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Registered Investment Advisor

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"Fear was the market mover for all of July, save one week."

Perspectives

July saw a perfect storm brewing. The debt ceiling talks drew focus to how feeble the US economy is and created a general malaise over the markets while the fear of the unknown worked itself out. Many traders believed the decline in stock prices would revert higher once politicians reached an agreement. Technicians saw evidence of that with the crawl lower for the S&P 500 (SPX) and Dow Jones Industrials (DJIA) to rest almost exactly on their 200 day moving averages the day before the deal was reached. The trouble for stocks was politicians could not agree on a compromise and went the route of trying to fix/patch the debt issue through spending cuts alone and no increase in revenues. Traders saw this as bad for companies' future earnings potential and began selling en masse, but that was just the warm up.

Meanwhile, various economic indicators started showing the signs of an economic recovery that is running out of steam. The end of the Federal Reserve's second round of quantitative easing (QE2) in June combined with spending cuts on the horizon caused stocks to fall below their 200 day moving averages. With the debt ceiling debate in the books, the European Union (EU) troubles came back to the top of the headlines. This time Italy took charge as the leading troublemaker. Italy's economy is teetering and the fear of contagion to other nations sank the markets. By the end of this past week, Jean-Claude Trichet, President of the European Central Bank gave a news conference that increased fears for investors on the stability of the EU. The euro sank and the dollar increased in value. As mentioned in this space the past two months, a looming potential negative for the US economy and stock market was a strengthening dollar. If the dollar continues to strengthen US stocks will feel the pain as the dollar and stocks continue to have an inverse relationship.

Treasuries reacted to all of this data by climbing in price and thus reducing yields. The US 2-year yield reached an all time low. 10 year yields are at historic lows. This bond rally shows the fears of a pending recession. Stocks showed the same uncontrollable fear as the S&P 500 and Dow Jones Industrial Average both moved into negative territory for the year-to-date. The slide in stocks has been so fast and mostly on speculation of what *could* come to fruition that equities could get a fast short covering rally on any good news from the current oversold levels. The unknown is what news has a chance of turning positive in the near term to launch such a reaction.

One of the reasons for the quick drop in stock prices is the technical break down in stocks' charts. Computer programs are set to sell when certain technical criteria are met. Those criteria were being met each day last week which triggered further selling. That means selling causes more selling. For every point lower in stock prices the calls for QE3 are starting to grow louder and the chances of a second half rebound look less likely. Stocks are cheap based on previous earnings, but fear of what's to come has today's prices down.

On a positive note, the feared economic slow down and drop in demand has oil plunging. This is good for the economy as it essentially acts a tax break. Those who still have jobs and commute will pay less to get to and from work. Companies that ship goods (i.e., any business outside of the service industry) will have lower input costs.

Does all of this doom and gloom mean stocks are heading off a cliff back to March 2009 levels (or lower)? It's possible, but not likely. US banks are not insolvent now like they were then. Many large companies are flush with cash. On the

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other hand, European Union (EU) banks might be getting more pressure than they can handle soon and without demand from EU customers US companies could take a hit too.

Mid-day Friday news surfaced that the European Central Bank is planning to provide support to Spanish and Italian bonds if these countries commit to specific reforms. This brought the bulls back into the market and lifted stocks more than 3% from their intraday lows. This shows how fickle the bears are and leads credence to the idea that a worthwhile solution could pull the market out of their depths.

75% of companies reporting earnings have beat expectations while nine percent met expectations. This helps the bulls, but the same companies lack visibility for future earnings due to so many macroeconomic factors up in the air which keeps the bulls from running away with another rally too easily. Couple this with the downgrade of US debt after the market close and investors have a worthwhile reason to be cautious. The downgrade will not likely cause much lasting trouble for the markets. This was an expected downgrade and US Treasuries are still trading at historical highs. This shows the little respect rating agencies have now. It does offer a fair warning to politicians though. It's time they get their acts together and reach fair compromises that actually help the economy and the US debt situation for the long term.

Things might not be as bad as the past two weeks' decline felt. The jobs picture is improving and the S&P 500 index is only down 3.5% for the year. It trades for close to 12 times projected 2011 profits. This is one of the lowest P/E ratios in decades. The Dow Jones Industrial Average's P/E is even lower at 11.6. The Dow's dividend yield of 2.62% is better than the 2.56% yield on the 10-year Treasury note. This rarely happens and further emphasizes the value available in the some stocks right now. That is, assuming these earnings estimates will stay accurate. For now, this fear of a 2008 repeat and the lack of visibility will keep this P/E ratio's multiple at historic lows.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
Domestic Stock Indexes					
DJ Industrial Average	8/5/11	-5.73	0.27	10.01	2.45
NASDAQ Composite	8/5/11	-8.13	-4.54	10.44	2.53
Russell 2000	8/5/11	-10.32	-8.2	10.41	1.12
S&P 500	8/5/11	-7.15	-3.56	8.66	-0.06
S&P MidCap 400	8/5/11	-10.43	-6.2	10.71	3.34
Bond Indexes					
Core Bond	8/5/11	1.59	5.22	5.29	7.51
Intermediate Core Bond	8/5/11	0.73	4.62	4.6	7.75
Long-Term Core Bond	8/5/11	2.51	9.5	8.96	10.89
Short-Term Core Bond	8/5/11	0.41	2.15	2.56	4.13

Market Movers

Fear was the market mover for all of July, save one week. It started in the form of Greece's debt concerns, then the US debt ceiling debate and finally back to Italy for more contagion fears. A Barron's article from July 23rd read, "*Thursday's 109 billion-euro ($157 billion) aid package from the European Union and International Monetary Fund to a bankrupt Greece kicks the can so far down the road that markets can stop worrying about a potentially widening debt crisis emanating from that small nation any time soon.*" It was as if now that Greece's issues are hidden for a while the markets should be fine, but the fact that Greece isn't the only troubled nation only took days to become a reality. Italy quickly stole the headlines and rocked the markets with fear. Spain is waving their hands showing they don't want to be left out of the brouhaha. Any upcoming solution for Italy will have to include Spain's debt too.

Once the fear settles, the markets will have an excuse to rally again. Until then, the urge to sell will be hard to resist and markets will struggle to rebound.

Fundamentals & Indicators

- Producer prices fell 0.4% month over month, more than expected. Core producer prices increased 0.3% month over month, also more than expected.
- Retail sales during June increased by 0.1% month over month. That was better than the 0.2% decline that had been broadly expected. Sales less autos were flat, as expected. Early estimates for July's auto sales indicate an improvement.
- The Empire Manufacturing Survey (a reading on sentiment among manufacturers in New York) showed a reading of -3.8 for July. The consensus was for a slightly positive reading, but this was still better than the -7.8 was posted in June.
- Consumer price inflation (CPI) data showed overall CPI for June decreased by 0.2%, which is slightly lower than the 0.1% decrease that was expected. Core CPI increased by 0.3%, which is slightly higher than expected. This shows inflation is still in check and allows the Fed to continue with any plans of further monetary easing.
- Housing starts jumped 14.6% in June to a seasonally-adjusted annual rate of 629,000. This was better than the expected rate of 570,000 and the highest level since five months. In turn, the market rallied. A consistent pick-up in housing would mean a lot for the economy.
- Existing home sales for June came in at an annualized rate of 4.77 million units. This is less than the 4.93 million units that had been anticipated and was somewhat surprising considering housing starts increased by such a wide margin as reported just the day before.
- Pending home sales for June improved 2.4% month over month, beating the consensus for a 3.0% retreat.
- The S&P/Case-Shiller 20-city Composite Index showed home prices fell 4.5% in May. That is close to the expectations of a 4.4% decline and a 3.96% drop for April.
- Durable goods orders for June fell 2.1%, which is a bigger shortfall than the expected decrease of 0.1%. To make the miss even worse, May's orders were revised lower. Excluding transportation, durable goods orders increased by 0.1%. This was slightly better than the expectation and May's numbers were revised upward to help the picture even more.
- The Fed's latest Beige Book showed that economic activity continued to expand for the most part since the last report, but the pace has slowed in many districts. Consumer spending and manufacturing activity both continued to expand in the majority of the districts.
- The second quarter GDP report showed growth of 1.3%. This is weaker than the first quarter report of 1.9% growth. While GDP still shows growth, it is coming at a slower pace than expected and the Street reacted to this disappointment immediately with a turn even lower.
- Chicago PMI (Purchasing Managers Index) came in at 58.8, narrowly beating the 58.0 that was expected.
- The Institute for Supply Management's (ISM) Manufacturing Index in July fell to 50.9%, much lower than expectations and barely in expansion territory (50% is flat). This disappointment took away all of the positive momentum from the debt ceiling deal and was a catalyst to help sink the market for days.
- Personal income rose to a seasonally adjusted 0.1% in June, the smallest gain since last November.
- As income was rising spending slowed. Spending by consumers dropped 0.2% to mark the first decline in nearly two years. This is good for the long term as consumers have been spending more than they could afford, but it is bad for an economy that needs consumer spending to bring it out of its morass.
- July ISM Services Index fell to 52.7 from 53.3 in July. Economists were expecting an increase. While still expanding, the unexpected slowdown highlights the potential for a new recession to take hold in the US economy.
- Factory orders, they fell by 0.8%, which is slightly better than anticipated, but the decline still shows a weakening economy.
- Weekly initial jobless claims fell into the low 400,000 range in the first part of the month. By the end of the month they came in level with the important 400,000 level; signally possible economy improvements are coming soon.

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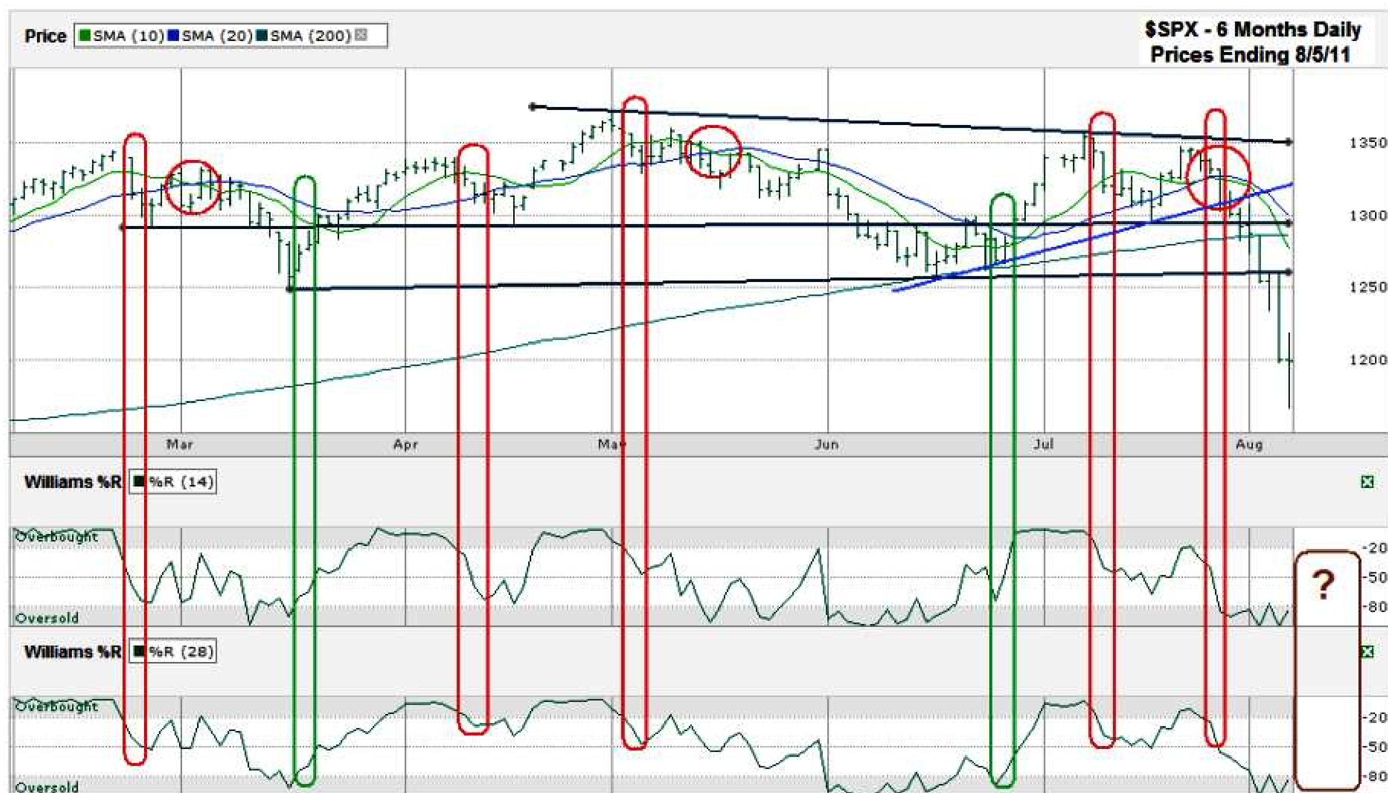
Index Chart & Analysis



This S&P 500 ($SPX) chart shows the past six months of daily prices after it finished the week at 1,199.38 on Friday, August 5, 2011. This past week was the most painful fall for bulls over such a short period since 2008, but a lot of that pain could've been avoided by traders who were paying attention to the technical indicators. The chart above shows each instance the Williams %R indicator broke down from overbought levels in red. The instances where this indicator broke above oversold are marked in green. The first breakdown came in the first half of July and should have been a signal to lighten exposure. Two weeks later, at the end of July, the second breakdown hit and traders would have been wise to head the second warning to exit.

If the Williams %R indicator was not enough to cause traders to sell and secure profits, the often accurate 10/20 day moving average bearish crossover issued another sell signal at the same time. These are two technical indicators that are often good at foreshadowing what is to come. Many traders held back though. The 200 day moving average was still holding support and the debt ceiling debate was close to coming to an end. Traders second guessed the charts and clung to hope that a resolution in the debt ceiling talks would trump the technicals indicators. Instead, the short trend line (in blue) of higher lows broke two days before Congress penned an agreement. This was the third indicator that begged traders to sell. Soon after, the 200 day moving average (one of the most important indicators for a wide group of technicians) gave in and massive selling ensued. The last hope for any remaining bulls was the longer trend line of support that slightly ascended just above the 1,250 line. A stampede to sell started after this line broke.

The next potential area of support was more than 50 points lower at 1,200. Bears were able to span these 50 points in one day on Thursday before the closing bell rang. By Friday, traders started getting margin calls and were forced to sell some of their better positions that had not failed yet. This caused another intraday nosedive, but finally value seekers couldn't hold back any longer and came to the bulls' rescue to snap up some of the perceived cheap stocks. What's not clear is if this is truly the end of the selling yet. The 1,200 line has already broken intraday which raises another red flag

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and creates the potential for one more test of Friday's 1,268 intraday low. This area also marks the low range for the dip in November 2010 and if it breaks could take the index 6% lower to the 1,100 line.

The question on every trader's mind is when to buy again. The charts haven't given an all clear sign yet. At the risk of not buying at the very bottom, which is not very important in the long run, bulls might be wise to wait for Williams %R to move back out of the oversold area and even give two confirmation days above it before buying in heavily. To play it even safer, nervous investors might want to wait for the 10 day moving average to pull back above the 20 day moving average. Waiting for these two should be enough to take some downside risk off the table, but just as the 200 day moving average was support on the way down, it could play out as resistance on the way back up. Any move higher is likely not to be as steep as the past two weeks' move lower which gives investors time to rebuild their positions without haste.

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- The US Nonfarm Payroll numbers came in better than expected showing a gain of 117,000 jobs in July.
- The unemployment rate fell to 9.1% from 9.2%
- Hourly earnings rose also which is another sign of recovery. June's payroll data was revised higher to 46,000 which added more credibility to the fact that the data is setting an improving trend. Even better, private hiring, which excludes government agencies, rose 154,000 in July. This shows the needed slow down in government spending and the improvement in private sector hiring. This better than expected data was crucial in stopping the mass sell-off in stocks last week as it drastically reduced the probability of a recession in the very near term.

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