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Investment Assessment
July 2011

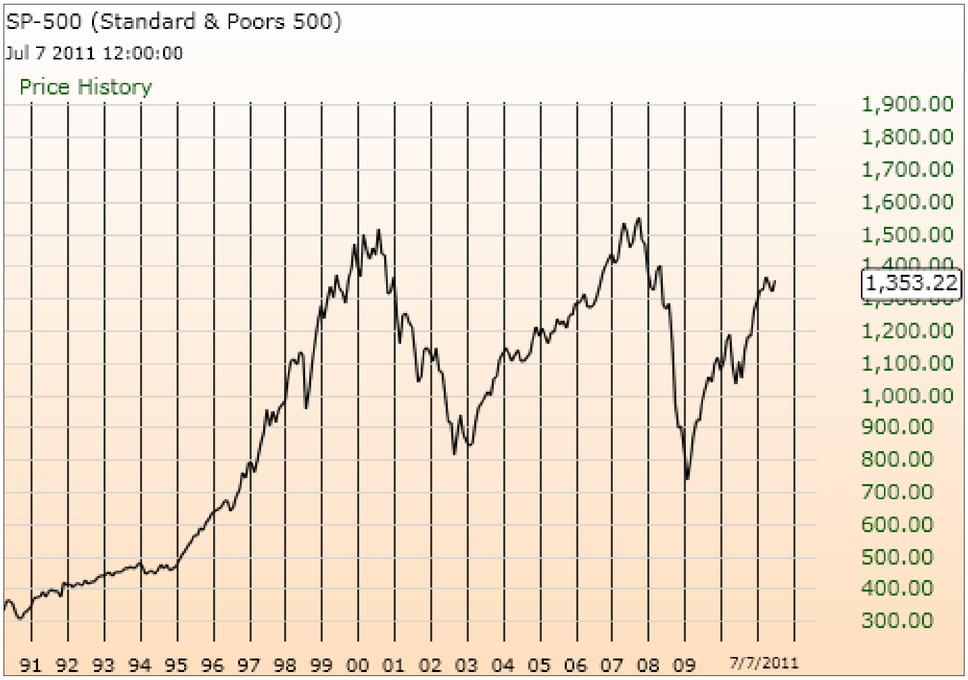
The seasonal pattern for stock prices seems to be holding thus far in 2011. The stock market adage - "sell in May and go away" - is based on the historical tendency for stocks to generate positive returns from November through April. The period May through October is a different story: over the last sixty years, the average return in the May through October interval is .4%, almost nothing. From January through April 30th, the S&P 500 advanced 106 points or 8.4%. It was an uneven advance in stock prices - the equity markets advanced for the first six weeks of the year, and then in February, upheaval in the Middle East sent oil prices as high as $113 a barrel causing the first significant market pull-back since the fall of 2010. The market dropped in March and then rallied to a recovery high in early May with the S&P 500 Index topping at 1370. Now we are getting the zigzag of stock prices that we described in our *Investment Outlook 2011*, published in January.

Seasonal factors, coupled with potentially significant financial events this summer, indicate to us that this is not a time to be fully invested. Our reasoning: first and foremost, the Fed's six hundred billion dollar Quantitative Easing program is now over. The market rally from July of 2010, when the easing started, through June 2011, was driven by the Fed. This source of stimulus has, at least for now, ended.

Secondly, the looming show down in Congress over the debt ceiling is a major uncertainty for the financial markets. Although past confrontations have always resulted in Democrats and Republicans coming to some agreement that avoids default, this time it's a real nail biter. The odds favor a compromise solution but that news may signal an end to the current market rally that began June 27th.

The third major uncertainty is debt issues in the U.S. and Europe. As far back as 2007, we have written about the risk to global markets from an oversupply of liquidity. In world markets, banks, insurance companies, hedge funds and other institutional investors borrowed money at low interest rates to invest in stocks, commodities, and mortgages. With the financial meltdown of 2008, the debt began to unravel and then to avoid financial panic, debt holders were artificially supported by central banks. Sovereign debt of countries like Greece, Ireland and Portugal has been supported by loans from the European Union. In the U.S., the Treasury and Federal Reserve have combined to fund "toxic loans" with public funds. Debt has not been restructured, just re-financed.

Economic fundamentals aside, what about a market evaluation using technical analysis to identify the primary trend of the market – is it a Bull, a Bear, or something else? The accompanying chart of the S&P500 clearly illustrates that the equity markets have been range-bound for over a decade. Currently we are closer to the top of the range, but the stock market cannot "break out" into a secular Bull market because of relatively low economic growth rates and excessive levels of debt. The floor for stock prices created in late 2002 and re-tested in 2008-09, was driven by massive government fiscal and monetary stimulus. To test that support level again, stock prices would have to drop 50%.



Our market indicators suggest that the current market rally will be short lived and that the correction that began in early May has not yet run its course. We expect more market volatility with a bottom in stock prices sometime in September-October. We believe investors will be rewarded by maintaining cash reserves and waiting for a low risk investment opportunity.

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