October 31, 2011

	Key Market Data		
	Week ending…		
	10/21/11	10/28/11	Change
Dow Jones Industrial Average Index	11,808.79	12,231.11	+3.58%
S&P 500 Index	1,238.25	1,285.09	+3.78%
NASDAQ Composite Index	2,637.46	2,737.15	+3.78%
10-Year Treasury Note Rate	2.203%	2.305%	+0.102 pct. pts.
NYMEX Crude Future (Barrel)	$87.40	$93.32	+6.77%
Euro/U.S. Dollar	$1.3896	$1.4150	+$0.0254

First the treat. Boosted by the deal reached in Brussels early Thursday morning, the Dow closed above the 12,000-point mark for the first time since Aug. 1 – quite a feat given the fact that it was parked at 10,655.30 as recently as Oct. 3. In fact, with one trading day left, the Dow was on the way to its best month in decades with the S&P 500 and NASDAQ following suit.

Then the trick. As has too often been the case over the last few years, the more closely investors looked into the latest plan, the more devils they found in the details. As *The Economist* put it, "As it is, this deal at best fails to solve the euro crisis; at worst it may make it even worse."

The eurozone leadership's "comprehensive package" featured three main steps. Step 1: It was agreed that Greek bondholders will now have to take a 50% loss on Greek debt (the original figure had been 21%), which was projected to knock Greece's debt as a percentage of GDP down to 120% by 2020 (Greece will also get the long-put-off next bailout payment.) Step 2: To protect them from the bite of bad bonds, the continent's 70 largest banks will have to raise more than €106 billion ($147 billion) in capital by June 30, which would increase their percentage of "safe" assets to 9%. And step 3: The European Financial Stability Facility, a.k.a. the bailout fund, would be more than doubled in size to around €1 trillion ($1.4 trillion) so that it would be large enough to cover crises in Italy and Spain.

When the plan was announced, France's President Nikolas Sarkozy said, "The results will be a source of huge relief to the world at large, which has been waiting for a decision." His opposite number from Germany, Chancellor Angela Merkel, added, "I believe we were able to live up to expectations, that we did the right thing for the eurozone, and this brings us one step farther along the road to a good and sensible solution." And Greece's Prime Minister George Papandreou said, "Tens of billions of euros have been lifted from the backs of the Greek people. The banks, rather than the citizens, will pay that cost."

Investors agreed. Stock indexes around the world soared while Treasurys yields fell and junk bonds became hot again.

The next day, however, after the hoopla faded, the second guessing began in earnest. Regarding step 1, there was that pesky word "voluntary" – bondholders don't have to get the haircut (though given the state of Greece's economy it seems like a wise move.) More importantly, of the estimated €340 billion in Greek debt, only about €200 billion will get that haircut, as the

International Monetary Fund and European Central Bank, which together hold €140 billion, said they would not participate. That means that Greece's debt will actually only be reduced by around 30%, not 50%. And even with that haircut, Greece's deficit as a percentage of GDP is still expected to be dangerously high at 120%, crippling to economic growth.

Second, most analysts had estimated that those banks needed far more than €106 billion – up to €400 billion, in fact – to be covered against the contagion of bad bonds from Greece et al.

And third, while €1 trillion has a nice ring to it, no one has said just where all that money is going to come from. As *The Wall Street Journal* put it, the larger rescue fund will "rely on Byzantine financial engineering and outside help," and outside investors may not see the eurozone as much of an investment right now. European leaders are courting China in the hopes that it will invest some of its trillions, but that nation's initial response was non-committal, and it's assumed that China will want something in return such as a more favorable trade agreement. And the question remains as to whether even €1 trillion will be enough if Italy and Spain totter, especially as most of the original €440 billion is already pledged to Greece, Portugal and Ireland.

All of which helps explain why, even though the markets soared here and in Europe, the high yields on bonds for Italy and Spain, for example, barely budged. In fact, Italy sold bonds the next day and had to offer the highest premium it had paid in 15 years, not a good sign. Indeed Italy, which has the eurozone's third largest economy, seems to have bumped Greece from the top of the watch list. At the run-up to Brussels, Italy's Prime Minister Silvio Berlusconi had been publicly scolded by Merkel and Sarkozy for failing to follow through on the austerity measures he'd promised to adopt months ago – Berlusconi is in a tight spot of having a tenuous hold in parliament and not enough votes to push through highly unpopular changes to pension plans and the retirement age. When he returned home, he and the Italian media howled at their mistreatment, but the fact remains that Italy, with no growth and debt running at 120% of GDP, is making investors very, very nervous. Berlusconi, who had been pressured to do something by Wednesday, only brought back a letter of intent outlining his plans.

And then there's the fact that France, which plays a key role second only to Germany, is on credit alert, and if its rating gets downgraded that would further shock the system – and weaken France's financial clout. Its growth forecast for 2012 was cut last week to 1%, and Sarkozy said he's about to unveil a new austerity plan. "If we want to defend the French social model, we will need to take the necessary measures," he said.

Need more cold water? Well, Spain's jobless rate hit a 15-year high last week at 21.5%. And in even worse news, the estimate for GDP growth in the third quarter for the 17-nation eurozone is expected to fall from the already sickly 0.2% recorded in the second quarter.

Perhaps that's why *The Economist* said of the plan, "This is the eurozone's third comprehensive package this year. It is unlikely to be its last." And even Chancellor Merkel toned down her enthusiasm, saying, "I don't think you can say one summit alone will do the trick. It's a long, drawn out process."

Back at home, it was, by comparison, a quiet week. President Obama, saying "We can't wait" for Congress, is apparently going to take some executive branch actions that don't require congressional approval. Last week, a plan was unveiled to give homeowners who are "underwater" (that is, their mortgage exceeds the value of their home) the opportunity to refinance their mortgages as long as they've kept up with their mortgage payments. Up to a million borrowers could be eligible as long as their mortgages are backed by Fannie Mae or Freddie Mac.

The Democratic and GOP sextets on the debt super committee each unveiled plans last week, both of which were curtly dismissed by the other side. Not surprisingly, the Dems' plan packaged entitlement cuts with new tax revenues, and the Republicans focused on spending cuts without such revenues. The two sides have until Nov. 23 to come up with a plan to lop off at least $1.2 trillion from the deficit over a 10-year period. If they don't, automatic spending cuts will take effect in January 2013. The positive spin was that at least they were talking and both of their plans exceeded the mandated $1.2 trillion. Still, Speaker of the House John Boehner (R - Ohio) said of the first plans, "We're into a really tough time and it is going to take a lot more work."

In a related story, the latest *New York Times*/CBS poll shows 89% of Americans don't think their government can do the right thing, 74% say the country is on the wrong track, and 84% disapprove of Congress. Ouch. In addition, almost half thought the Occupy Wall Street movement reflected the thinking of most Americans. Two-thirds of those surveyed felt that the nation's wealth should be distributed more equitably, and 70% thought the GOP favored the rich. Finally, two-thirds were against corporate tax cuts and the same number was for taxing millionaires at a higher rate.

As if to underscore those findings, the Congressional Budget Office released a report showing that the top 1% of Americans have more than doubled their share of the nation's income over the last 30 years, adding that taxes have done less over the same period to reduce the concentration of income: "The equalizing effects of taxes was smaller." Examining the years 1979 through 2007, the CBO found that the average inflation-adjusted, after-tax income for the top 1% of Americans jumped 275% over that period. For others in the top 20% it rose by 65%, while for the poorest 20% it increased only 18%.

In New York, William Dudley, the president of the Federal Reserve Bank of New York, said a third round of quantitative easing was in the cards, if need be: "I don't think the Fed has run out of bullets," he said.

In other news, the U.S. economy bounced back in the third quarter with GDP growth up at an annual clip of 2.5% compared to 1.3% in the second quarter and 0.4% in the first, the Commerce Department reported. The rate was driven by consumer spending (up 2.4%) and business investment (up 17.4%) – just what the economy needs more of and hasn't been getting. That said, it's not enough to get us back to where we were before the recession nor will it result in many jobs or completely erase fears of a double dip. And there are concerns about revisions – the first quarter originally came in at 1.8%. There was also a feeling that the rate was not sustainable because the numbers also showed that Americans made and saved less last quarter, not a winning combo. The Commerce Department said that consumer spending increased 0.6% in September while disposable income only inched up 0.1%, and the savings rate fell to 3.6%, its slowest pace since December 2007.

The Commerce Department also reported that durable goods orders fell 0.8% in September because of a decline in aircraft orders. Excluding transportation, orders were up a respectable 1.7%.

The Standard & Poor's Case-Shiller Index showed that prices in August rose in 10 of the 20 cities it tracks, the fifth month straight that at least half of the cities registered an increase. Prices rose 0.2% from July but were down 3.8% from last August. And the Commerce Department said new single family home sales improved 5.7% in September to 313,000, the best rate since April, though the median price dropped to $204,400 from $210,900.

The Conference Board said that its consumer confidence index hit 39.8 in October, its lowest point since March 2009 when the stock market hit rock bottom; a reading of 90 indicates a healthy economy.

China's Premier Wen Jiaboa called for his nation to "fine tune" its economic policies to support growth while curbing inflation, but the Ministry of Foreign Affairs followed up with a strong statement that a rapid rise of the yuan was "not possible."

The Reserve Bank of India raised its benchmark rate one-quarter of a point to 8.5%, the 13th hike in the last 19 months, to fight inflation which has been in the 10% neighborhood. The bank also lowered its growth forecast for this year to 7.6% compared to 8.5% in 2010.

Finally, the high-profile investor and corporate director Rajat Gupta was charged with six counts of insider trading, presumably having been outed by his friend and former investing partner the recently sentenced hedge fund operator Raj Rajaratnam, who *The Wall Street Journal* referred to as the "disgraced hedge-fund titan."

A look ahead

Beyond the releases, there will be two important meetings this week that will be closely watched by investors around the world: the Fed's two-day session on Nov. 1 and 2 and then the meeting of the G-20 in Cannes on Nov. 3 and 4. The releases, which will culminate with the latest unemployment rate on Friday, include ISM manufacturing and nonmanufacturing, construction spending, mortgage applications, new car sales, nonfarm productivity and factory orders.

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All index references and performance calculations are based on information provided through Bloomberg. Bloomberg is a provider of real-time and archived financial and market data, pricing, trading, analytics, and news.

The Dow Jones Industrial Average Index® is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Standard and Poor's 500 Index® (S&P 500®) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Standard & Poor's offers sector indices on the S&P 500 based upon the Global Industry Classification Standard (GICS®). This standard is jointly maintained by Standard & Poor's and MSCI. Each stock is classified into one of 10 sectors, 24 industry groups, 67 industries and 147 sub-industries according to their largest source of revenue. Standard & Poor's and MSCI jointly determine all classifications. The 10 sectors are Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services and Utilities.

The NASDAQ Composite Index® Stocks traded on the NASDAQ stock market are usually the smaller, more volatile corporations and include many start-up companies.

NASDAQ - National Association of Security Dealers Automated Quotations. The NASDAQ is a computer-operated system owned by the NASD that provides dealers with price quotations for over the counter stocks.

Bear market calculations and interpretations are derived from data supplied by Ned Davis Research, Inc.

The International Monetary Fund (IMF) is the intergovernmental organization that oversees the global financial system by following the macroeconomic policies of its member countries, in particular those with an impact on exchange rate and the balance of payments.

The European Central Bank (ECB) is the institution of the European Union (EU) which administers the monetary policy of the 17 EU eurozone member states.

The S&P/Case-Shiller Home Price Indices are designed to be a reliable and consistent benchmark of housing prices in the United States. Their purpose is to measure the average change in home prices in a particular geographic market. They are calculated monthly and cover 20 major metropolitan areas, which are also aggregated to form two composites – one comprising 10 of the metro areas, the other comprising all 20.

The Conference Board *Consumer Confidence Index* communicates the results of its monthly *Consumer Confidence Survey*. The survey is based on a probability-design random sample and is conducted for The Conference Board by The Nielsen Company, a global provider of information and analytics around what consumers buy and watch.

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy.

The gross domestic product (GDP) is the amount of goods and services produced in a year, in a country.

The Institute for Supply Management is a not-for-profit U.S. association for the benefit of the purchasing and supply management profession, particularly in the areas of education and research.