
- The latest Case-Shiller 20-city Index topped forecasts with a drop of just 1.9% when analysts had forecast a 2.5% decline.
- Durable goods orders numbers rose. Overall orders increased in May by 1.1%, which is more than double the 0.5% increase predicted, but orders less transportation increased only 0.4% when a 0.7% increase was anticipated.
- Pending home sales for May spiked by 5.9%, which is far better than the 0.5% reading that had been expected. The jump also makes for a positive turn from the 5.5% drop in April.
- The third estimate of first quarter GDP showed growth of 1.9%, just as in earlier readings. However, the first quarter GDP Deflator was revised higher in the third estimate to reflect a 2.0% increase while economists were looking for it to stay steady at an increase of 1.7%.
- Personal income improved in May by 0.2%, which is slightly greater than an expected increase of 0.1%. Personal spending stayed flat, instead of increasing by 0.1% as anticipated. Core personal consumption expenditures were up 0.1% month over month. They had been generally expected to increase by 0.2%. In the short term, traders would like to see an increase in spending, but the economy will be in better shape longer term if income grows faster than spending.
- The June Chicago PMI reading of 52.9 was close to expectations and stronger than the May reading of 52.7.
- The June ISM Index disappointed investors with a reading of 49.7 vs. earlier calls for 52.2, down from May's 53.5 reading.
- May Construction Spending rose 0.9% month over month when a 0.2% improvement was anticipated.
- May Factory Orders increased by 0.7%, which was better than the +0.4% consensus. This was a big improvement over April's data that disappointed investors by turning negative.
- China's non-manufacturing PMI came in at a 3-month high of 56.7 for June compared to 55.2 in May. This improvement eases worries surrounding the speed of China's economic slowdown, at least temporarily.
- The June ISM services index came in at 52.1, which is slightly below the 53.0 consensus and below May's reading of 53.7. This was the lowest reading since January 2010. Readings above 50.0 indicate expansion.
- The US added only 80,000 jobs in June, well below what the Street's estimates closer to 100,000. The labor participation rate remained steady which kept the unemployment rate at 8.2%.
- The two positive signals from the employment report came from the average workweek which rose in June by 0.1 hour to 34.5 and from the average hourly earnings number which increased 6 cents to $23.50.
- The U6 rate which includes discouraged jobseekers and those working part-time because they cannot find full-time positions rose to 14.9%, well up from its low of 14.5% in February.

Index Chart & Analysis

This S&P 500 ($SPX) chart shows the past six months of daily prices after the index finished the week at 1,354.68 on Friday, July 6, 2012. Resistance at the trend line of lower highs proved too much for the large cap index this past week as the rally in stocks was halted after surging higher from the lows two weeks earlier. The move lower kept the SPX within its descending trading channel with more room to the downside than the upside. However, the same trading channel might not last too much longer. The 10, 20 and 50 day moving averages (dma) are lined up in a bullish formation. The 10 dma is above the 20 dma and the 20 dma is crossing above the 50 dma. These patterns indicate momentum that favors the bulls.

The descending trend line in the middle shows a line that has wavered between support and resistance multiple times over the past four months. This line could act as support again now that it has converged with the 20 and 50 dma. Just below this mark, and ascending quickly, the shortest trend line that marks the line of higher lows could offer support for another quick bounce higher. If this ascending trend line does not hold support, the S&P 500 could move closer to its trend line of lower lows, 3% below Friday's closing level. This is where another trend line of higher lows (excluding the early June bottom) has a strong opportunity to stop further declines.

The Williams %R indicator moved lower for the 14 day period, but the 28 day period has not broken below the overbought range and therefore has not issued a sell signal yet. The fact that the 56 day period did not make it into the overbought area should limit the length of the move lower. Indexes rarely have larger than 5% sell offs without having more substantial overbuying seen in the 56 day period. This makes the current chart appear to have limited downside, assuming 1,315 holds support. The upside potential is limited until the SPX moves above 1,375.

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