July 14, 2012

the X-factor Report
by Lance Roberts

Market Strategies, Economic Analysis, Risk Management

Short Covering Saves The Week

I am currently on vacation with my family so this week will be a short market update. I will back next week with a full update and complete analysis.

Thank you for your readership and be sure and email me any specific questions or comments that you may have.

This past week's market action doesn't change any of our recent analysis. After six days of negative market returns a bounce was overdue – that bounce was driven into overdrive by short covering in a very thinly traded market. As of the close on Friday the losses for the entire week were reversed but for the month of July the market is so far still sporting a mildly negative return.

This falls in line with our recent analysis of the summer 2011 repeat where the May selloff was followed by a June rebound, chopping sideways action in July followed by an August selloff. With earnings season underway and already a bit disappointing, weakening economics and a continuing daily saga of the Euro crisis there are more negative catalysts overhanging the market than positive. In fact, just about the only thing supporting the markets currently are hopes for further stimulative action from the Fed which is all but baked into the market at the current time.

Here is a bit of analysis just to keep things in perspective particularly with the *"Buy and Hold"* mentality of *"investment professionals"* via David Rosenberg:

"The S&P 500 first hit its current level of 1,330 on April 8, 1999. So, what we have on our hands are 3,339 sessions of NO capital appreciation but tons of volatility.

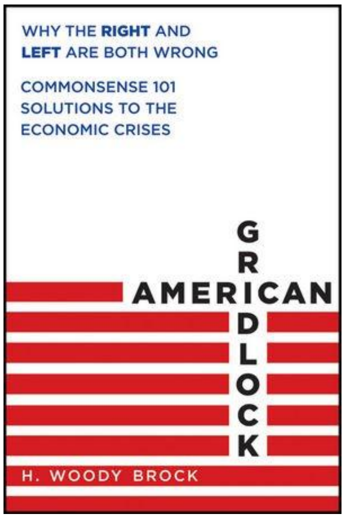
The market peaked on October 9, 2007 at the all-time high of 1,565 on the S&P 500. That is 1,200 sessions in which a new high was never made – the hallmark of a secular bear market."

Inside This Issue:

SPECIAL INTERVIEW – DR. WOODY BROCK

If you have not listened to the interview with Dr. Woody Brock it is probably one of the best interviews that we have had on *"Streettalk Live"*

Dr. Horace "Woody" Brock, one of the world's foremost economists, is the author of the new book, ***American Gridlock - Why the Right and Left Are Both Wrong, Commonsense 101 Solutions to the Economic Crises.*** This is a must listen interview on the impact of Obamacare, Deficit spending and solutions to begin repairing the economy.



As the founder and president of Strategic Economic Decisions, a renowned economic think tank, Dr. Brock has spent more than 25 years counselling global corporations and other institutions who benefit from his in-depth analysis of on-going structural changes in the global economy. Dr. Brock earned his B.A., M.B.A. and M.S. from Harvard University, and his M.A. and Ph.D. from Princeton University (mathematical economics and political philosophy). He studied under Kenneth J. Arrow, Stanford University, and the late John C. Harsanyi, University of California, Berkeley, both winners of the Nobel Prize in Economics.

CLICK HERE TO LISTEN

ORDER THE MUST READ: *"AMERICAN GRIDLOCK"*

NFIB – NOTHING GOOD GOING ON

Each month the National Federation of Independent Business releases their survey of their members which range from very small to large scale independent businesses. The recent release for June was anything but positive. The index declined 3 points in June, falling to 91.4 which is the lowest level since October of 2011. The decline is significant and relinquished all the *"weather related"* gains that we warned about earlier this year and is a clear indication of slowing economic growth.

The 10 Index questions lost a total of 30 percentage points in net favorable responses and what was most concerning was the sharp increase in *"poor sales"* as the number one concern of businesses. The continued lack of aggregate end demand continues to keep businesses on the defensive and impacts employment. Furthermore, the *"uncertainty factor"* of the recent SCOTUS decision on health care will likely show up in the July survey putting even more downward pressure on future plans for employment, expenditures and planning. With over 20 new taxes *(totaling roughly $800 billion)* the unknowns of costs and regulations *(most of which have not even been written yet)* are clearly not business friendly.

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FEEDBACK

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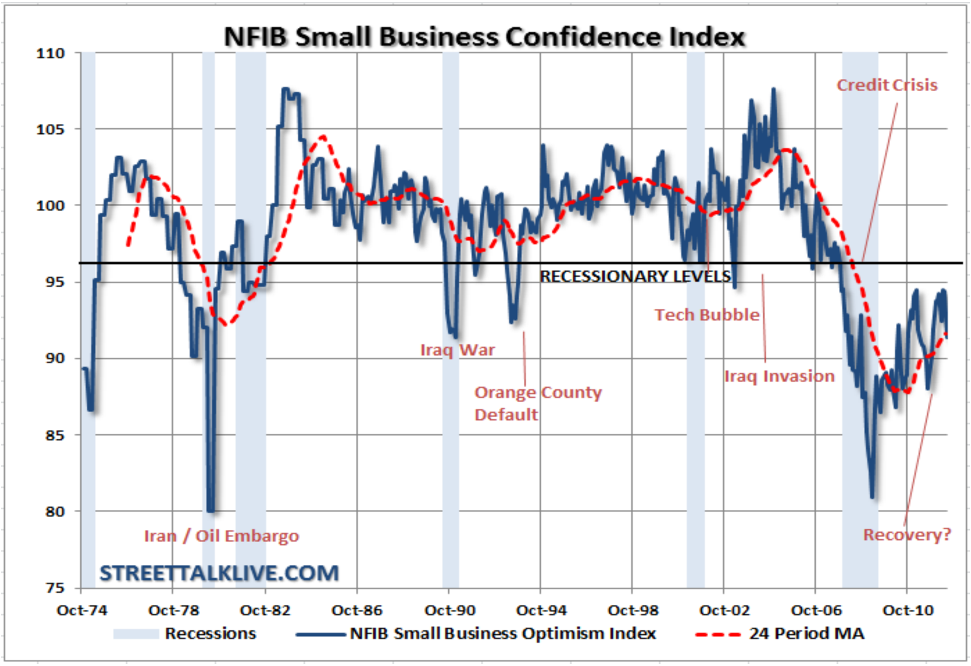
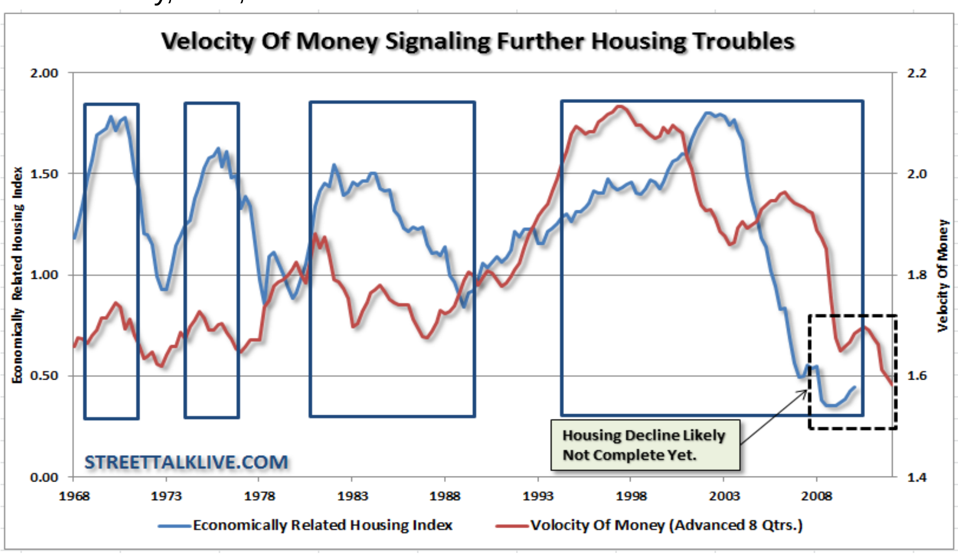


Trade And Mortgage Data – Economic Weakness Persists

The recent spate of negative economic news continued on Wednesday with the release of mortgage purchase applications which showed a continued decline even as mortgage interest rates hit historic lows and the wholesale trade data which showed accelerating weakness in consumption trends. This, of course, is really not new information for our regular readers as we have been discussing the weakening economic trends for several months now, and most recently, here, here and here.



The mortgage purchase applications release was further evidence that the recent bump in the housing data, particularly purchases and existing home prices, is likely a temporary phenomenon. With a continued decrease in the velocity of money, as discussed in detail here, as a result of excess reserves continuing to pile up at the banks, credit remaining extremely restrictive, wages stagnant and low savings rates which impair individuals abilities to accumulate the needed down payment, expectations of a housing recovery are likely premature.

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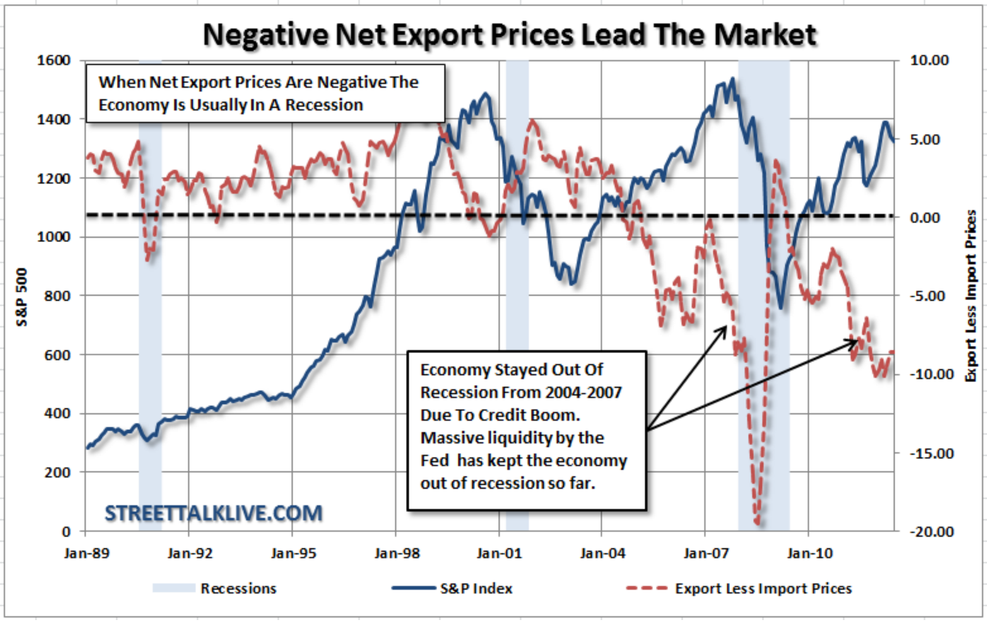
IMPORT-EXPORT PRICES AND JOBLESS CLAIMS

The data continues to pile up on the negative side of the ledger. The deficit in June was $59.7 billion which was only slightly less than expectations of $60.0 billion. The sharp decline in petroleum costs, and a recession in the Eurozone, were the biggest drivers to this change. More importantly we should not forget that May showed a $125 Billion deficit, and $59 Billion in April. June was also $16.7 billion higher compared to last June. Total debt in June increased by $85.7 billion and the cumulative deficit in Fiscal 2012 is now $904 billion through June, compared to $970 billion last year over the same period. The continued policies of ultra-low interest rates, a weak dollar policy and continued interventions by the Fed continue to push negative export prices which are ultimately very negative for the economy.



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THE BEAR MARKET IS ONLY BEGINNING – Comstock Partners

Long before it became headline news, we were talking about the corrosive effect of deflation deleveraging, excessive debt, the softening U.S. and global economy, the *"fiscal cliff"*, the implausibility of a European solution, the probability of a hard landing in China and the prospect that corporate earnings estimates were far too high. Now these negative stories are carried in the Wall Street Journal every day and the word *"deflation"* is now being used by almost all market commentators.

When we first brought up this word to warn our viewers about the damaging effect of the deleveraging associated with it, Microsoft Word did not recognized the word. We were asked if we meant *"inflation."* This week alone carried articles on downward earnings revisions at major corporations, Brazil's sputtering growth, the worsening slowdown in China, new austerity measures in Spain and Italy, the continuing disappointment in U.S. economic indicators and more worries about the fiscal cliff. As if that were not enough, the news has been full of reports on the fixing of Libor rates, the fraud at Peregrine Financial, and the J.P. Morgan losses.

In the face of the now-obvious negative outlook, the question we get most often is why the market has declined so little, and why it seems so resistant to bad news. In our view, the reluctance of the market to give up much ground is typical of many past market declines and reflects a state of denial by investors as they grasp at reasons to remain bullish. Currently, the reasons cited most often are that the market is cheap, corporate earnings are strong and the Fed, as well as other central banks, will provide all the liquidity that's needed to avert a serious economic downturn. We believe that each of those evaluations is flawed.

The current earnings estimates for 2012 are unlikely to hold up and the market is not undervalued. The consensus estimate for S&P 500 operating earnings (even though we believe "reported earnings" is the more relevent) is about $104 for 2012 and $118 for 2013. The bulls simply multiply the 2012 estimate by 15 and come up with a prospective S&P of 1560 (usually something between 1500 and 1600). Various studies, however, indicate that the more relevant method is to use a trendline estimate of reported (GAAP) trailing earnings. Our estimate of trendline earnings is currently about $75, and, on this basis, the market is overvalued rather than undervalued. The problem is that estimates of forward operating earnings are almost always wrong by a wide margin, most often on the high side. In May 2008, for instance, the estimate for 2009 was $110, and eventually came in at $57. In this regard, it is noteworthy that although the second quarter earnings report season has barely started, 42 major corporations have already guided their estimates down.

In a similar vein, we believe that investors' faith in the ability of central banks, including the Fed, to avert a serious downturn is ill advised. In 1999 and early 2000 we had the so-called *"Greenspan put",* which referred to the supposed ability of the Fed to avert a recession. Despite the fact that it didn't work, investors still had great faith in the so-called "Bernanke put" in 2007, and we now know how that worked out. Despite the disastrous outcome in those instances, investors now seem to have great confidence in a global central bank put. In our view, global debt deleveraging and deflation will overwhelm any central bank attempts to prevent a serious downturn, particularly when we take into account that central banks have already used their best ammunition and have to rely on unconventional and untried measures with questionable chances of success.

In the last four major bear markets the decline started very slowly from the peak, and was interrupted by numerous rallies, but continued to gather steam, ending only after a scary waterfall decline toward the end. We suspect that the same pattern may happen this time around.

As you can see from all of this analysis there are few positive dynamics behind the market save the "hope" of further Q.E. injections to drive asset prices higher – in the short term. The problem is if you are not an adept trader short term exuberance leads to long term pain.

See you next week.
Lance Roberts

Technically Speaking

Market Holds Support – For Now

The market rallied sharply on Friday after 6 consecutive days of declines took the markets to a critical support level. The rally, boosted by short covering and low volume, did little to reverse our recent analysis of a choppy July trading pattern and an August decline as market action eventually catches up to the deteriorating underpinnings.

The market is still struggling with the resistance from last year's market peak which means the market has had a negative return over the last 16 months.

This is an important consideration given the fact the media focuses on daily and weekly returns rather than the context that for almost one and one half years investors have lost money.

Furthermore, the market is currently also wrestling with the downtrend from the March peaks. With the markets still on weekly sell signals the easiest path at the current time is still to the downside – therefore we still advise being cautiously allocated.

While history never repeats exactly the current market environment is still playing out very similarly to the same period last summer. The difference is that this time the market is heavily banking on the Fed intervening sooner, rather than later, which raises the *"sell off"* risk in the event of a *disappointment.*

More QE On The Way – Not Yet

Here is our best guess of what will play out over the next couple of months as the market wrestles with the economy, earnings and the Eurozone crisis.

- In order for the Fed to get any real benefit from a liquidity program such as QE the market must **not** be expecting it. With the current levels of expectations the bulk of the potential impact from a QE is already built into the market. Because of this the Fed is likely to remain on the sidelines for a while longer.
- Furthermore, with GDP currently growing near the Fed's current target of 2% they will likely wait to see what the 1st and 2nd estimate of GDP for the 2nd quarter. The reason for this is that the 1st estimate is built around the consensus estimate while the 2nd estimate has some actual second quarter data contained.
- With the market currently up nearly 8% year-to-date there is really now reason to launch a QE program in order to boost asset prices from this standpoint.
- We expect at the July 31-August 1st meeting that the Federal Open Market Committee will continue to reiterate continued concerns over employment and the economy and stand by their recent statements that they have policy tools available if needed. This will likely disappoint the markets at a time that economic trends are likely to continue to weaken combined with weakness in earnings.
- In the month of August the majority of Europe goes on vacation which will leave the markets with a vacuum of support and more rhetoric surrounding the Eurozone crisis or resolutions.
- If the markets have suffered a 10-15% decline from current levels with the economy slowing towards a recession – it will be the September 12-13th FOMC meeting before the Fed will announce some further action.

The most important caveat here is that the market MUST be at much lower levels and the economy near a recession. Without such catalysts the Fed will continue to opt for *"jawboning"* the markets and punting responsibility of solutions to the White House. This is the most logical course of events at this point, however, as always there is nothing that is guaranteed so we must continue to remain vigilant to the trends and analysis of the markets and make adjustments accordingly.

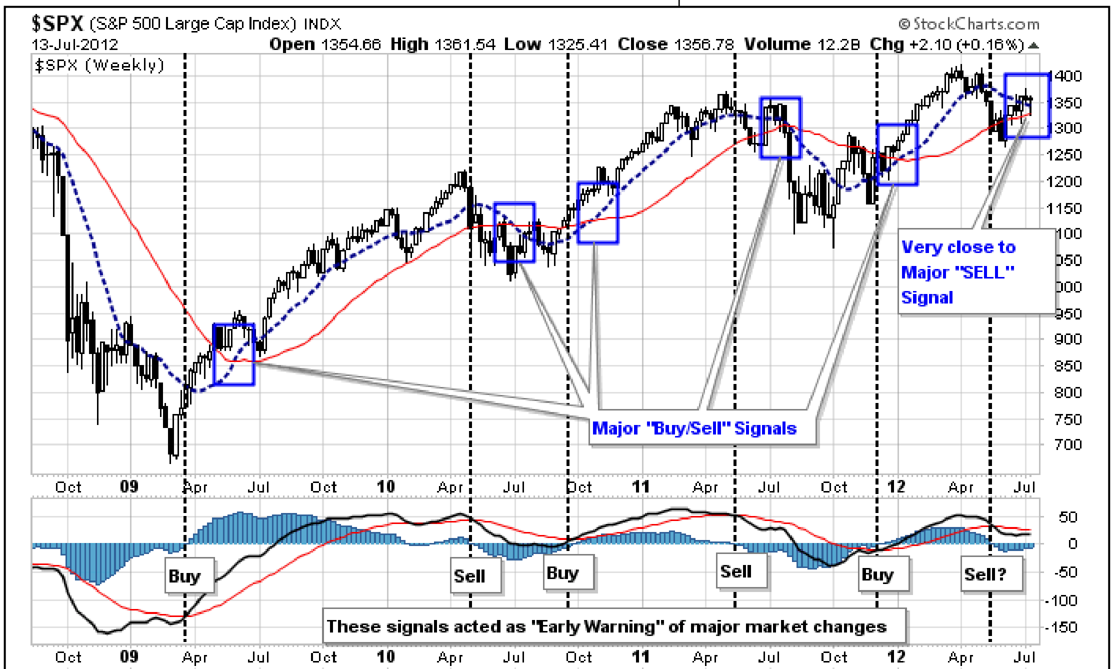
Nothing has changed from last week's analysis on any front so the discussion around rebalancing to the target allocation in the model below is still relevant. However, there is one thing to note which is that the continued rallies, and subsequent failures, is not a sign of a healthy market. The bullish dynamics that existed in June are beginning to fade in July, as expected, and continued negative fundamentals are likely to keep the pressure on.

Stay cautiously allocated at the current time and next week I will do a full market analysis and update for you. Have a great week.

JOIN US ON FACEBOOK and/or TWITTER to stay up to date. We will continue to post intra-week updates exclusively at our social networking sites.

401K Plan Manager

The rally that occurred over the couple of weeks came to a halt last week and the indexes failed at their respective resistance levels.



We are now entering earnings season which is sure to increase the volatility in the markets.

We continue to highly recommend that you rebalance this week to the current allocation levels if you have not done so already.

The market is currently at a very critical juncture and will either break out to the upside, needing us to increase exposure, or it will break down. In either event we will adjust allocations accordingly.

If you need help after reading the alert; don't hesitate to contact me.

Current 401k Allocation Model

35% Cash + Future Contributions

These options include:
Stable Value, Money Market, Retirement Reserves

35% Fixed Income

Bond funds are a play on the direction of interest rates
Short Duration, Total Return & Real Return Funds

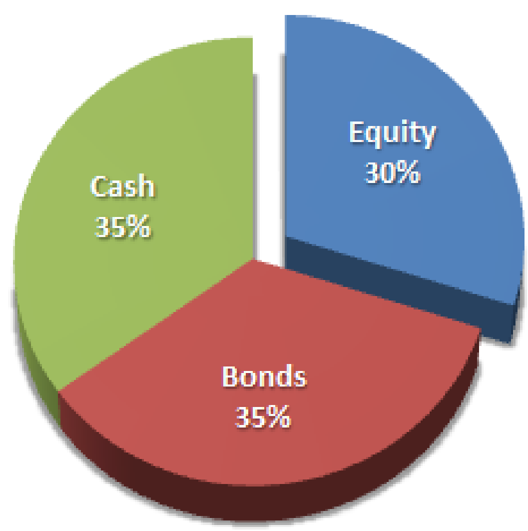
30% Equity

*The majority of funds track their respective index. Therefore, **select ONE fund** for each category. Keep it simple.*

30% Equity Income/Balanced/Growth & Income
0% Large Cap Value
0% International Value

ALL NEW MONEY (Monthly Contributions)
100% Cash Option

Current Allocation Model



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