

June 2011

Executive Summary

As we noted in our May report, “This would be a strange time of year for the equity markets to break out to new highs as approximately 80 percent of market gains have occurred between November 1 and April 30 over the past 60 years. May–November has tended to be a period for consolidation and corrections.” What we have witnessed is a market correction that has lasted six straight weeks. This represents the longest streak of weekly losses for the major equity indices since 2002. Much of the recent correction has come on the heels of a slew of poor U.S. economic data as well as continued concern over a Greece debt default. The U.S. economy remains sluggish which is very concerning due to the fact that the government has been running record deficits in an attempt to re-inflate our economy. The U.S. economy grew +1.90 percent in the first quarter of 2011 with the assistance of massive government stimulus, including a 2 percent payroll tax holiday, \$140 billion monthly deficit spending, and \$100 billion per month treasury purchases by the Federal Reserve.¹ On the bright side, corporate earnings remain very strong which is helping support current stock market valuations.

Japan versus the United States

We have believed for many years that there is much to be learned from the 1989 (to the present) Japanese debt deflationary situation. Japan is the third largest economy in the world and shares characteristics with the United States: maturing economies, aging populations, high government debt/GDP, massive unfunded liabilities, and below trend economic growth.¹

The Japanese NIKKEI equity market peaked in 1989 at 38,957 and today (22 years later) stands near 9,500. Japan’s real estate bubble popped in 1989 and what followed was a deflationary, stagnant economy for many years as they de-levered their massive indebtedness. Today, we face a similar debt bubble here in the United States, and we may face a similar period of slower economic activity as we go through a period of debt de-leveraging similar to that of Japan. Ken Rogoff and Carmen Reinhart extensively studied this matter after they witnessed the U.S. credit crisis in 2008. Their findings illustrate that economies go through a period of higher unemployment and slower than trend growth for an average five to seven years after a debt crisis. This time table would suggest a bottoming of the current de-leveraging cycle in 2014–2016 here in the United States and also provides a clue when organic, above trend growth may start.¹

Macro Economic Data

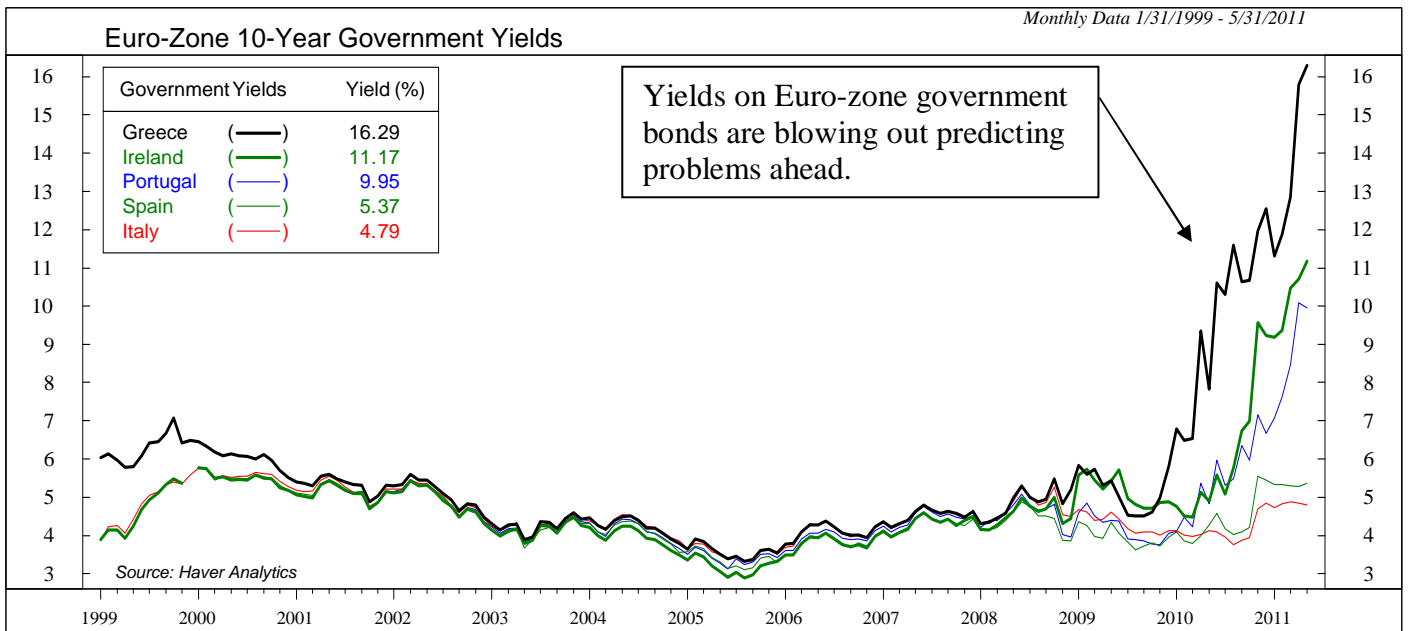
Positives

- + China’s economy continues to produce impressive growth numbers—their industrial output rose 13.3 percent versus a year ago.²
- + Interest rates remain very low. Credit spreads are back to pre-crisis levels but have started to widen recently.²
- + Energy prices have pulled back from their recent peak levels providing some relief for the global consumer and energy reliant businesses.²
- + The U.S. service sector continues to display strength.²

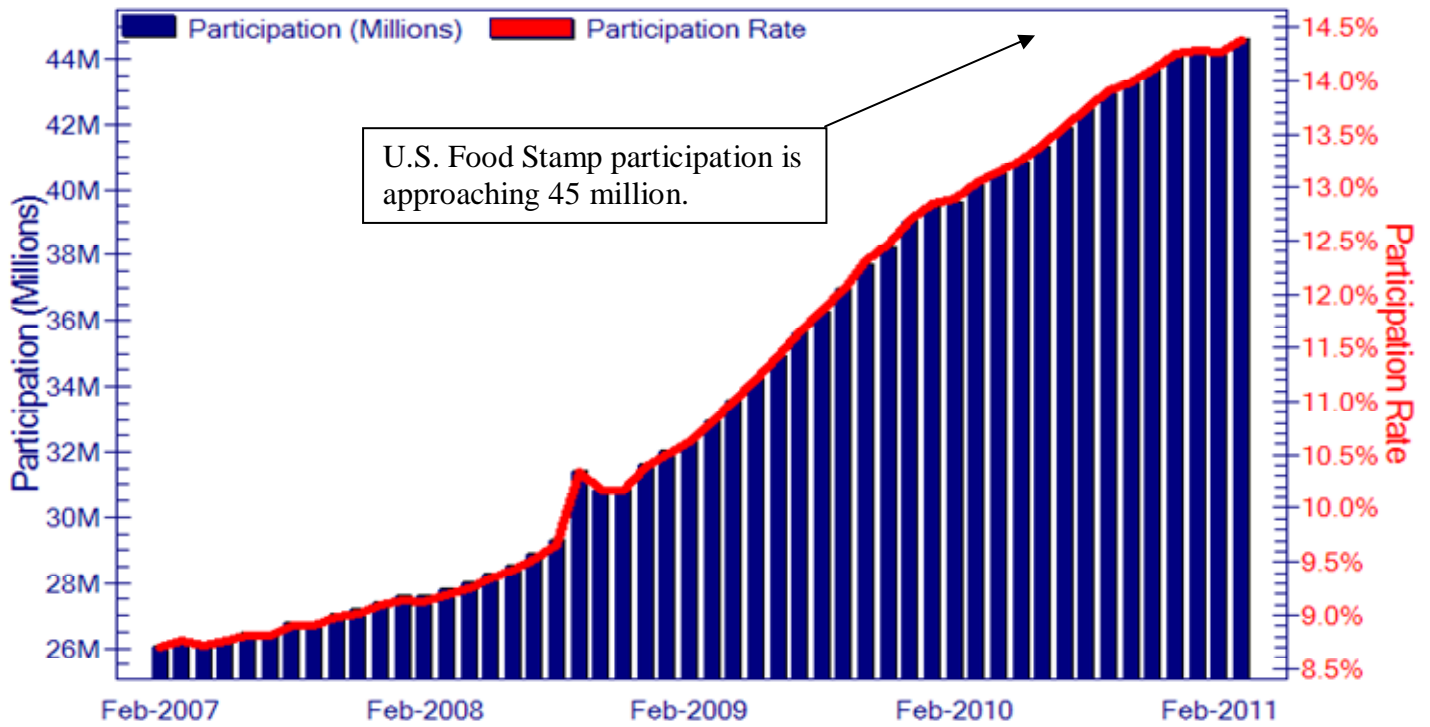
- + Drought, flooding, stimulative Federal Reserve Policy, food based energy products and increasing global demand for food continues to drive up the price of corn, beans, and other food commodities. This is creating a Renaissance for the U.S. agricultural industry.²
- + Bank lending is showing signs of life as commercial loans and consumer credit are beginning to expand.²
- + Corporate America is running lean and profits so far have continued a reasonable growth trajectory.¹

Negatives

- The unemployment rate moved back above 9 percent in May and now stands at 9.1 percent. We had written several months ago that government austerity would create a wave of layoffs which would begin to have a negative impact on our economy. In May, we saw 29,000 government jobs eliminated.³
- New claims for unemployment have remained above 400,000 on a weekly basis for 11 straight weeks.⁴
- Housing data continues to be very weak. We are seeing home price declines accelerate. Housing has dropped more in this “Great Recession” than it did during the Great Depression. During the Great Depression, U.S. housing dropped 31 percent in value from peak to trough and we are currently down in excess of 33 percent in the current housing depression. Most experts expect more downside to come in the next 12–24 months.⁵
- We now have 44 million U.S. citizens receiving food stamps. This is up from 27 million in 2007. Yes, we do have bread lines, they just aren’t visible.⁶
- The U.S. government has now surpassed its debt limit of \$14.3 trillion. The government is currently borrowing money from Federal Pension funds to finance its current deficit. A showdown is coming in the next month between Republicans and Democrats regarding the state of U.S. debt ceiling. A temporary technical default on U.S. debt could cause major disruptions in the capital markets.⁷
- The European Union is working on a resolution to prevent a default of Greek debt.² This may prove to be more challenging to resolve than many expect as the citizens of Greece must agree to massive cuts. We believe there is the potential for restructuring of the European Union before this credit crisis runs its course.



Food Stamp Participation

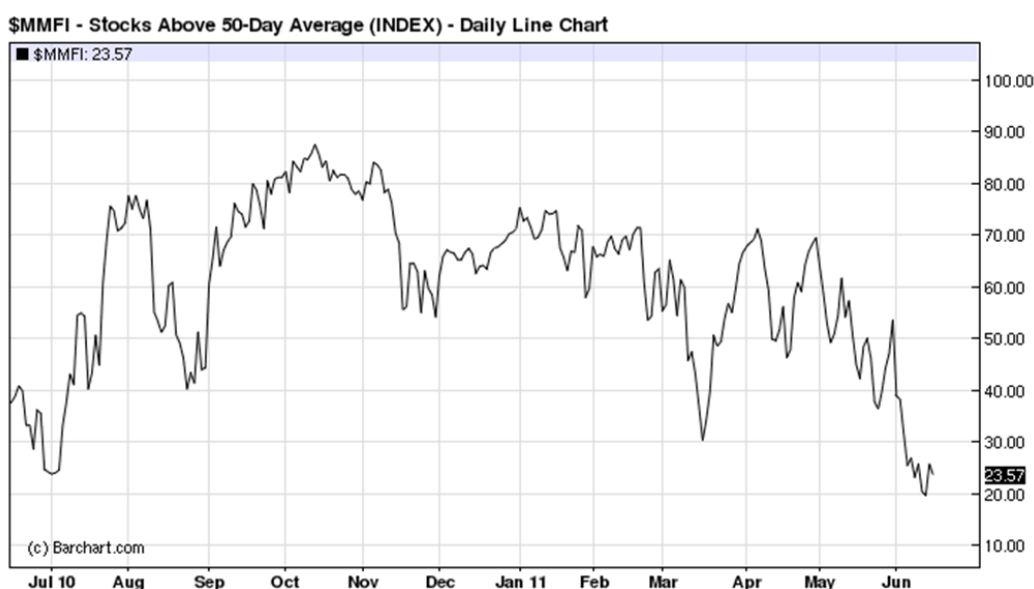


Source: SNAP

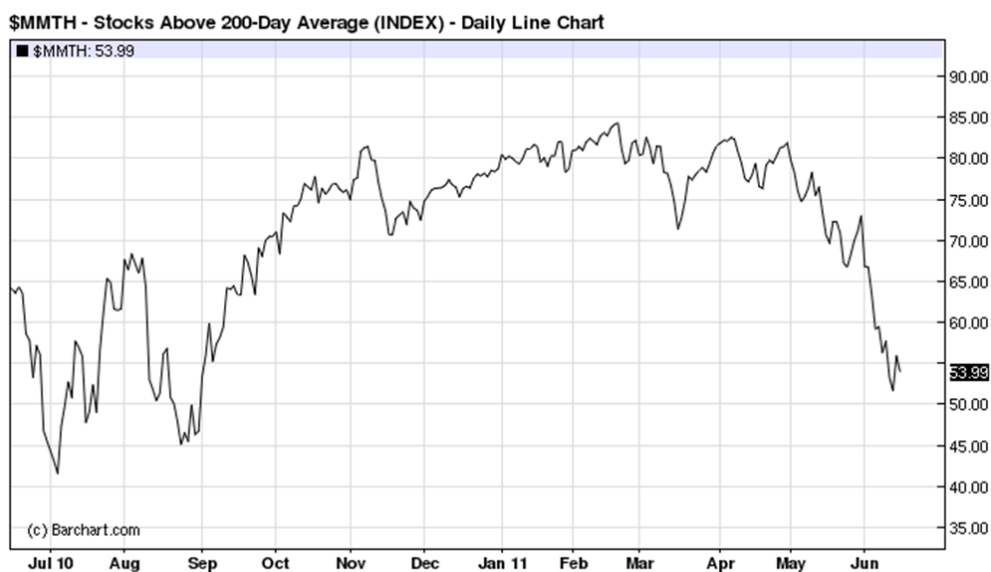
Technicals

- The technical picture of the U.S. market is breaking down as 80 percent (see charts below) of NYSE equities are below their 50-day moving average with 43 percent below their 200-day moving averages. The markets are oversold on a short-term basis and due for some form of a short-term bounce. Time will tell if this is just a correction or the beginning of a renewed cyclical bear market.
- Technical indicators are flashing caution at this point. We would like to see the market repair itself prior to getting more bullish. This may simply be a correction within the uptrend that stated in 2009 or it may be the beginning of a turn in the market. If the markets maintain their structure at current levels, the cyclical bull market will likely remain intact.

Percentage of stocks above 50-day moving average



Percentage of stocks above 200-day moving average

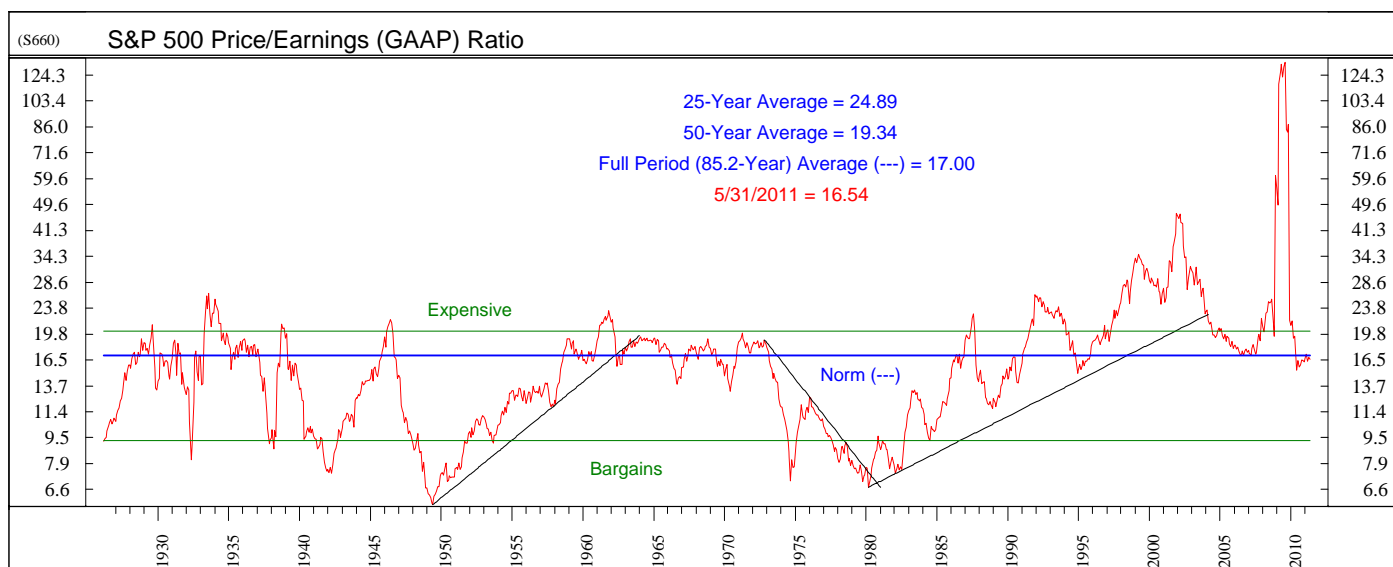


Valuation

U.S. valuations are beginning to look attractive on a forward and trailing price-earnings (P/E) basis. On a normalized basis (10 year P/E average), the market looks over valued.

If we entered a secular bear market in 2000 (long-term bear market), then one would expect that P/E ratios will continue to contract during the current bear market cycle. Typically, P/E ratios drop to extremely attractive levels (6–8x earnings) at secular bear market bottoms.

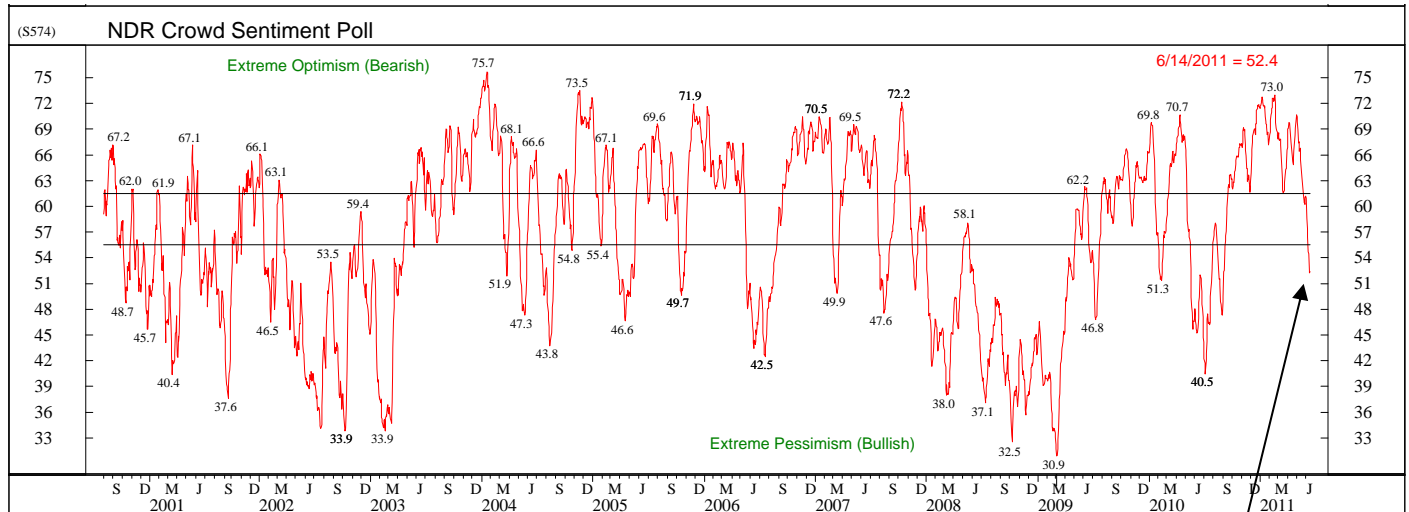
We continue to see multiple compressions since the beginning of the current cyclical bear market. At the peak in 2000, we observed trailing P/Es at 35x earnings. At the peak of the market in 2007, we observed P/E ratios at 18x. Many market historians maintain the current secular bear market may end with P/E ratios around 6-9x earnings.⁸ Japan has witnessed a similar contraction in P/E ratios during their secular bear market that peaked in 1989 with P/E ratios at 67x earnings. Japan’s market today trades at 16x earnings.²



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Sentiment

The recent correction has taken some of the froth off the sentiment indicators. A pullback in investor sentiment can provide an indication that markets are short-term oversold.



We have been warning of high sentiment readings for months. Sentiment is declining dramatically with the market sell-off. This should eventually set up a trading opportunity scenario for equities in the short to intermediate term.

Sources:

- ¹ Ned Davis Research
- ² Bloomberg
- ³ Department of Labor
- ⁴ St. Louis Fed
- ⁵ S&P/Case-Shiller
- ⁶ U.S. Department of Agriculture
- ⁷ Zero Hedge
- ⁸ Richard Russell, Dow Theory Letters

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