

Market Update – October 12, 2011

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What do Europe, gold and doing the Twist have in common? In some circles they might remind you of travel, things that glitter and a time to dance. Well, that was then and this is now – and when you're talking about the financial markets today, these things take on a whole new meaning. But we don't need ask you what "double-dip" reminds you of either since those words are currently the darling of all media -- and they're not talking about ice cream. In fact, all of these topics have been major drivers of the headlines over

this past quarter.

The European sovereign-debt (governments) crisis created a stomach-churning roller coaster during the past few months. At this point, a Greek default is anticipated and is assumed to be built into the market. That means that if it *does* actually happen, it hopefully won't have much more of an affect than it has already.

It is the secondary effects of that default that are harder to anticipate. As you might imagine, getting 17 European countries to create a bailout solution can be quite a task. The daily news of the bailout options has also added to the extreme volatility in the markets. Suffice it to say, we expect things to remain messy for the near future.

As the world seems to get smaller almost daily, the financial markets tend to move together more than ever. As Europe muddles through a slow down, so goes the rest of the world. The future of the Euro currency remains in question. That uncertainty has helped perpetuate a recent rise in the dollar. This augmented a September drop (Boy Howdy) in gold prices after a climb to new heights earlier in the quarter.

As you will see from the table below the third quarter was tumultuous to say the least:

% CHANGE	2010	QTD CHG	1-YR CHG	10-YR AVG
DJIA	-5.74	-12.09	+1.16	+2.35
NASDAQ	-8.95	-12.91	+1.97	+6.32
S&P 500	-10.04	-14.33	-0.86	+0.89

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REAL YIELD	09/30 RATE	1 YR AGO	5 YR AGO	10 YRS AGO
10 YR TIPS	0.17%	0.75%	2.27%	3.50%

Sources: online.wsj.com, bigcharts.com, treasury.gov, treasurydirect.gov – 9/30/11.

Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.

These returns do not include dividends. Past performance is not indicative of future performance.

The Fed is now resurrecting a policy used by President Kennedy in early 1961 to stimulate the economy known as Operation Twist. This program would buy long term Treasuries financed by selling short-term Treasuries. The committee did surprise markets with its decision to reinvest principal payments from its mortgage security portfolio into agency Mortgage Backed Securities (MBS) in an effort to lower mortgage rates -- which have not come down as much as Treasuries in past few months. Going forward, it will be important to watch whether the Fed is successful in lowering mortgage rates but more importantly, if lower rates can spur demand for home loans and help the housing market contribute to growth. (JPMorgan)

Other big news of the quarter was the rating downgrade of the US Government. - The yield on the 10-year Treasury note was 2.57% on 8/05/11, the day that S&P announced a downgrade of the USA from AAA to AA+. Now 8 weeks later, the yield on the 10-year Treasury note closed last Friday (9/30/11) at 1.92% as funds around the world continue to buy US debt (source: Treasury Department).

Of course, the stock market would prefer to see a full-blown QE3 rather than the comeback of Operation Twist. Yet with our GDP so lean and the stock market and housing sectors both needing boosts, any idea with merit is welcome – and these proposals may go from drawing board to reality this fall.

The other looming question is whether or not we're in for another recession. An interesting fact: recessions are officially declared by the National Bureau of Economic Research but, hind sight being what it is, that's usually after the fact. A CNNMoney survey of economists this week pointed to a one-in-three chance of a new recession in the next six months. This poses a particular threat to the jobs market which has not yet recovered from the last recession. So what does all this mean for investing today? According to JPMorgan, stocks may now be cheap in light of lower prices and continued strength in earnings. They also believe that large-cap and growth stocks look the cheapest right now, high-yield bonds appear cheaper than Treasuries and that a diversified approach to fixed income investing continues to seem appropriate given the current economic uncertainties.

In response to the experience of the financial crisis and continuing uncertainty, investors may move to preserve capital by investing in portfolios that are constructed to capture some market gains yet with an eye to protecting against some market losses as the same time. Specifically, investors may choose to enhance risk management by supplementing traditional asset class diversification with a more thoughtful mix of strategies that are designed to position their portfolio for a variety of market environments. Of course, no asset allocation can completely

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eliminate the risk of fluctuating prices and uncertain returns but there are several strategies that may make a difference.

One approach found by State Street to have benefited portfolios during the financial crisis was the blending of “convergent” and “divergent” strategies. Convergent strategies analyze fundamental data to determine the value of an investment and divergent strategies focus on trends and sentiments. Convergent strategies often do well in quieter periods, while divergent approaches tend to perform better when the market is volatile. . Some divergent, or non-traditional, approaches are designed to mitigate the downside volatility that has been shown to be a feature of market-dependent strategies.

You might be thinking that this is one long-winded way to say, “Don’t put all your eggs in one basket” but as the economic climate changes due to so the various issues that we will be forced to adjust within, our strategies must have a way to adjust as well.

As you may know, the fourth quarter tends to be a very good one for Wall Street: across the last 50 years, stocks have gained an average of 3.6% in the last three months of a year. Let’s hope the historical pattern repeats in 2011. (USAToday). Hopefully, some bullish sentiment will wander back onto Wall Street before 2011 ends, perhaps enough to notably reverse some of the YTD numbers above.

Charles Darwin perhaps said it best: *“It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change.”*

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