



Year End 2011 Outlook

The close of a record setting October proves to be a good time to reflect on the market action of the past three months and take a look at what the next final two months of 2011 may hold. The past three months have clearly offered the most volatility since the market bottomed in March 2009 mostly based off fears of debt issues in the U.S. and Europe and an ongoing concern over lack of economic growth or even a reentry into recession.

ECONOMY

The October ISM manufacturing survey offered little to clear up the foggy economic outlook. While there were no real signs of positive growth, there were also no signs of further deterioration. After several recent data points that suggest we are clearly not at risk for a recession, we believe the bottom line is that the economy will avoid a definitional recession while it remains weak enough to keep investors and policy makers nervous. This has the effect of creating jittery markets and increases day to day volatility.

We think recent economic data suggests a growth rate in the 4th quarter of approximately 2%. The bigger issue appears to be the ongoing concerns in Europe and the daily news updates adding to market concerns. The large drop in prices paid index suggests that producers are beginning to benefit from lower raw material costs which could yield margin improvement in future quarters. The U.S. Leading Economic Index rose 0.2% in September and has NEVER in its 52 year history hit a new recovery high if recession was to occur within the next 6 months.

Naturally, with all the gloom and doom in the media and serious issues in the Euro Zone that impact the U.S. financial system, consumer confidence and consumer sentiment is quite negative. Typically however, when sentiment is below 60 as it currently is, the major stock indexes have risen over the next 6, 12 and 24 month time frames. The always important NFP (Non-Farm Payrolls) report is due Friday and that is quite often a market mover. We expect data to show a minor improvement in jobs in the + 75,000 area but believe the overall economy will be held in check.

MARKETS

The Standard and Poors 500 Index (SPX) closed down 14.3% for the third quarter as each individual month declined. The rally up in August left room for a September decline even though September was an inside month. By inside month, we mean that all price action took place within the previous period's action. This process of putting in a lower high and a higher low often sets the stage for an explosion move which we saw in October as prices exploded higher, but only after the lows of August were briefly taken out. This is also typical as the final washout move tends to shake out the last few stubborn bulls who sell below the August low only to see the demand overtake supply finally and rally.

The SPX gained 10.8% in October while the S&P Mid Cap 400 was up 13.7% and the S&P Small Cap 600 rose 14.9%. The Dow Jones Industrial Average (DJIA) rose 9.5% and the NASDAQ 100 (NDX) was up 10.3%. These gains are impressive but tend to suggest that the higher quality names raised the least during the rally and many of the areas that were hardest hit also raised more which indicates an oversold bounce more than a new bull market rally. While the market did experience a follow through day, the long term buy signal has not yet been recorded which forces us to be cautious.

A technical setup that we have noted is that most major indexes recorded bullish engulfing patterns on a monthly chart in October. A bullish engulfing is simply a bar on a chart which represents one period (in this case 1 month) that totally eclipses or "engulfs" all price action of the previous bar. These can be very good signals especially when accompanied by high volume and you often see the price of the engulfing bar close high in the range like it did in October. A bearish

engulfing would be the opposite with a close in the lower portion of the range. These patterns can be especially useful at the end of a trend in either direction to signal a change in trend. Again, the narrow range formed in September's inside month contributes to this setup.

The most recent bullish engulfing month prior to October was July 2009 which closed strong and led to a continuation rally into the April 2010 top. While historically we prefer these setups on the bullish side there was a bearish engulfing pattern after an inside bar in January 2009 as December 2008 was an inside bar and an up month in a decline. The SPX dropped 20% in less than 2 months after the bearish engulfing in January 2009. There was also a bearish engulfing pattern in July 2007 that proved false as the market rallied the next 3 months by 8% before topping and the start of a major bear market.

There was a bullish engulfing pattern in March 2003 that reversed that bear market and began a four year bull market. These patterns are fairly rare and worth noting. On a historical note there were also bullish engulfing patterns in October 1998 and 1999. The SPX rallied into yearend in those two cases respectively by 11.92% and 7.8%.

The pullback that began Friday October 28 has sent the major indexes back below their 200 day moving averages. These averages will be a key tell to monitor in the days and weeks ahead as the market must be able to maintain price action above the 200 dma to stay healthy. This is a key long term moving average that the SPX tested to the tick in June before bouncing. Then the benchmark index penetrated its 200 dma on August 2 just as the collapse was about to begin in earnest and the market fell 14.4% in the next 6 trading sessions. This was the first time the SPX had traded below its 200 dma since September 2010.

OUTLOOK

Finally, November 1 marks the start of the best six month period in which to invest in the markets. While the exact reason this pattern has played out over the past 5 decades will never be fully explained, its track record is simply too amazing to ignore. This does not make us bullish or bearish on our own, but again it must be noted to serious traders and investors. If you analyze the returns in the SPX starting in 1960 and going through the current markets an investor who was only in the SPX from November 1 through April 30 each cycle would have seen his or her investment grow with a 42 fold increase (\$100,000 would have become \$4,389,670). However, if an investor was only in the market for the other 6 months (May 1 through October 31) for each cycle their investment would have barely doubled (\$100,000 became \$226,590).

We have always argued that valuation is not a timing signal but is a good measure of risk. When values are too high there is more risk of a decline and vice versa when values are too low, there is less risk of a decline. The current environment with its historically low interest rates has forged an interesting backdrop in terms of valuation. For the first time since the 1950s the yield on the SPX is greater than the 10 year bond yield. Typically low rate environments tend to result in higher valuations but currently the Price to Earnings ratio is hovering in a quite reasonable range of 14 to 16. We continue to believe that well selected, higher yielding stocks will outperform fixed income investments over the next 5 and 10 year periods though it may be a bumpy ride.

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