



MARKET OUTLOOK

A publication of Strategis Financial Group and MarketOwl.com

Bonds doing opposite of what is expected

Back in late spring of this year, Strategis Financial Group switched a large portion of its client assets to long-term bond funds like iShares Barclay's 20+ Year Treasury Bond ETF (TLT).

For most of the summer we looked quite intelligent because long-term bonds did well. All that changed quickly over the past few weeks as long-term bonds have done a sharp retreat.

Some variable annuities and 401K plans did not have a long bond option. In those cases we moved to a total return bond fund like Pimco Total Return (PTTRX). These funds have lower volatility than long-term bond funds and generally less risk. Total returns bond funds have held up well by comparison.

The irony is that the decline in bonds occurred when economic fundamentals would seem to warrant rising bond prices.

"Bond market defies Fed" was the headline on a Nov. 16 *Wall Street Journal* article.

The article noted that the Federal Reserve's plan to buy \$600 billion is U.S. Treasury bonds was intended to push interest rates lower to encourage more borrowing by consumers, businesses and investors.

"That should have driven up prices on those bonds and lowered their interest rates or yields, which move opposite to the price," the article said. "Instead, yields on almost every Treasury have been rising.

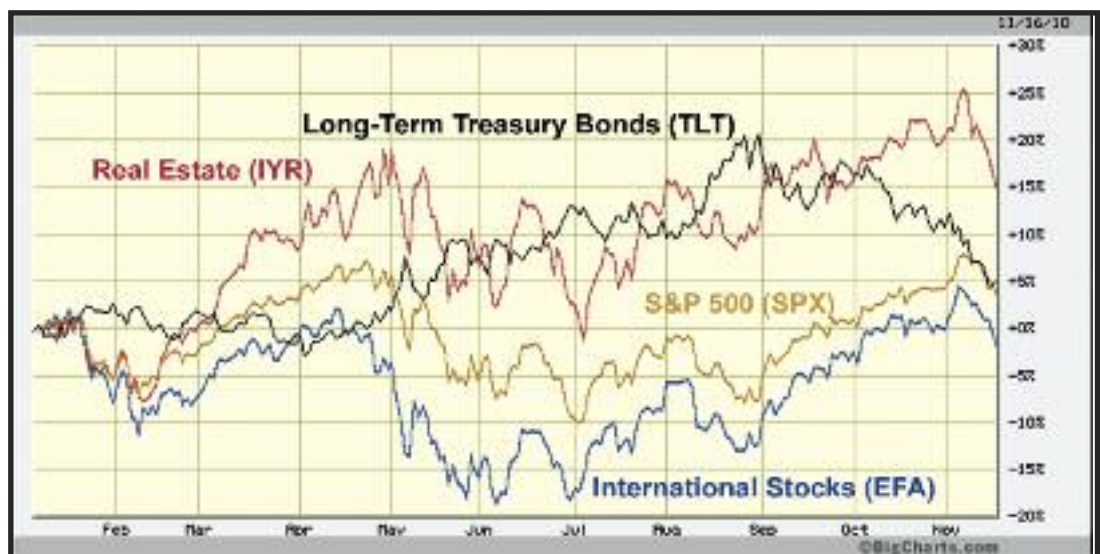
"Many observers still believe that the power of the Fed's printing press will prove overwhelming and economic growth disappointing. Both forces would eventually

drive rates lower."

The accompanying chart below shows the performance of TLT during 2010. We began taking bond positions in May. The chart includes three other positions we use to help us assess overall market conditions: International stocks (EFA), Real Estate (IYR) and the S&P 500 Index (SPX).

As the chart shows, throughout the summer months, bonds drifted upward as the other investments bounced around without making any real progress. In August bonds soared and the other three positions slid.

When September came, the



1-800-279-3377

Fall 2010
2230 N University Pkwy 9C • Provo, UT 84604
www.sfginvest.com

When September came, the three equity investments began rising while bonds struggled to hold their ground. In November the situation changed again. While bonds continued to slide, the other three positions also fell off sharply.

Similarities seen in market movements

Now take a look at the chart to the right. By the end of September, technical indicators showed that although the upward move in equities reached an overbought level, stocks continued to rise for several weeks.

This chart shows the S&P 500, but the other two positions referenced on the previous page were in a similar condition. The pink highlighted portion of the chart shows that the rally that began at the end of summer was similar to the one that occurred earlier in 2010 that was followed by a significant correction. We believe that a similar correction over the next few months is a distinct possibility.

The middle portion of the chart is a moving average convergence divergence (MACD). This



indicator is usually reliable at identifying market turning points. By the end of September, it reached an overbought level and the MACD actually crossed below its moving average—something that typically precedes a market correction.

As shown in the green highlighted oval, this indicator is still at an overbought level, but it has crossed over again—signaling

that a more significant downturn could occur. Again this indicator looks much like it did earlier in the year prior to the correction that began in May.

The bottom portion of the chart shows a stochastic oscillator. It reached an overbought level in early September. This indicator was showing that the move in stocks appeared to be overextended and ripe for a corrective downturn.

Beginning in September it generally remained above the 50 level never completing a normal downward cycle until early November.

The bottom line is that in October, our indicators were showing that a stock market downturn

Important Investor Information:

Past performance may not be indicative of future results. Therefore, no current or prospective client should assume that future performance of any specific Strategis strategy will be profitable or reach its performance objective. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment or strategy will be either suitable or profitable for a specific investment portfolio. Certain portions of this newsletter might contain a discussion of various positions and beliefs as to current and anticipated market conditions, which are based upon professional judgment. However, there can be no assurance that any such position or belief will prove to be correct. In addition, due to various factors, including changing market conditions, such discussion may no longer be reflective of current position(s) and/or belief(s). Finally, no reader should assume that any such discussion serves as a substitute for personalized advice from Strategis or any other investment professional. Securities offered through Liberty Partners Financial Services, LLC Member FINRA and SIPC

Copyright 2010, by Strategis Financial Group, Inc., 2230 N. University Pkwy, Ste. 9-C, Provo, UT 84604. It is a violation of United States copyright law to reproduce this publication in any manner without permission.

downturn was likely. They still are. A downturn in stocks would normally propel long-term Treasury bond prices higher again.

As a result, we have been reluctant to move into stocks because there is a possibility that a correction will follow and the price of bonds will again rebound. So while we looked smart for several months, October and the first week of November made us look like we quickly lost IQ points.

We anticipate that this situation will correct itself. As illustrated by the chart at right, technical indicators are showing that long bonds are oversold and a rebound should occur soon. Both the MACD and the stochastic oscillator are at overextended levels where an upturn would normally be anticipated.

Using perfect hindsight, we wish we had moved out of bonds at the end of August and perhaps switched to international or U.S. stocks, but at the time that seemed imprudent.

Now the indicators are showing that a rally in long-term bonds is likely along with a downturn in stock prices.



Commodities added to selection set

As a result of this experience, we have made a change to our Focus Growth Strategy, which is fundamental to the way we deal with market rotation. In addition to the positions shown in the first chart, we have added commodities such as precious metals to our selection set.

The financial media has devoted a lot of air time to gold this year and most people have probably also seen advertisements from companies that buy and sell gold.

Perhaps because of all the attention, many investors believe that gold prices have skyrocketed. Gold reached an all-time high in November. For the year, it is up about 20%—a nice gain, but much less than some imagine.

Other commodities have significantly outperformed gold. For example, silver is up more than 40% in 2010. The chart on the next page shows a comparison between silver and gold.

The bottom portion of the chart shows a MACD for the gold position. It shows that gold reached an overbought level in October but managed to resist one attempt at a downturn and climbed to a higher high. Since then, however, the MACD has crossed over and momentum now seems to be to the downside.

There is no way to know how long this corrective move in precious metals will last. For now, buying gold or silver would appear to carry a high level of risk. But going forward we believe that having the option to consider commodity positions like precious metals will better enable us to manage market rotations.

Investment Company Act, Rule 3a-4

As your investment advisor, we are required by the Investment Company Act, Rule 3a-4, to make recommendations in accordance with your individual needs and financial circumstances. We must also periodically check to ensure that these needs and circumstances have not changed. So if there have been changes in your financial circumstances, please contact your advisor at 1-800-279-3377. We will be happy to make any necessary adjustments in your portfolio selection.

Federal Reserve taking a big risk

Most people are aware that the Federal Reserve is actively manipulating the bond market in an attempt to stimulate the economy. Normally it does that by lowering interest rates. When rates fall, bond prices tend to rise. After the Fed began buying bonds in August, interest rates declined and bond prices spiked.

When Federal Reserve Chairman Ben Bernanke announced the Federal Reserve's intent to purchase \$600 billion in Treasury bonds, he said the decision to buy bonds came about because the Federal Reserve has already lowered its lending rates about as much as possible.

In a Nov. 4 guest column for the *Washington Post* Bernanke explained that members of the Fed agreed to the bond purchase in part to attempt to stimulate inflation.

"Most measures of underlying inflation are running somewhat below 2 percent, or a bit lower than the rate most Fed policymakers see as being most consistent with healthy economic growth in the long run. Although low inflation is generally good, inflation that is too low can pose risks to the economy—especially when the economy is struggling. In the most extreme case, very low inflation can morph into deflation (falling prices and wages), which can contribute to long periods of economic stagnation."

So far there is no evidence that the Fed will achieve its objective of boosting inflation. Although it has been actively buying bonds since August, the



core Consumer Price Index (CPI) has remained unchanged since that time.

The most recent data from the U.S. Labor Department showed that the October CPI rose just 0.2% for the month. Over the past year, the annual core rate is up just 0.6%—the smallest increase since the index began in 1957.

In order for the Fed's plan to have the desired effect, banks have to be willing to loan money and consumers must be willing to spend. Unfortunately, with continued high unemployment rates there are fewer people who can qualify for loans and fewer people with excess money to spend.

The 2010 holiday shopping season will undoubtedly play an important role in determining the direction of the U.S. economy over the next several months. Strong retail sales will boost consumer and investor confidence. A weak showing could potentially send the markets and prices into

another downward spiral—something the Fed wants to avoid at almost any cost.

Until there is more evidence about whether or not the Fed's plan to stimulate the economy will have the desired effect, the situation is likely to remain uncomfortable for investors.

—Flint Stephens

Mr. Stephens is marketing director and a financial advisor for Strategis Financial Group. He has been a writer and editor for numerous investment publications. He has a masters degree in communications from Brigham Young University.