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Registered Investment Advisor

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Perspectives

2011 finished the year almost as flat as it possibly could. The S&P 500 closed on the final day of 2011 .04 points below where it finished 2010. This made the year look very tame when only looking at the book ends. However, the path that brought stocks here through 12 months of ups and downs was not for the faint of heart and produced one of the most volatile years in history. According to Bloomberg, the S&P 500 "moved an average of 1.9 percent a day from May through the end of the year, compared with the 50-year average of 0.6 percent before the collapse of Lehman Brothers Holdings Inc. in 2008". This volatility shows no signs of abating until the European Union can stabilize itself. Such volatility does not mean stocks cannot have a strong year in 2012. Historically the markets tend to outperform their average annual returns during the 12 months after a flat year. This makes 2012 look promising, especially with unemployment improving and the housing sector on the verge of finding a bottom.

The correlation among stocks in the S&P 500 reached record levels in October and still remains much higher than its historical average. This means that stocks are moving together to new highs and new lows without regard to their sector or size. This herd mentality is rare and voids passive investors' ability to diversify properly in an effort to reduce risk. These excessive levels of volatility and price correlation will not last forever. A reversion to the mean will occur at some point. Until then, expect large intraday price swings within larger trading trends that only last weeks rather than months. Investors can reduce their downside risks by selling puts to buy stocks at reduced prices and sell covered calls to further reduce the costs per share at the end of such cycles.

The fears of a complete economic melt down in Europe ebb and flow in regular cycles. Listening for the change in tone is one way to avoid being on the wrong side of momentum while the bulls and bears alternate who is in charge. While the bulls are in charge the most frequent voices on TV and in print recall the improving US economic conditions and strong corporate fundamentals. When the bears resume the reigns the emphasis shifts to events outside of the US and how they will drag the US markets down when Europe can no longer delay the inevitable write-down of debt (and maybe Greece's withdrawal from the euro). The threat of a slowing Chinese economy comes to the surface when the European Union members make fiscal progress unexpectedly before a bear cycle is complete. Once the markets sell off again and negativity is built into the market sufficiently, the bulls come back. Bulls point out how much upside potential is available in stocks based on their valuations and how small the yields are on bonds.

2011 was a year of consolidation for stocks. Prices did not improve as a whole, but most corporate balance sheets did. This imbalance of improving economic conditions without stock prices rising often leads to a strong surge in stock prices as investors become numb to the fears of what might happen and return to focusing on the growth that is happening. The inverse relationship between stocks and the dollar's strength has highlighted the fears of what could be. As a sign of a change in sentiment over the past few weeks, stocks have risen along with the dollar's gains over the euro. This change in stocks' reaction to dollar strength could be the first signal that the mood is changing.

Bulls are not going to be allowed to run freely down Wall Street too easily. Bears can produce a counter argument for every piece of positive economic data that surfaces. Bulls were prepared to stampede when Friday's unemployment data beat expectations and helped to paint the picture for an improving economy. Bears were quick to respond that a large number of the jobs added came from seasonal employment and the employers are not expected to hold onto these workers into the 2012. In addition, the number of job seekers (the denominator in the unemployment rate percentage) fell again. This reduction in total participants skews the overall picture and might give a falsely upbeat outlook. Uncertainty will subside as each piece of data is unveiled in 2012. Stocks will have a clearer path to move higher. The road will not be straight higher and the lows of 2012 are likely still to be seen, but for the patient, better days are ahead. The first test of this begins in a few days with the first earnings calls of the season.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	1/6/2012	1.25	8.54	14.33	2.72
NASDAQ Composite	1/6/2012	2.65	-1.32	17.41	1.9
Russell 2000	1/6/2012	1.2	-3.99	14.93	0.69
S&P 500	1/6/2012	1.67	2.44	13.43	0.2
S&P MidCap 400	1/6/2012	1.42	-0.96	18.6	3.71
Global Stock Indexes					
Developed World (Ex-US)	1/5/2012	0.59	-10.11	9.07	-2.94
Emerging Markets	1/5/2012	1.77	-17.3	18.45	3.91
Bond Indexes					
Core Bond	1/5/2012	-0.31	8.41	6.34	6.6
Intermediate Core Bond	1/5/2012	-0.03	7.63	6.18	6.72
Long-Term Core Bond	1/5/2012	-1.25	18.2	10.57	9.1
Short-Term Core Bond	1/5/2012	0	2.53	3.33	4.3

Market Movers

- The Eurozone Central Bank floated rumors that it is planning to inject 1 trillion euros $1.27 trillion US dollars) for bond purchases.
- Reports surfaced that Italy introduced new austerity measures which will help sustain their debt payments.
- These two positive inputs were enough to move the markets higher for the final weeks of December out of the hopes that European leaders not only understood the severity of their situation, but were also beginning to act on it with the appropriate sized tools.
- Lower inflation numbers (sharp declines in both CPI and PPI for November) reported out of China will allow the country to maintain economic growth without having to tighten controls yet.

Fundamentals & Indicators

- Retail sales rose during November by 0.2%, which is less than the 0.6% analysts anticipated. Sales less autos also rose by 0.2% during November, but analysts were looking for a 0.5% increase.
- The Empire State Manufacturing Survey jumped to 9.5 in December from 0.6 in the prior month. The Street expected the survey to improve to just 3.0.
- Producer prices increased by 0.3% during November, when an increase of 0.1% had been targeted. Core producer prices for November only increased by 0.1%.
- November Consumer Price Index (CPI) showed no change in overall consumer prices and a 0.2% increase in core prices. Little to no increase in CPI is crucial for the Federal Reserve to keep interest rates low.
- The Philadelphia Fed Survey soared from 3.6 in November to 10.3 in December, more than double expectations.
- Housing starts rose from an annualized rate of 627,000 units in October to 685,000 units during November. Building permits climbed to a pace of 681,000 from October's rate of 644,000.
- Existing home sales for November hit an annualized rate of 4.42 million units, which is below the consensus estimate for a rate of 5.03 million units. This was still an improvement from the rate of 4.25 million units reported during October.
- New home sales numbers for November hit an annualized rate of 315,000 which was close to the consensus among economists.
- Pending home sales data for November showed a monthly increase of 7.3%, which is below the 10.4% increase recorded in October, but greater than the anticipated 0.6% increase.
- In a surprising announcement, The National Associate of Realtors released downward revisions to historic existing home sales data which showed sales numbers for 2007 through 2010 were revised downward by 14.3%. This does not change the outlook for the future as much as it highlights the lack of reliability of such reports.
- Economic output in the third quarter expanded by 1.8%, which is down from the 2.0% growth rate that was posted in the second estimate. Economists had expected no change to the third estimate headline number.
- Durable goods orders for November advanced 3.8%. Excluding transportation related items, durable goods orders improved by 0.3% which was in-line with earlier estimates. Durable orders less transportation for October were revised higher to show a 1.5% increase.
- Personal spending and personal income during November both expanded by 0.1%, which is more tepid than the anticipated 0.3% change in the two readings.
- The Consumer Confidence Index for December jumped to 64.5 from 56.0 in November and 39.8 in October. This shows consumers are worrying less about the economy and are more likely to spend more in the coming months.
- Chicago Purchasing Managers Index (PMI) for December slowed to 62.5 from 62.6 in the prior month, but was still better than expected.
- The ISM Manufacturing Index improved from 52.7 in November to 53.9 in December, better than targeted rate of 53.4.
- For two months in a row, the ISM Services Index failed to meet expectations. November came in at 52.0, below an expected 53.4 reading. December improved to 52.6, but slightly under estimates averaging 53.0. Staying above breakeven at 50.0 shows continued growth.
- Construction spending advanced by 1.2% during November after a downwardly revised 0.2% drop in October. This was better than the earlier calls for a reading of 0.5%.
- Factory orders for October fell 0.4% and then increased by 1.8% in November as the economy took another step forward.
- Employment reports favored the bulls again over the past month. The unemployment rate fell to 8.5%, below the consensus calls for 8.7%, as nonfarm payrolls expanded by 200,000 in December.
- Hourly earnings were up 0.2% to $23.24. Hours worked rose 0.1 hour to 34.0. These are both seen as bullish reports since employees increase spending as earnings improve and employers hire more workers as hours worked increases.
- The U6 rate, which includes part-time workers and those who recently stopped looking for work, fell to 15.2% in December from 15.6% in November. This is more often viewed as the real unemployment rate.
- Initial weekly jobless claims remained below the key 400,000 level throughout December and the first week of January. Having fewer layoffs offers an important psychological impact to workers who are likely to spend more without the threat of losing their jobs looming over them. This is a significant factor with 70% of the US GDP derived from consumer spending.

Index Chart & Analysis

This S&P 500 ($SPX) chart shows the past three months of daily prices after the index finished the week at 1,277.81 on Friday, January 6, 2012.

The S&P 500 is approaching resistance at its October 27th intraday high of 1,292.66 and volume will likely stay light until the large cap index can move past this key technical level. The bulls have the advantage going into this challenge based on several technical indicators. These indicators include a bullish chart pattern, bullish moving averages and momentum as seen through the Williams %R indicator.

SPX has two ascending triangles within this chart. The smaller one has a horizontal line around 1267 and an ascending trend line of higher lows that converged with it on Friday. Using this bullish pattern alone indicates a break out is due that should take the index another leg higher during the current rally. The larger ascending triangle started with the October 27th intraday high and has an ascending trend line of higher lows that is moving higher at a lower angle. These

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two lines still have weeks remaining before they converge. As happened with the smaller triangle, a period of consolidation is expected at the horizontal line. If the line of resistance breaks and stocks are allowed to move higher, then volume should surge above its average and stocks should leap higher.

The moving averages support this bullish outlook. The 200 day moving average (dma) has been a strong point of resistance for months. The index moved back and forth across this moving target during the last week of December and finally started to use the line as support rather than resistance. Technicians expect one more test of support on the line before the SPX can move higher freely. This retest could come at the same time the longer trend line of higher lows reaches the same point to offer further support. In addition to the 200 dma, the 20 dma had a bullish crossover above the 50 dma in the second half of December. By the end of December the 10 dma (not shown) moved above the 20 dma for further emphasis of the trend.

After the bears failed to push the S&P 500 to new lows after December 19th, the bulls regained momentum. Although volume did not accompany the move, Williams %R showed the clear momentum shift. Technically, stocks are currently shown as "overbought" in the Williams %R indicator. As history has shown, being overbought is not as important as when it stops being overbought (a move below -20). Indexes can stay elevated for weeks if not months. Waiting for the break in momentum is the time to sell, not while momentum is still bullish.

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