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"The question on every investor's mind is if this time is different."

Perspectives

Timing is everything. The annual "sell in May and go away" phenomenon happened to surface at the same time as uncertainty of the Greece's financial stability increased again, bond yields rose throughout the European periphery and the US economy showed a slow down in multiple indicators. The culmination of so many negative inputs at a time when investors are seasonally nervous created an easy climate for a correction to take place in May. At the S&P 500's intraday low on Friday, the large cap index was down more than 10% (the definition of a "correction") from its April 2nd intraday high. The bulk of the decline (6.3%) came during May.

Timing the markets will be important again after Greece's July 17th the election results are finalized. If the pro-austerity party wins, the S&P 500 should have a strong rally as uncertainty is removed and falls in favor of stability. If the anti-austerity party wins, the S&P 500 could fall another 10% from current levels as stability is removed and the probability of a Greek exit (aka "Grexit") from the euro increases substantially. Many traders expect a strong policy response to be put into place after the initial panic. This would push stocks above first quarter 2012 levels, possibly as much as 25% higher as perceived stability returns, bond prices drop and high inflation takes over the euro-zone.

Both scenarios point to higher prices for US stocks, but with the risk of much downside movement before new highs can be found. Some of the downside has already played out as traders removed risk in anticipation of the worst possible outcome. The selloff in stocks has taken valuation levels for the S&P 500 below 13 times the trailing 12 months of earnings and less than 12 times forward looking earnings. This is considerably lower than historical norms and far below levels that tend to precede a bear market (defined by a 20% drop in prices).

The question on every investor's mind is if this time is different. Do the macro-economic circumstances warrant an even lower multiple due to the likely decrease in corporations' earnings power if Greece tumbles and brings Spain and others with it? Spain could be where the real trouble is for Europe and then the US economy. Cautious investors have kept an eye on the rising yields on Spanish debt. With the interest rates rising in Spain, their government is getting closer to reaching a point where they cannot make payments during the country's recession. In addition, Bankia, Spain's third largest lender, is in dire need of a bailout that Spain cannot afford without help from the European Central Bank (ECB). While Greece has been a loud distraction during the world's economic recovery, a Spanish dept default would be deafening and would be hard to heal from as quickly as Greece's first default was dismissed.

Credit Suisse puts the odds of a Grexit at 20%, but JP Morgan (JPM) gives Greece a 50% chance of leaving the euro. At the same time, JPM considers the chance of contagion to Spain and Italy to be less than 10%. However, traders have sold stocks and bought bonds as if a Mediterranean meltdown was imminent. If such a dire chain of events does not unfold, those who sought safety in bonds will be punished with one of the worst bond price declines in history as prices have a reversion to the norm. 10 year treasury yields dropped to a record low of 1.44% before recovering slightly. With the benchmark yield close to 1.5%, investors are not able to keep up with inflation and have an unreasonable downside risk. The risk does not equal the potential reward for bonds and these imbalances do not exist for long in free markets. At some point, traders will decide bonds are not helping them reach their financial goals and the selling will begin. This change in sentiment will send cash back towards stocks and the cycle will continue.

The inflection point for this change in sentiment could be brought on by the weakening US economic picture. That

might be counterintuitive, but the weaker the US economy gets, the higher the probability of further Fed action is. Inflation comes with any additional quantitative easing. An exodus from bonds and into stocks to maintain gains in real (inflation adjusted) dollars follows increases in inflation. It's not just the weakening US fundamentals that could lead to the Fed stepping in again. One of the biggest risks to the US economy is deflation. If the Fed was to err on one side over the other it would prefer to create too much inflation rather than any deflation. Commodity prices fall as the dollar strengthens. Cheaper oil and gas is good for creating more disposable income for consumers, but lower commodity costs also result in lower prices for goods which equal lower incomes for workers in the supply chain. Meeting payments on debt, such as home and college loans, becomes increasingly difficult for employees who make less than they used to. Defaults on debt lead to further economic weakness and the spiral lower continues. This is why the Fed will not allow deflation. Instead, they will take the opposite path (inflation) that leads to higher incomes and an improved ability to pay down debt and spend extra money on discretionary items which in turn boosts the economy as a whole.

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	6/1/2012	0.39	1.36	14.68	0.38
NASDAQ Composite PR	6/1/2012	5.46	-0.78	14.53	1.00
Russell 2000 TR	6/1/2012	0.07	-8.91	13.74	-1.52
S&P 500	6/1/2012	2.57	-0.61	13.00	-1.49
S&P MidCap 400	6/1/2012	2.54	-6.76	16.20	0.94
Global Stock Indexes					
Developed World (Ex-US)	5/31/2012	-2.74	-19.71	5.34	-6.03
Emerging Markets	5/31/2012	-1.21	-21.10	6.99	0.84
Bond Indexes					
Core Bond	5/31/2012	4.28	7.61	10.50	7.34
Intermediate Core Bond	5/31/2012	4.83	5.68	9.93	7.64
Long-Term Core Bond	5/31/2012	5.17	12.33	14.78	9.40
Short-Term Core Bond	5/31/2012	2.49	2.22	5.10	4.48

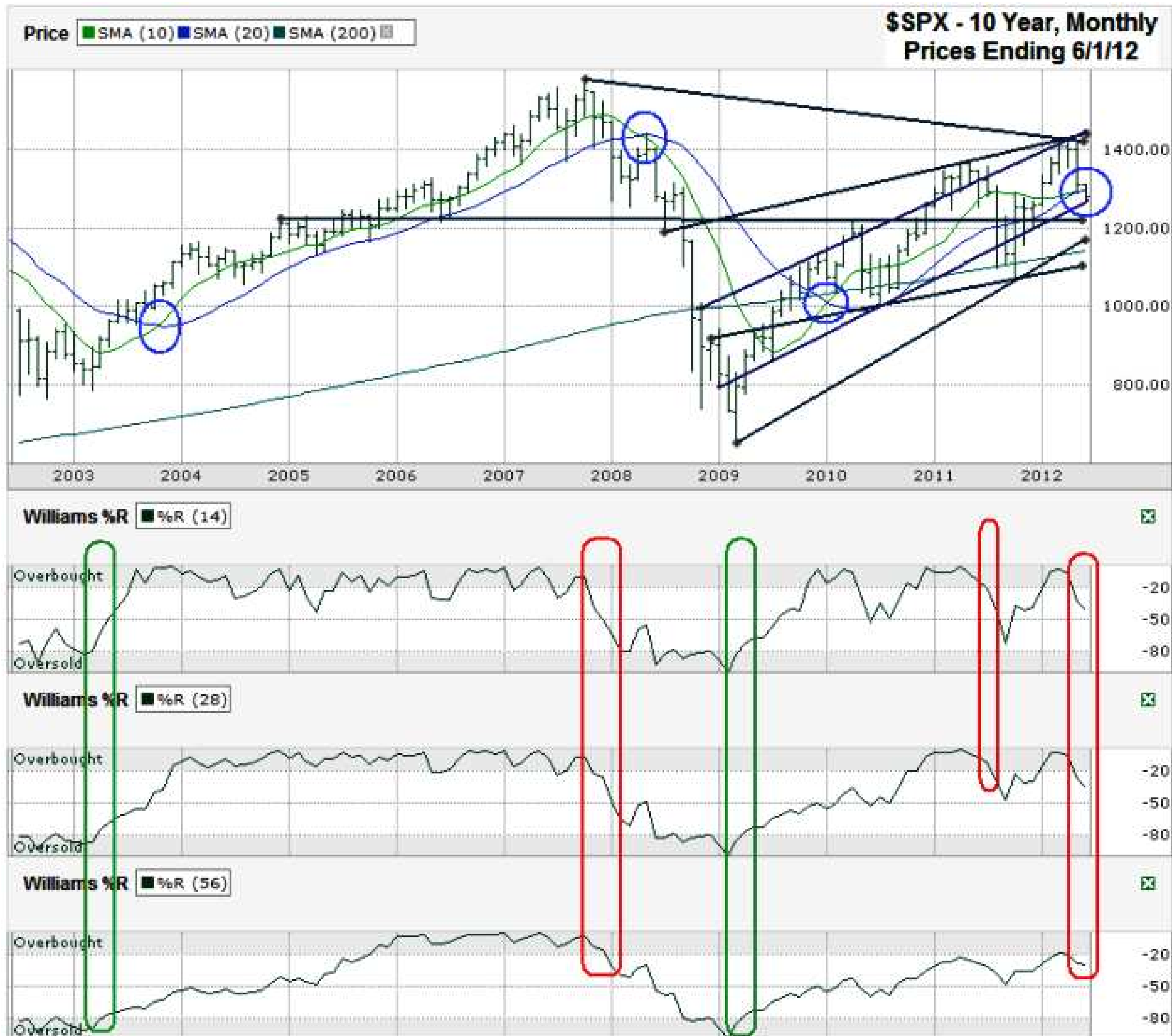
Market Movers

- JP Morgan (JPM) admitted to losing $2 billion on a hedge. This brought down the entire financial sector since the mistake was made by one the banks many consider to be the best at managing risk and increased the calls for more banking regulation. Since the initial announcement, rumors surfaced that the loss could grow to as much as $5 billion while JPM tries to unwind the position.
- Greece's exit from the euro is feared to happen earlier than many anticipated. The uncertainty of another debt default caused many traders to sell in advance of any announcement and well ahead of June's Greek election.
- As the euro weakened, the US dollar strengthened and the inverse relationship between the dollar and US stocks resumed its trading pattern of the past few years. Stocks were able to rally briefly once the euro found support at 1.25, but resumed the fall as soon as the EU's currency decline broke below 1.25 for the first time in more than two years.
- Disappointing Flash Manufacturing readings from France, Germany, and the broader eurozone proved disappointing. China also reported a disappointing Manufacturing PMI reading.

Fundamentals & Indicators

- Retail sales increased during April by 0.1%. This was below the 0.2% increase that had been expected. Sales less autos also increased by 0.1%, below the 0.2% forecast.
- The Consumer Price Index (CPI) for April was flat from the prior month, just as expected. Core consumer prices increased by 0.2%, which was in line with the consensus.
- The Empire State Manufacturing Index improved in May to 17.1 from 6.6 in April, better than the 8.4 reading many economists anticipated.
- Monthly housing starts hit an annualized rate of 717,000 in April. That exceeds the rate of 680,000 units that had been expected. This is above the upwardly revised rate of 699,000 units that were recorded for March.
- Building permits registered an annualized rate of 715,000, which is slightly less than the anticipated rate of 730,000.
- Existing home sales for April hit an annualized rate of 4.62 million, which is slightly less than the rate of 4.65 million that had been forecast.
- Durable goods orders for long-lasting goods edged up 0.2% in April, the second rise in three months after demand for cars and car parts increased, but orders less transportation items declined by 0.6%. Both of these data points were below earlier predictions.
- The HSBC flash PMI for China's manufacturing sector dropped to 48.7 in May from 49.3 in April showing further slowing in China.
- New home sales numbers for April hit an annualized rate of 343,000, which is up from the March rate of 332,000, and a little better than the rate of 339,000 that was expected.
- U.S. home prices were unchanged in March, according to the S&P/Case-Shiller 20-city composite index. Over the past 12 months, prices have fallen 2.6% as measured by the Case-Shiller index, which is now at a post-recession low and reinforces the idea that housing is bottoming.
- Pending home sales numbers for April were down 5.5% month over month, when economists were looking for a 0.6% increase.
- First quarter GDP was revised lower to an increase of 1.9% from a 2.2% increase initially. Economists expected the revision to drop to 2.0%.
- The Chicago Institute for Supply Management (ISM) business barometer declined to 52.7 from 56.2 in April, less than earlier calls for a gain to 56.5. As with other recent indicators, this still shows growth, but at a slower pace than investors want to see.
- China's Purchasing Managers' Index fell to 50.4 from 53.3 in April showing a steep decline in manufacturing activity. A reading above 50 still shows expansion, but momentum has slowed considerably.
- Britain's May PMI fell to a three year low and shows an economy in contraction at 45.9, down from 50.2. Economists had forecast a reading of 49.9.
- Weekly jobless claims reversed their trend in May and moved higher with the most recent report coming in at 383,000 when Wall Street was looking for 368,000.
- The consensus call for US payrolls in May was 165,000, but only 69,000 jobs were added. This helped to push the unemployment rate from 8.1% to 8.2%. As the single bright spot in the month's dismal report, the number of people counted in the workforce increased which is a change from the past few months' exodus.
- In addition to the lower than anticipated payroll numbers, the total counts for March and April were revised lower.
- The average workweek fell 0.1 hour to 34.4 in May and average hourly earnings rose 2 cents to $23.41.
- The U6 rate, which includes discouraged workers and those who are forced to work part-time, increased to 14.8%. This was the first increase in three months for the rate many consider to be the true unemployment rate.
- Personal spending increased in April by 0.3%. Personal income increased in April by 0.2%.
- Core personal consumption expenditures increased by 0.1% during April.
- The ISM Manufacturing Index decreased to 53.5 in May from 54.8 in April. Early expectations were for a reading of 54.0.
- Construction spending increased during April by 0.3%, but that is less than the 0.5% increase that had been forecasted.

Index Chart & Analysis



This S&P 500 ($SPX) chart shows the past 10 years of Monthly prices after the index finished the week at 1,278.04 on Friday, June 1, 2012. The recent SPX correction moved the index into the middle of its ascending trading channel where it found support at a trend line that has worked as support multiple times in the past few years. This trend line is far from flawless and might not be the best indicator to trust after last summer's breakdown. A more likely opportunity for support could come from a 50% retracement of the 25% rally that started in October 2011. At 1,244, the 50% retracement level is only a percent or two above previous areas of resistance. Resistance often becomes support (and vice versa). This is marked by the horizontal line that started at the end of 2004.

The bears will turn to other indicators to point out what favors their gloomy predictions. The 10 and 20 month moving averages have been excellent forecasters of what is to come. On the previous three crossovers during the past decade (and the two from the prior 10 years not shown here), each occurrence foreshadowed multi-month trends. The bulls rule the markets when the 10 month line moves above the 20 month line and the reverse is true

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for the bears' opportunity to take control. The 10 month moving average is converging with the 20 month moving average as May ends and June begins. If stocks rally soon then the full crossover will be avoided. If not, this indicator will favor the bears.

The Williams %R indicator tends to send out its signals of long term sentiment shifts prior to each of these crossover events and is more dependable when longer time period breaks coincide with the 14 month indicator. Although the 56 month indicator failed to make the move completely into the overbought portion, it has fallen away from overbought along with the 14 and 28 month periods. This does not bode well for the bulls, but as 2011 proved, these sentiment shifts can play out over just a few months.

Caution should be the plan for most investors this summer. The rally that follows this correction (and possible bear market) will be sharp when momentum shifts back in favor of the bulls. Shorting the market at this point is extremely dangerous. It might take a macro-economic event as a catalyst for change or it could be a touch on the 200 month moving average, which happens to be close to the bottom of the ascending trading channel mentioned above. Whatever the trigger, stocks will turn higher and those with a long enough time horizon will be rewarded.

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