



# Market Perspectives

A Glance At How The World Affects You!

January 23, 2012

## Rally Getting Fatigued

Year-to-date 2012 is looking good and investors are maintaining their “feel good” attitude. According to the American Institute of Individual Investors (AII), investor sentiment remains bullish though we note the bull-bear spread has come down slightly since the January 12<sup>th</sup> reading. Still, it remains the highest in more than a year. This kind of one-track thinking among investors is nothing new, but that doesn’t mean they are right. After all, pretending you don’t have a problem won’t make it go away. Lest those bulls forget; we still have some serious headwinds. Trouble is, for most of January, investors have suddenly started ignoring that little problem across the Atlantic and ostensibly believing that America has outraced the possibility of slowing corporate profits among other challenges. Regardless of investor sentiment, we will look to metrics that don’t rely on emotion; global growth estimates, bond spreads, legal insider trading (corporate executives buying their company stock) and technical analysis.

Estimates for global economic growth were once again revised lower in recent weeks. Starting in Europe, the forecast for GDP is expected to decline during 2012. This revision stems from the continuing sovereign-debt crisis as well as the austerity plans being considered and implemented. Germany reported a decline in the fourth quarter of 2011 as did China. However, China is still projecting solid growth in the 8% range. Japan is looking to continue its rebound from the 2011 recession caused by the earthquake and tsunami. Their esti-



mated growth is less than 2%. It is plausible that estimates will improve as we move further into 2012 but that will require strong consumer spending.

Bonds also play a significant role in determining how investors feel about risk. In the last month, yields between government and corporate bonds have widened as government rates declined but corporate rates increased. This reversal may be a serious warning signal but that remains to be seen. The 50 year average spread (differential) between AAA corporate bonds and government bonds is 0.84%. Over the last two months the average has been 1.84%. Most recently, that average has increased to 1.95%. The gap between BAA rated bonds (still investment grade) and government bonds is 3.27%, substantially higher than the historical average of 1.82%. If these spreads begin to spike on worries related to Europe’s debt crisis it would send an ominous signal. From an investment standpoint, however, corporate bonds are still attractive on a relative basis; as long as corporate balance sheets remain flush with cash. Sluggishness in hiring will help keep this theme intact.

Since late last year, the market has slowly worked its way higher. During that time, insider trading (corporate

executives exercising stock options) improved; they were steadily buying their company stock. Of late, that trend has started to weaken. Our sell/buy ratio has moved lower over the last eight weeks but remains in positive territory. I have said many times that insider trading alone can’t be used to discern market movements. However, as an overlay to other metrics, the latest mini-trend is suggesting that insiders are right; the reasons for buying at this level are less compelling than one month ago. We will continue to monitor this secondary gauge.

Turning to the calendar, January and February have produced 0.4% decline over the last twenty years. The last ten years were even worse as the average decline was 3.4%. So far, the latest sector rotation has helped prolong the current bull rally and past calendar events are doing little to influence that momentum. Technology, materials, energy and financials are leading the pack year to date (opposite of last year) and last year’s winners are bringing up the rear. Though sector rotation can be viewed as a positive, I am strongly convinced that the two month old leg-up is getting fatigued. Relative strength (a technical indicator known as RSI) for the S&P 500 on a 14-day trailing basis is above 70. Readings below 50 are bullish and readings above 50 are bearish. Current readings are quite bearish and likely signal eventual profit taking. The S&P 500 relative strength indicator reached similar levels last October just before the index took a precipitous fall from 1284 to 1161.

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**A Recap of Last Week:** Equities posted moderately healthy gains with techs and financials being notably strong. In the holiday-shortened week, stocks got off to a good start Tuesday with lift from an unexpectedly strong rise in the Empire State manufacturing index. Also supporting gains were better than anticipated economic data from China and Germany and a favorable auction in Spain. Not surprisingly, Carnival Cruise dropped sharply after the cruise shipwreck and fatalities the prior Friday.

On Wednesday, equities rose notably on news of the International Monetary Fund's bailout plan to contain Europe's sovereign debt crisis. Also, industrial production and the NAHB's housing market index topped expectations and Goldman Sachs' earnings came in better than forecast, dispelling early worries over bank profits.

Thursday, it was all about earnings and jobless claims. Bank of America returned to a profit in the latest quarter, Morgan Stanley posted a smaller than expected loss, and initial jobless claims fell to the lowest level in almost four years. Initial jobless claims fell 50,000 in the week of January 14 to 352,000 for the biggest drop since September 2005 when economic expansion was in full gear. Market expectations, according to Econoday's panel, called for 383,000. Housing starts disappointed somewhat but were offset by steady housing permits maintaining November's jump.

The week closed a little mixed with the Dow advancing notably, the NASDAQ down slightly, and others little changed. The Dow was boosted by strong earnings from IBM. Also, strong existing home sales provided a positive mood for the day. American Express missed and weighed on the Dow while Google disappointed and tugged down on the NASDAQ.

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**The Bottom Line:** 2012 has been a very impressive year, so far. The domestic recovery remains subpar but it is gaining strength in manufacturing and housing. Last week's drop in jobless claims implies more traction in the consumer sector. All of this points to a better economy.

However, investors have temporarily forgotten the myriad problems around the globe. For now, fourth quarter earnings silence from Europe is taking stocks higher. Consequently, we have recently raised our near term caution though our asset allocation continues to favor stocks over bonds given low interest rates as well as the expected weaker dollar.

The primary wave in the market has been up since January 3<sup>rd</sup>; this is the longest run of consecutive up days since early July 2011. The ongoing rally started in November and hasn't looked back. Conversely, relative strength in the market is suggesting we are reaching a period of much needed profit taking. The VIX (volatility gauge) is reaching levels similar to end of July 2011, just about the time we experienced the bottom falling out of the market.

Other technical indicators are also saying the market is overbought. While the rally has generated outstanding performance this year, it hasn't been a blast-off type up move and much of the gains have come on weak volume; another bearish signal.

Our investment policy maintains a long term approach and diversification. Using a combination of fundamental and technical data, specific securities are selected for inclusion with weighting considerations for sectors that are expected to outperform. Fundamental analysis provides the basis on which we select securities. Technical analysis is then used to assist in determining entry and exit points.

As an active manager, portfolio appreciation and protection remain top priority. For this reason, our portfolio strategy calls for a tactical rebalance for profit taking based on confirmed overbought conditions.

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**A Look at This Week:** The highlights this week are the Fed's FOMC statement and chairman conference Wednesday and the advance report Friday for fourth quarter GDP. More housing updates post with pending home sales and FHFA home prices on Wednesday and new home sales Thursday. Additionally, we will see if manufacturing momentum continues with durables orders Wednesday. The mood of the consumer is updated Friday with consumer sentiment.

Best Regards,  
Phillip L. Clark, RFC  
President/CEO

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