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Registered Investment Advisor

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Perspectives

Investors' have the job of managing risk and reward. That's it. They ask repeatedly, is this the time to be invested in stocks or is it time to move more heavily into bonds or even cash? Some of the risks investors have been watching recently include the slowdown in China, the recession in Europe, the employment picture in the US, the housing slump in the US and corporate earnings growth flattening. As each risk was reduced or eliminated, stocks moved higher. This is the cycle of a bull market in its simplest form – fading risks equal an expanding market multiple.

This process of risk monitoring and discounting has been helping stocks ascend since their low in March 2009. This stage of ascension is commonly referred to as "climbing a wall of worry". Eventually, stocks become fully valued with the fears of downside risk pushed aside. After stocks reach the reasonable value level, prices tend to overshoot as previously cautious investors begin to forget that risks tend to resurface. Greed takes over as worry subsides and the fear of missing more gains takes over.

Stocks reached this reasonable value level by mid-September according to many economists. The next stage could have been euphoria and a surge ahead in prices, but a new cause for worry surfaced. When the Fed announced they would not begin to taper their massive bond-buying program in September, the first reaction for traders was to push stocks higher since the full stimulus program would remain in place. Within a couple of days, traders reasoned the decision not to taper was partially due to the fact that the economy was not ready yet. The consensus quickly changed from a "risk-on" to "risk-off" stance and a consolidation phase began.

Once sentiment changed and the bulls backed away from their buying frenzy, traders' fears of the latest Washington D.C. standoff became the center of attention. The majority of traders expect the government shutdown to be temporary and have little effect on the economy's direction. However, the situation creates little reason to buy until politicians can reach an agreement. The longer politicians dawdle over a resolution, the more stocks are prone to lose ground in the short-term. Longer-term investors will use any weakness as a buying opportunity to catch oversold stocks at a discount.

The government shutdown does have risks. Thousands of workers are without income, which will lead to reduced spending. In all likelihood, these government employees will receive salaries in arrears once politicians reach an agreement. Patient investors understand this temporary setback will be reversed and will not flee from stocks until a bigger risk comes to the forefront.

The trigger for selling en masse could come sooner than later. The dispute over the debt ceiling will be catastrophic if the US does not pay the bills it has already incurred. The chances are low that the US would default, but the risk is worth noting, because the repercussions would be severe. Interest rates on US Treasuries would soar and take mortgage rates with them. A spike in rates would cripple the housing market and cause a ripple effect throughout the US economy and beyond.

In hindsight, it's easy to see that the Fed took the correct position by continuing its easy money policy. As Fed Chairman Bernanke said months ago, the decision will be "data dependent" and the mixed data has not shown the economy is ready to ride without training wheels, especially with Washington at a standstill. Bernanke's outlook could change quickly once politicians get past the current month's issues, but his action will have to be quick before the next fight begins.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	10/4/2013	17.23	13.98	14.94	10.94
NASDAQ Composite	10/4/2013	26.10	20.90	17.55	14.35
Russell 2000	10/4/2013	28.23	29.48	18.85	13.33
S&P 500	10/4/2013	20.47	18.27	16.62	11.45
S&P MidCap 400	10/4/2013	24.39	27.94	18.14	15.44
Global Stock Indexes					
MSCI Emerging Markets	10/4/2013	-4.48	0.24	-2.60	6.33
MSCI World, Excluding US	10/4/2013	14.53	19.83	7.95	6.38
Bond Indexes					
Core Bond	10/3/2013	-1.57	-1.49	3.06	5.38
Intermediate Core Bond	10/3/2013	-0.54	-0.52	3.31	5.37
Long-Term Core Bond	10/3/2013	-6.32	-6.17	4.57	8.59
Short-Term Core Bond	10/3/2013	0.44	0.56	1.38	2.93

Market Movers

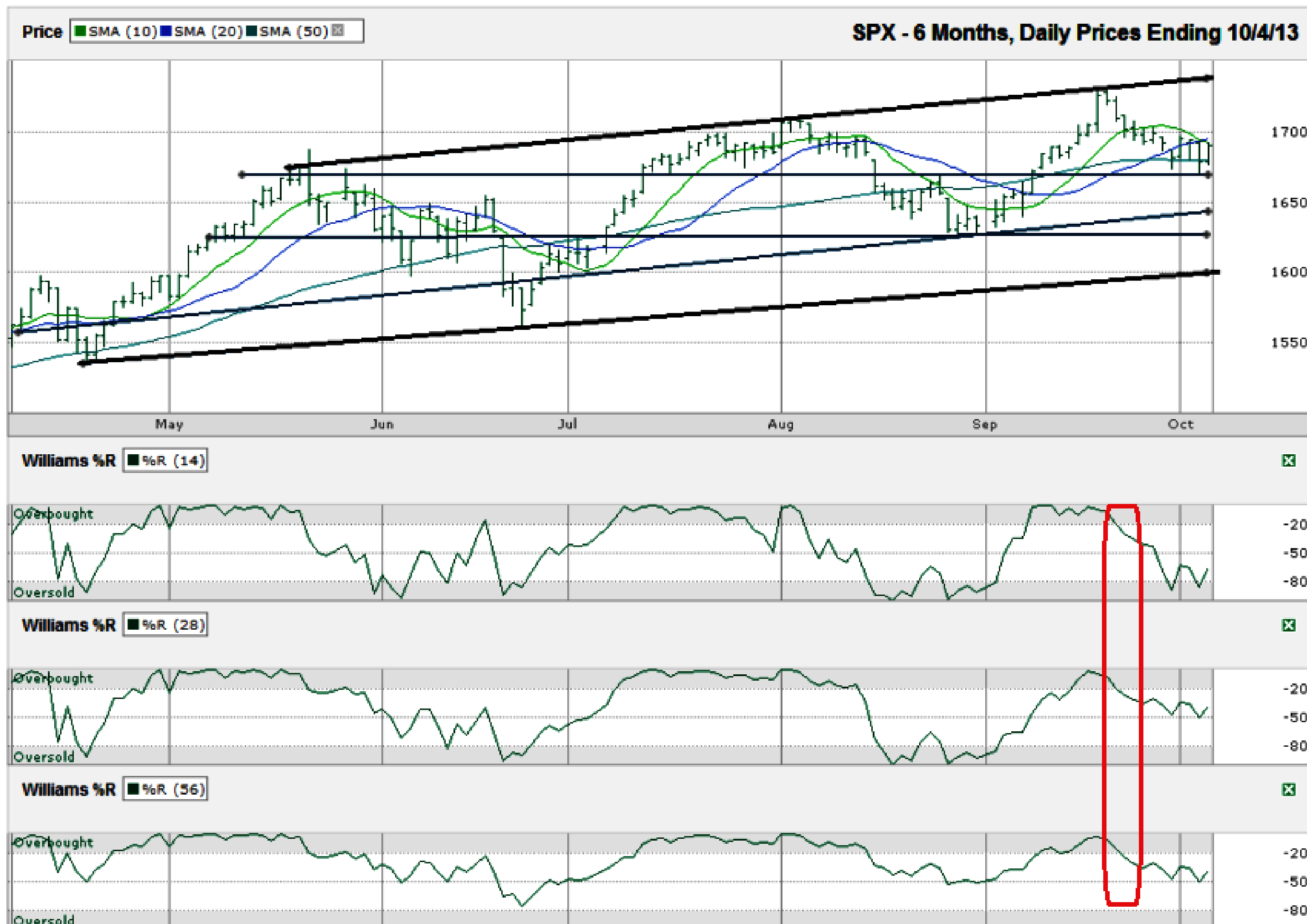
- China's HSBC Manufacturing PMI moved from a contraction at 47.7 in July to expansion at 50.1 in August and again in September with a reading of 50.2. The reversal in China's economy removed a lot of worry from investors who feared the bubble had begun to bust.
- In mid-August, Atlanta Fed President Lockhard hinted that the Fed might not begin tapering in September due to the lack of data.
- On September 18, Fed Chairman, Ben Bernanke, announced the Fed would delay tapering its bond-buying program. Stocks rallied initially based on the idea that "easy money" would keep stocks from falling far. After traders heard Bernanke's testimony and read his prepared statement, stocks lost ground when his concerns (low job growth and the upcoming fiscal cliff debate) hit home.
- The Eurozone Composite PMI hit a 27-month high of 52.2 in September, its third straight month above 50. The data indicate the Eurozone economy continues to improve.

Fundamentals & Indicators

- The Producer Prices Index remains weak with the past three months' results showing an increase in June of 0.8% followed by a flat July and a 0.3% increase in August. The tame production prices showed inflation was in check and allowed the Fed to keep its stimulus in place.
- Retail sales have been mediocre and are unlikely to improve much until personal income improves. The reports from June through August were positive (0.6%, 0.4%, and 0.2%), but not outstanding.
- The Consumer Price Index (CPI) echoed the PPI reports showing tame inflation over the past few months. June rose 0.5% and then the index slowed further with increases of 0.2% and 0.1% in July and August respectfully.
- The Empire Manufacturing Survey has been positive recently, but shows a weakening trend. The July reading of 9.46 was followed by 8.2 in August and 6.3 in September.
- The July NAHB Housing Market Index added another bullish indicator with a rise from 52 at the end of Q2 to 56 in July and 58 in both August and September.
- Housing starts showed the same upward trend with growth from an annualized rate of 846,000 in June to 896,000 in July and then flattened at 891,000 in August.
- Building permits have not shown the same bullish trend as housing starts. The data from the summer months was below the spring reports. June, July and August averaged 930,000 after running as high as 1,005,000 in April.
- Existing home sales started the quarter slower than expected with an annualized rate of 5.06 million units. However, July and August both beat expectations with rates of 5.39 and 5.48 million units respectfully.
- New home sales had a rough July report that included a downward revision to the June number from 497,000 to 455,000. The report also showed the largest percentage drop since May 2010 to 390,000. Sales rebounded in August to 421,000 to reverse the slide. New home sales tend to move with changes in interest rates. When rates began to rise, sales spiked in June as buyers locked in lower rates. The higher June sales were simply pulled forward from July. The August recovery shows buyers are getting more comfortable with the higher rates, which are still historically low.
- Pending home sales saw three consecutive months of declines. June fell 0.4% while July fell 1.3% and August fell 1.6%. While declining sales are never a bullish sign, each month was better than forecast, which shows the economy wasn't as bad as feared.
- Some of the most bullish housing data came from the Case-Shiller 20-City Home Price Index. Each of the last three readings beat already high expectations. May rose 12.2%, June rose 12.1% and July improved 12.4%.
- The Philadelphia Fed Index (a survey of regional manufacturing conditions) added more positive news as each report beat consensus estimates. July hit 19.8, August came in at 9.3 and September spiked to 22.3.
- Durable goods orders slowed over the past few reports. After a stronger than anticipated June reading that showed an increase by 4.2%, July stumbled as orders fell 8.1%. August orders grew by 0.1%.
- The Chicago PMI has shown a strengthening trend with a rise from the July reading of 52.3 to the August 53.0 and September 55.7 readings.
- The ISM Manufacturing Index has shown increasingly strong expansion recently with reports trending higher from 55.4 in July to 55.7 in August and 56.2 in September. An improving manufacturing index is bullish sign for the economy.
- Construction spending reports confirmed the economy is improving, albeit at a slow pace. May spending increased 2.0%, followed by a flat June and a 0.6% increase in July.
- The ISM Services Index maintained its readings of expansion (above 50). In July, the index reported 56.0, followed by a very strong August reading of 58.6 (the highest since December 2005) and a lower, but still expanding, September reading of 54.4.
- Gross Domestic Product (GDP) estimates are revised monthly. The advance second quarter GDP estimate showed growth of 1.7% and was revised higher in the second estimate to 2.5%. 2.5% was confirmed in the third estimate. The second quarter GDP was an improvement over the 1.1% first quarter GDP.
- Factory orders slowed through the past three reports. May started strong with a 3.0% increase, but then slowed to a 1.6% increase in June and a 2.4% decline in July.

Please see Index Fundamentals & Indicators on page 5

Index Chart & Analysis



The chart above shows the daily prices for the past six months on the S&P 500 index ($SPX) after the index closed at 1,690.50 on Friday, October 4, 2013. The S&P 500 is in an interesting position as the government shutdown enters its second calendar week. Friday's close left the large cap index in the upper half of its six-month ascending trading channel. This view, taken alone, leaves more room for stocks to move lower than higher, but one indicator never tells the full story.

The 10-day simple moving average (sma) broke support nearly two weeks ago and has acted as resistance since then. The 20-sma broke support at the beginning of last week and has added further resistance to any recovery attempts. By the end of the week, the two lines formed a bearish crossover with the 10-sma falling below the 20-sma. During this past week of consolidation, the SPX fell below its 50-sma twice, but managed to close above the longer moving average both days. While the 50-sma has not held strong support over the past six months, traders continue to view the line as a key indicator for future movement. Stocks have further to fall if the 10/20 bearish crossover holds true to previous accurate forecasts. This descent will not happen until the 50-sma gives up support.

A horizontal line, around 1670, marks previous support and resistance just below the 50-sma. This line, coupled with the 50-sma, will be a crucial stand for the bulls. If it breaks support, the S&P 500 could lose another 20-40 points very quickly. The next line of support could surface at the middle trend line of higher lows that excludes some of the extreme low points. This ascending line is close to the horizontal line that marks the August low. This area, a retest of previous weakness, has a higher probability of stopping a sell-off. If it fails, the next opportunity for the bulls to make a stand is the uninterrupted trend line of higher lows that moved up to the 1,600 line this past week. Traders will be looking for a key reversal at this point, before a true bear market forms. Stocks will have fallen 7.5%

from their September highs and the 200-sma (not shown) will have caught up to the index to offer further support.

In most cases, the Williams %R indicator offers a clear forecast of what is to come. The recent slide was marked by a break in the indicator below the overbought area and traders were given a clear signal to exit aggressively bullish trades. The bullish reversal might not be as easy to see forming this time. The 14-day indicator reached oversold and reversed, issuing a buy signal, but the 28 and 56-day indicators only made it half of the way to a clear bottom. The mixed signals make any reversal less obvious, but do not rule out the chances that the index is beginning its path back towards its trend line of higher highs, approaching 1,800.

Continued from Fundamentals and Indicators from page 3

- The unemployment rate dropped to 7.4% in July, the lowest level since December 2008, but the data wasn't positive outside of the headline number. More people dropped out of the labor force and only 104,000 new jobs (initially reported as 162,000) were added. Average hourly wages fell 2 cents and the new job totals from the previous two months were revised lower.
- The unemployment rate fell to 7.3% in August, but the overall report was not positive. 169,000 new jobs were added, which was below the 177,000 expected. The real disappointment came from a reduction of 74,000 in revisions to June and July figures.
- Due to the government shutdown, the latest employment numbers from September were not released on Friday. In place of the data from the Bureau of Labor Statistics (BLS), investors looked to the ADP National Employment Report that registered 166,000 new jobs in the private sector. The ADP report rarely matches the BLS data, but investors used this report to assume the BLS numbers would remain flat also.
- Weekly initial jobless claims made a steady decline through the third quarter. This decline in claims pushed the four-week moving average down to 305,000, the lowest since September 2007.

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