



Market Fundamentals

Wow — what a thrilling and chilling roller coaster ride the Market took us on this week! All considering, we feel quite relieved that the S&P 500 ended down only 1.8% for the week and a total of 5.8% for 2011. It certainly could have been worse, and it looked like it would be worse on several occasions depending on which minute you happened to glance at the TV. In fact, this week was without historical precedent, since it became the only time ever that the Dow Jones Average has moved more than 400 points in either direction for four straight trading days. Below is a graph of the S&P Volatility Index (VIX). What you will notice over the 5 year chart is three major spikes occurring in October 2008 (Lehman Bros. Collapse), May 2010 (Flash Crash), and yes, last week (US downgraded to AA+).



Based on the last three data points, there seems to be a link between increased volatility and negative stock market returns. It is important that we consider why this time may be different.

Certainly the circumstances are much different than in 2008. Banks around the world have raised billions of dollars in capital to strengthen their balance sheets, sub-prime mortgage assets have already been written down to (in some cases) pennies on the dollar, and the economy growing, albeit at a slow clip. What is similar however, is the level of fear and, in some cases, panic that swept over the Market and investors. Like 2008 and May 2010, the plummeting Market felt a little unnerving, and as an article in Barron's put it, "Walt Disney (DIS) wasn't suddenly 9% less great a company at 4 PM Wednesday versus 4 PM Tuesday." So, what should we make of this?

One might think that stocks should be a bargain now, but on the macro level there are still some major issues to address.

One of those major economic issues came to the forefront this week as the fiscal stability of the US was questioned and downgraded one notch by the Standard & Poor's rating agency. This, in and of itself, was not a big deal—especially coming from an agency that had given a AAA rating to Greece as well as billions of dollars of sub-prime mortgage securities a mere 4 years ago. But, it did remind us that this nation is heading down a path of spending that is unsustainable and must be addressed sooner rather than later.

The other major macro level issue that surfaced again this week was the sovereign debt crisis in Europe. We touched on this in more depth in our July Newsletter, but in summary, the problem in Greece is not going away. What made it somewhat scary this week was the fear of contagion to Portugal, Spain, and more shockingly, Italy. The first three periphery countries mentioned have been referred to quite often as needing a bailout, but Italy brings a whole new size and scope to the issue that would be catastrophic to the European Central Banks efforts to stabilize matters. That news was far more critical than the US downgrade and likely had the most profound effect on both the negativity and volatility we experienced this week.

On the Equity front, the drop this week and the 18% fall over the last three weeks has certainly created some attractive valuations for many companies. On a trailing 12 month basis the Price to Earnings ratio for the S&P 500 is currently 13.4, which is a historical low for the past 20 years. Further confirmation of this fact was evidenced by CEOs and corporate insiders purchasing \$861 million worth of shares thus far in August. Only March of 2009 (Market trough), with \$1 Billion in purchases currently represents a bigger buying spree. Finally, one last contrarian indicator was triggered as individual investors pulled more money (\$22.9 Billion) from equity funds in July than in any month except for October 2008.

Unfortunately, when visibility on the economic landscape is low, and uncertainty is high, Markets tend to trade illogically for extended periods of time. So, regardless of the fundamentals, the only place to look for guidance may be Market technicals.

2011 Market Update

S&P 500	-5.14%
DOW	-1.11%
NASDAQ	-5.46%
RUSS 2000	-10.36%
MSCI World	-7.53%
BONDS	+6.04%
GOLD	+15.21%
SILVER	+29.03%

Did You Know?

This week Apple officially surpassed Exxon and is now the largest company in the world with a market capitalization of \$350 billion.

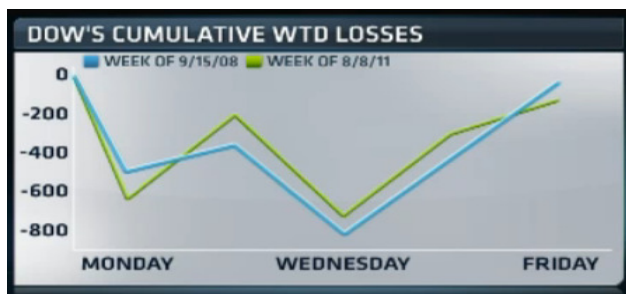
Over the last 50 years we have on average experienced a "bear" market every 5 years. — meaning a drop of 20% or more from peak to trough.

President Nixon took the U.S. off the gold standard 40 years ago this Monday, August 15th. At that time, Gold bullion could be had for just \$35 an ounce.

Technically Speaking

When volatility of this magnitude strikes, many times the fundamentals get thrown out the window and all that any of us are left with in the short-term is technical analysis. In layman's terms, technical analysis is a method of evaluating stocks by analyzing statistics such as past prices, volume, moving averages, etc. Pure technical analysts don't care about a company's intrinsic value (the realm of fundamentalist), but instead use charts and other tools to identify patterns that can suggest future activity. We're not saying that one method (Fundamental vs. technical) is better than the other, but it is important to know both sides of the equation since enough market participants practice both disciplines. So, what are the charts saying right now?

There is some interesting precedence for what we saw this past week. If you compare last week versus the week of September 15, 2008 (the week after Lehman failed) it's hard to not notice an eerie similarity.



In 2008, market losses were just getting started as the S&P went on to see an additional 40% in downside over the following six months.

The good news in currently is that there is substantial technical support on the short-term horizon. At its worst point this past week, the Market had a almost a 20% retracement (a reversal in the movement of a stock's price, countering the prevailing trend) from the 2011 market highs, nearly putting us officially into Bear Market territory. However, the Markets survived the first critical test and most likely will fight a very important technical battle between 1,000 and 1,100 on the S&P in the coming weeks. Should corporate profits during earnings season continue to surprise to the upside, and stocks' momentum turn positive, then it is quite possible for the markets to rally off these levels and create a new baseline for stocks to climb 40% to 50% and begin challenging all time highs from 2007. However, should stocks fail to gain momentum and bounce off these support levels, then a renewed and challenging bear market is likely to follow.

As pictured in the chart below, once the S&P 500 firmly breaks below the 1,000 level, there is no meaningful technical support for at least 200 points or 20% to the downside.

Potentially exacerbating this downside scenario is an impotent Federal Reserve that has exhausted most of the policy tools at



its disposal. In the last bear market in 2008-2009, the Fed lowered interest rates a full four percentage points in order to kick start the economy. Working from near 0% now leaves little room for further traditional monetary stimulus.

At this point, one trading on the technicals should proceed with extreme caution. While there is potential for big upside gains from here, volatility of the magnitude seen recently is almost always accompanied by further losses. Only positions that one is comfortable holding for the next 24 months should be purchased at this point while cash and high quality fixed income will hold a premium.

Another important consideration is to re-evaluate your true risk tolerance. Everyone loves to take on more risk in the form of stocks when times are good, but it is only in downward Markets that we find out if we are comfortable sleeping at night with all our chips in play. The good news is there are things we can do to dial down the risk and still participate in a long-term growth strategy. Whether it's tweaking your asset allocation, adding more diversity through mutual funds, or hedging your portfolio via derivatives, please talk to us if you have questions or concerns about how these volatile times are likely to affect your investments. While doing nothing is obviously the easiest strategy, it is not necessarily the most prudent.

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