

Rochester Financial Services

Fee-Only® Financial Management Services

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Earnings Yield (S&P)	Gold	Crude Oil
11,868	1,254	2,669	767	2.61%	7.46	\$1,661	\$93.20

Principal



Investment Strategy Report

Debt Deal Fails to Calm Markets. Investors Concerned About Slowing Growth and Europe

During the past few weeks, clients have called me, concerned about what we should do in the event that the debt ceiling debate in Congress didn't reach a resolution. I wrote in last month's letter that this was a time to exercise caution but added that "You have to believe that this will get resolved before the Aug. 2nd deadline", or as it turned out, *on* the Aug. 2nd deadline. When the deal was announced Sunday night, stock futures were up substantially, with the Dow futures up about 180 points, and that's how the market opened up Monday morning. However by mid morning, we saw a complete U-turn, with all the gains erased and stocks ending in negative territory. Today it was much worse, as the US market dropped over 2.5%, despite the Senate's vote to approve the debt ceiling bill which averted a US default. What happened? We were supposed to get a relief rally but instead got a 450 point Dow sell off from Monday's high to today's close.

Did the markets not like the deal put together in Congress? That's probably not what's going on here. While no one liked this deal, it was most likely the best that they could have come up with. I have no doubt that stocks would have dropped much further had no deal been reached and the US defaulted. More likely what happened was that with the debt debate out of the picture, the markets now concentrated on other problems, namely the slowing economy and default concerns in Europe.

On Monday morning, when the US markets were experiencing their "about face", the Italian stock market was falling 4.5%. Yields on Spanish bonds were exploding higher. It is no longer just Greece now. The European contagion is now spreading to the larger economies. And these economies are much larger than Greece's and can not be bailed out so easily.

Investors are also now focusing on the US economy, which all of sudden appears to be stalling out. The latest Institute for Supply Management (ISM) data shows signs of a broad-based economic downturn. Economists were also alarmed at the 2nd quarter GDP number which was revised down to just 1.3%. Even worse, the 1st quarter number was revised down to 0.4% from a previously estimated 1.9%.

There is no question that the problems that caused the greatest recession in a century will be with us for a while. The recovery from where we were 2-3 years ago has been somewhat miraculous, but problems have to be expected. Hopefully, we can avoid the mistakes made in the 1930s (when the economy had a relapse in 1937), but we have to expect a difficult recovery, not a sharp snapback. The debt debate distracted from the fact that we had a great 2nd quarter earnings season. Companies are doing well, with solid earnings. If you compare corporate earnings to the extremely low interest rate environment, you find that stocks are the cheapest they've been in many years. At the same time, investor sentiment is very negative. In fact, if you look at how investors are pouring money into the safety of Treasuries, even though yields are approaching historic lows, you can say that they are panicking. This negative environment with an oversold market is ripe for a rebound. We have seen it already twice this year from similar levels. With a slowing economy, we still need keep our guard up and remain defensive. But good stocks at cheap prices will always present opportunities.

Market Sectors - 1) Gold has been another safe haven amidst the global turmoil, as investors have sent the price to a new record high. Our precious metals funds had a good month which certainly helped our overall performance. **2)** While emerging markets haven't been doing much lately, my largest holding had an excellent month as it outperformed funds in its category and also helped our performance. **3)** Our biotech fund did nothing special last month as it performed in line with the rest of the market. I am waiting for its relative performance to begin moving higher again before adding to our holdings. **4)** Interest rates continued to move to incredibly low yields, seemingly defying logic. Given that the US deficit is moving inexorably higher, with no slowdown in sight, interest rates will have to rise. But for now, as I mentioned above, investors are sensing Armageddon and are flocking to Treasuries, even though they will be paid only 1.2% for a 5 year note. This caused my rising interest rate fund to get hammered last month. While it's hard to imagine that rates won't begin rising at some point, if it doesn't happen soon, I will have to cut our losses. *Jeff Feldman*

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