Market Commentary
Mid-Year 2011

The Big Picture. The market rallied from early September 2010 into an interim top registered on April 29, 2011 with the S&P 500 closing at 1364. During that timeframe the market rallied, without significant correction, for 35 weeks, equaling the longest, uncorrected rally phase during the entire 2003-2007 bull market. By that parameter, the market was extended on the upside. Additionally, numerous internal technical/momentum indicators had begun to turn down as early as February, giving confirmation to the argument that a market top has temporarily been seen. Because the market is a discounting mechanism, meaning that present market behavior is a precursor of future events, I found it interesting that the market began to technically deteriorate in February, six months in advance of one of the most important fundamental events of modern times - the necessity to raise the debt ceiling of the United States (tentatively scheduled for early August). This upcoming event has my full attention. The market will most likely react negatively, possibly in a material way, to any raise in the debt limit without corresponding steps to significantly reduce the runaway federal budget deficit.

The Budget Deficit Problem. The mathematics of the federal deficit problem seem to be of a complexity far beyond my mathematical ability. In second grade, I am sorry to report, I was only able to get a C+ in math. So, in my unending quest for a competent analysis of the problem, I consulted my 8-year old niece, Tiffany, whose qualifications for the assignment included an A+ in math in second grade. Tiffany's analysis of the problem is as follows:

"The U.S. is currently running about a $1.5 trillion dollar annual budget deficit. For many of the past decades, government revenues (taxes) have generally averaged about 19% of gross domestic product. Currently, revenues are running about 15% of GDP. Historically, government expenditures have run about 20% of GDP. Currently, expenditures are running about 25%."

"Given that the U.S. appears to be in an economic recovery, how do you account for the 4% revenue shortfall?" I asked the wonderkid. She replied that not only are 50% of the country's citizens **not** paying any income taxes at all, but a good portion of them actually **receive** checks from the government in the from of tax credits. "Can't be!" I gasped! "That's right", she matter-of-factly replied. "There's the earned income credit, make-work-pay credit, child-care credit, college tuition credit, credit for getting up in the morning, credits for buying a house and credits to multi-millionaires for buying a bigger house." I asked, "What is this make-work-pay credit? Doesn't work always pay?" She replied that, although she has never had a job herself since she is only 8 years old, her research indicates that work **does** pay, but apparently not enough. So, the government supplements paychecks with the make-work pay credit. "Wow, that's pretty cool, that make-work-pay tax credit", I exclaimed!

I asked if the elimination of all of the unnecessary tax credits would be enough to bridge the 4% revenue shortfall. “Probably not”, she said finishing her Cheerios. “The tax rate schedules probably need to be tweaked”. Horrified, I immediately jumped to the defense of the job creators of the country – the Fox News analysts, without exception, tell you that if you tax those folks any more, they will never hire another new employee, ever! “A highly over-rated ideology”, she replied, while flipping to Nickelodeon. “The people making salaries well into the millions and tens of millions of dollars annually have only one major decision to make every month – to determine which tax-free municipal bond to buy. A tweaking of the tax rate schedules, slightly more progressive, will not alter their overall spending behavior one iota – they will have to be content to add a little less to their municipals each month. And Larry Ellison won’t have to downsize into a smaller yacht either”, she assured me. She summed up the revenue side of the equation by saying “If the country could just return to the normal historic percentage, tax revenues at 19% of GDP, and if GDP were to grow by 3% per year, the current budget deficit would be cut in half.”

I sensed that Tiffany’s focus was starting to wane. She began texting, to I don’t know who, at a fever’s pitch. I wanted to get her back on task so I asked her if she thought the current corporate income tax rate should be changed. I obviously struck a nerve. She shot back that if had to ask a question with such an obvious answer, then perhaps I shouldn’t even be involved in the conversation! She grudgingly offered the following commentary, “Corporate income taxes do not comprise the lion’s share of federal revenues. The employees who work for those companies pay federal income and FICA taxes - they comprise the lion’s share of federal revenues. So, if our corporate income tax rates were to become close to the lowest in the world, rather than the second highest (as they are now), it stands to reason that overseas companies might find it advantageous to move operations to the United States, and hire employees. “I might go so as far to say”, Tiffany said while peeling a banana, “the powers-that-be should explore the identification of tax-exempt (from corporate income taxes) industrial zones in blighted areas in our county”. “Then”, she said confidently, “you might really have something!”

By this time Tiffany had my attention. I am feeling that, maybe, we can solve the budget problem. But, how about the expense side of the ledger? She replied that government spending needs to return to 20% of GDP versus the current 25%; a notion that has apparently eluded those individuals at the highest levels of our government. I pleaded, “What about all the grandmothers with medicare-provided ventilators…we can’t take those away from them, can we?” I now know I’ve completely lost her attention. She didn’t want to get into specifics, since the “Best of Bugs Bunny” was getting ready to start. She summed up her response very succinctly by quoting Jackie Burke, PGA hall-of-famer, 3-time Masters champion, part-time philosopher and patriot, who once proclaimed – “Son, if you make $50, you can’t spend $51!” It seems so simple!

The Debt Ceiling Timeline. Bullet points, key dates, and possible effects relative to the raising of the country’s debt limit are summarized below (source: conference call with Fidelity analysts):

- On or about July 1st, there should be a “skeleton” agreement on which lawmakers have agreed to broadly defined terms of the raising of the debt level.
- Lawmakers’ (U.S. Senate and the House) summer recess is scheduled for August 5. So any final agreement that is made will likely be made before recess.

- If a debt ceiling agreement has not been entered into by approximately July 25th, the treasury will likely cancel debt security auctions scheduled the following week.
- Any potential of no agreement by late July could result in the lowering of credit ratings of the Federal Government from "AAA" to "AA" by numerous rating agencies (Moodies, Standard and Poors, etc.).
- If rating agencies lower the credit rating of the U.S., there exists the possibility of a large scale sell-off of government bonds, as many holders of these securities, many of whom are mandated to hold only debt securities with a "AAA" rating, are forced to sell their holdings.
- It is possible that, in the worst case, social security checks, scheduled for August 1st, will not be mailed.
- It is possible that interest payments on some U.S. debt obligations would not be made. This event would taint the "risk-free" status of U.S. government debt securities and could permanently damage the reputation of the U.S. government to the point that investors would likely require an additional ½%, or more, in interest.
- The government could "kick the can down the road" a few days if tax receipts in August exceed projections, effectively extending the date that the government runs out of money some days past August 2.
- Since it seems to be the political way of doing business, Congress will not likely reach consensus until it actually **must** do so, August 2 or thereabouts. Fidelity's view is that the debt ceiling will be raised by August 5th, but not without some anxious moments. Those anxious moments could result in a "TARP-like" panic in late July or early August, if a deal is not reached. But that event itself could quickly force lawmakers back to making a last minute deal.

My comment on the above: I cannot imagine that any reasonably clear thinking politician will allow the possibility of any of the catastrophic outcomes described above from occurring. I think the probabilities favor a timely and reasonably favorable outcome of the debt ceiling issue, although I think there could be some highly volatile market days until the eventual day of resolution.

Bull Market Scorecard. It is still a bull market, but aging. A return of slower, or temporarily declining economic growth, should have the effect of extending the bull cycle as peak economic activity is pushed further out into the future. I will state, with much emphasis added, that all bets are off if our government does not take responsible action with regard to our national debt and deficit. Perhaps the Greek debacle might be a wake-up call to, at long last, do the fiscally prudent thing!

TECHNICAL, SENTIMENT AND TIMING CHARACTERISTICS OF TYPICAL BULL MARKETS/ CURRENT STATUS

Bull or Bear. A bull market has been in progress since March 9, 2009. The time frame of mid-December 2011 would bring the bull market within the outer-limits of an extended advance as described in my year-end 2010 commentary.

Psychological Phases. Bull markets are divisible into 3 distinct psychological phases. Phase III, currently in progress, is characterized by a full fledged movement to investor overconfidence (recognizable during the 35 week rally of September 2010 to April 2011).

Initial Public Offerings (IPOs). Also characteristic of late bull market behavior, the pace of IPOs has noticeably picked up in the first half of 2011, with one IPO, Linkedin, setting the standard for IPO euphoria. Pandora, Zipcar, and several Chinese IPOs have set the standard for IPO failures.

Technical Indicators. The advance-decline line has dropped sharply since peaking in late April 2011. Stocks making new 52-week highs collapsed to a total of 6 registered on June 6th, far off the bull market high of 672 issues seen on April 26 2010. I find it unlikely that the peaks of both of these metrics will be bested before the next major market top. Bull market tops are normally registered six months or more after a peak in the advance-decline line.

Fundamental Backdrop. Announced economic statistics (unemployment data, GDP rates, housing data, etc.) have weakened in recent months. For example, new jobs in the U.S. are nearly non-existent, GDP growth has stalled, and it appears there is not one single person in all of North America who wants to construct a new home. Weak economic data has the potential to prolong the bull market as stock market rallies are borne out of weak, but improving, economic activity.

Investor Sentiment. I have noticed that the level of fear and angst has been rising in recent weeks. Deteriorating investor sentiment can be seen in recent polls of the American Association of Individual Investors and Investors Intelligence. And many ETFs are trading at substantial discounts to their net-asset-value, indicating an excess in bearish sentiment, a bullish development from a contrarian's point of view. Weakening economic statistics and a sudden return of the emotion of fear may be found at the outset of stock market corrections, but not at major market tops. So while the summer could experience some stock market turbulence, we won't see a major top until my favorite waitress at the Grandview Café starts to dispense stock tips.

Valuations. I find many excellent values in the market today. Intel yielding 3.8% with a single digit PE ratio….Cisco at $15 per share with $8/share in cash sitting in their balance sheet (you've got to be kidding me!)….stable pipeline businesses with tax-deferred yields exceeding 6%.... good values that may get much better during the summer correction and next bear market. Reasonable valuations should serve to limit downside during the next bear swing. The bear markets of 2000-2003 and 2007-2009 were abnormally severe with declines of more than 50% in the major averages. Perhaps the next bear swing might result in a garden-variety decline of 20-25% in the major market averages.

The Next Bear Market. Just as certain as death and taxes, bull markets are followed by bear markets, and bear markets are followed by bull markets. Since we are in the later stages of a bull market, following are some of the signs that I would look for as an alert to the next impending bear cycle: 1) a potential peak in corporate earnings; 2) a material contraction in worldwide economic growth. The solution to the worldwide debt problems lies in the austerity of higher taxes and lower government spending. Both of these solutions serve to solve the problem of excessive budget deficits. They are also significant inhibitors to economic growth; 3) months of technical deterioration while stock averages make news highs accompanied by extremely bullish investor sentiment; 4) noticeable pickup in new IPOs, corporate mergers, secondary offerings, and stock splits; 5) spike in aggregate margin debt. Finally, I would observe it is the buy and hold investment advisor's lot in life to tell you that it is absolutely mandatory to maintain a fully invested position in bear markets. I would submit that it is not mandatory, but that it is definitely optional. Bear swings are actually opportunistic events for the well-positioned investors.

Have a Great Summer!

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