

July 2011

Executive Summary

We have witnessed a tug of war on Wall Street over the past several weeks. The equity markets declined for seven straight weeks ending in June followed by a one week recovery rally the first week of July. Most analysts contend that short covering had much to do with the advance in early July as many hedge funds were betting heavily on a declining equity market into the end of June which also coincided with the end of the Federal Reserve Quantitative Easing program (QEII). Equity markets look to be locked between 1250 and 1350 on the S&P 500, and it would be surprising to see the markets break out to the upside or downside of this range in the near term. Corporate earnings are expected to come in strong from the second quarter which should give the market support. Sovereign debt problems in the United States, Greece, Spain, Portugal, Ireland, and Italy should provide plenty of political/market uncertainty, and this cloud will likely keep a lid on any market advance above 1350 in the near term.⁴

We believe we are witnessing a cyclical rally (one-three years) off the March 2009 stock market bottom within a secular bear market (long-term) which started in 2000. The current cyclical rally is growing old in terms of percent recovery and duration vs. prior cyclical rallies. The current cyclical rally has recovered 104.7 percent through June 2011 since the March 2009 bottom and has lasted 843 days. The average cyclical rally within a secular bear market witnesses an increase in value of 64.3 percent and a duration of 508 days. Thus, the current cyclical rally has recovered 40.4 percent more than the historical recovery, and it has lasted 335 more days. If we are in a cyclical rally within a longer term bear market, it is critical that investors begin to manage risk more effectively than any time in the past three years. This may be a good time for investors to focus on income and stability within their portfolio.¹

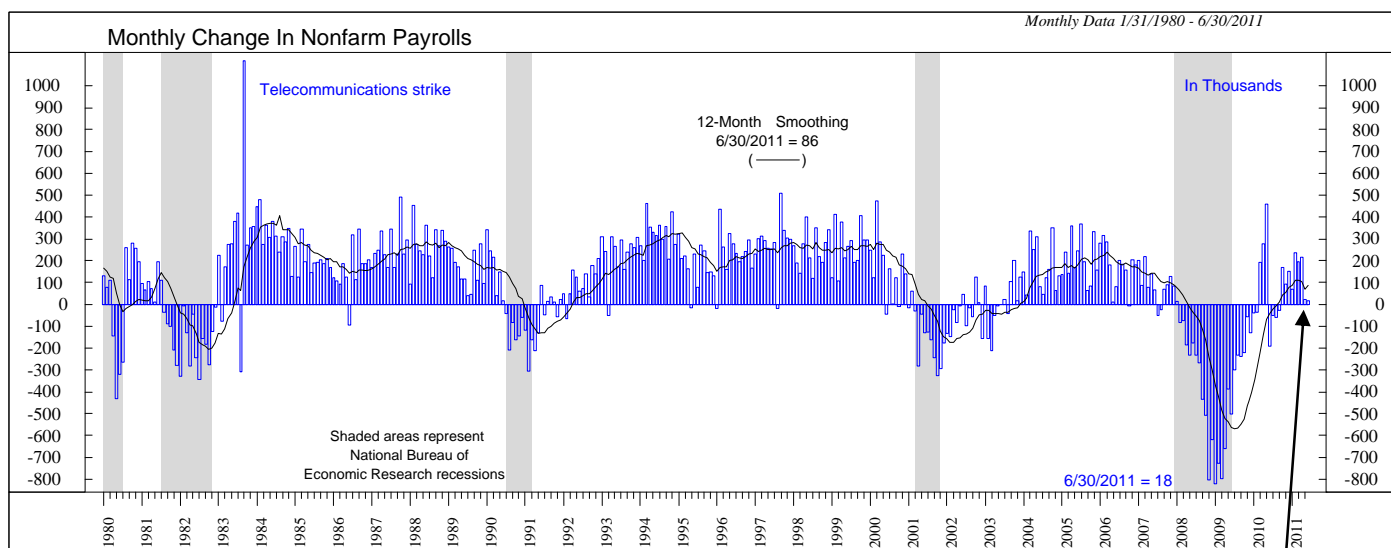
Macro Economic Data

Positives

- + Recent manufacturing data displayed a recovery in June from May data.¹
- + Early indications are that corporate earnings will continue to come in strong as Federal Express and Nike both announced strong earnings and guidance at the end of June, suggesting that global business activity remains strong.²
- + Interest rates are low as the 10-year treasury remains below 3 percent which in turn provides for very low mortgage rates and some support for the housing market.²
- + Energy and food prices have continued to drift lower on the heels of the end of QEII. This should put more discretionary funds in the hands of consumers.²
- + Chain store sales and consumer credit continue to show that the U.S. consumer is still spending.²
- + Central banks around the world are very accommodating, which has created a tremendous amount of liquidity in the global capital markets.²

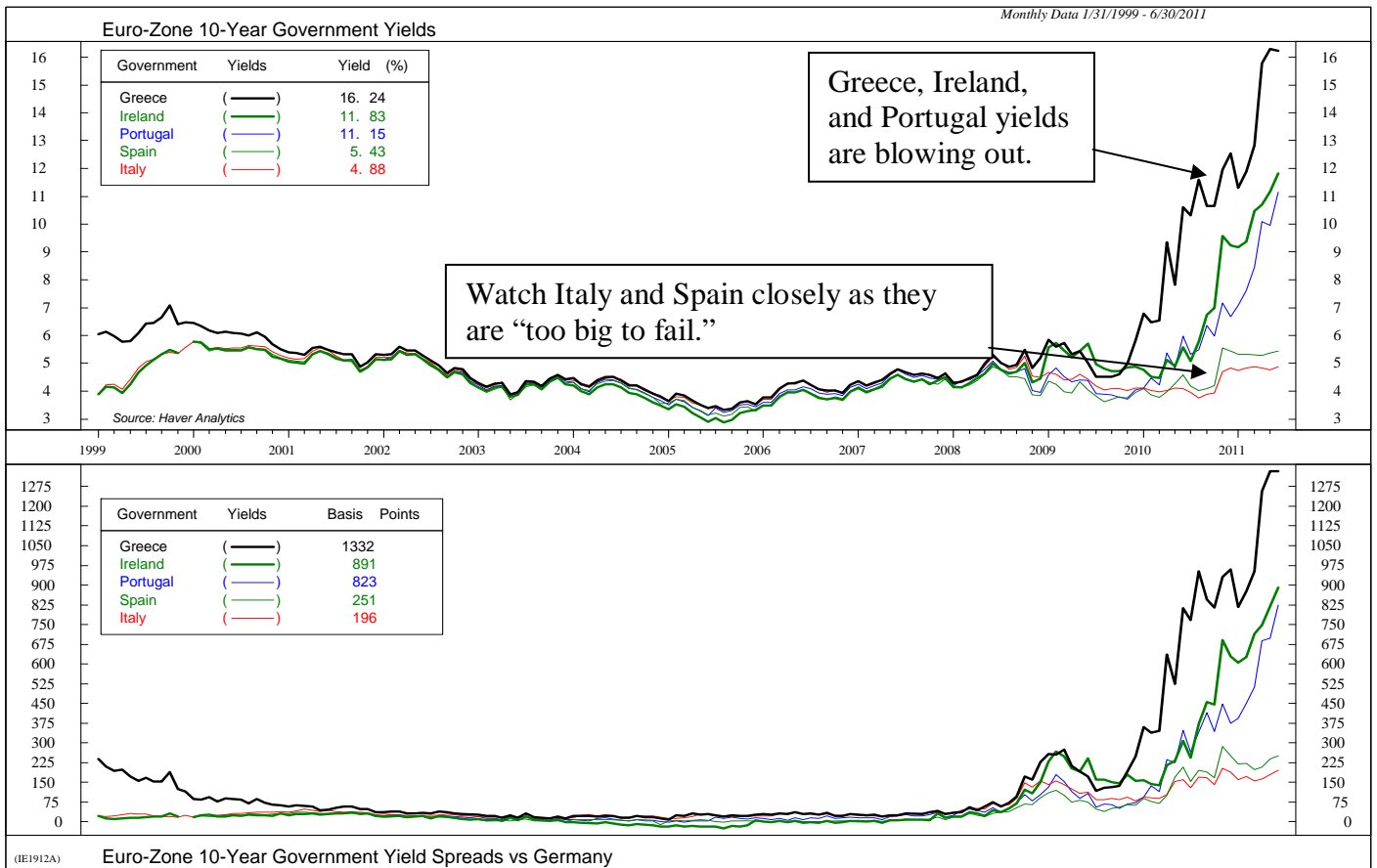
Negatives

- The U.S. government must come to terms regarding its debt limit. If a deal is not agreed upon by August 2, 2011 the U.S. government would be in technical default on its debt which would most likely send equity markets substantially lower.²
- The European debt crisis continues to progress. Although a short-term resolution to a Greece default has been found, longer term fiscal issues continue for Spain, Ireland, Portugal, and Greece. The vigilantes now have their cross hairs focused on Italy as bank stocks in Italy have declined substantially while Italian government bond yields have increased to recent high levels. Spanish government bonds have broken out to new highs recently as well. As we have stated time and time again here, we believe the European debt crisis is the single biggest risk to the current global economic recovery.³
- U.S. unemployment data continues to remain a problem as the June Labor Department employment report disclosed that the U.S. economy only generated a net gain of 18,000 jobs. This was far below the consensus estimate of most economists. The unemployment rate rose from 9.1 to 9.2 percent. Weekly jobless claims continue to come in above the all-important 400,000 level.⁵



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Technicals

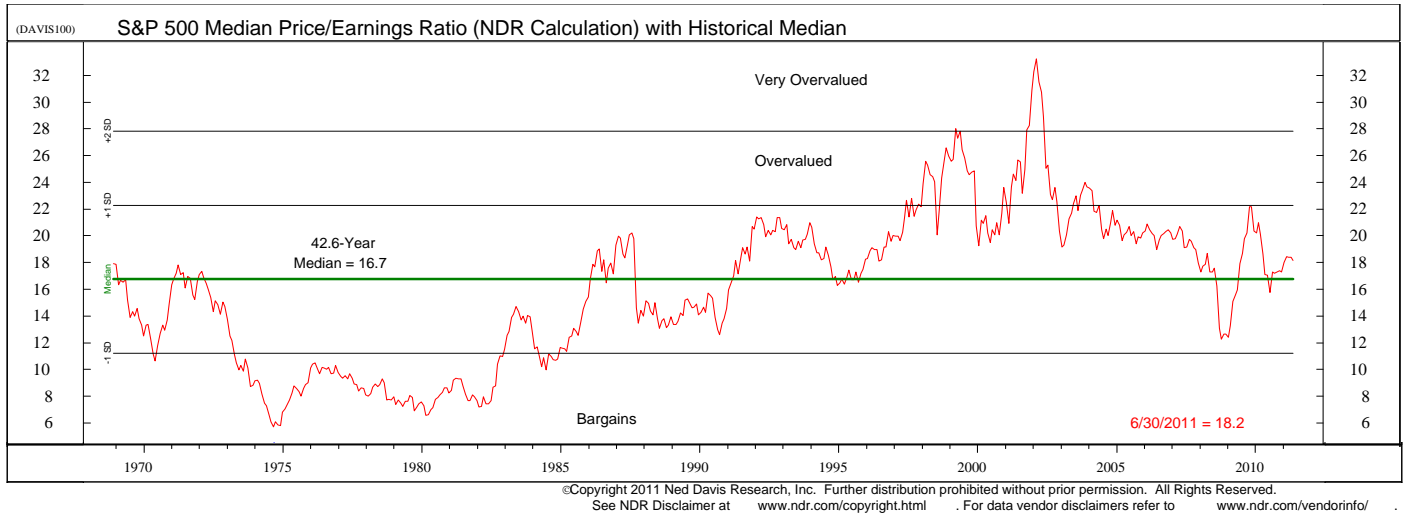
- The technical structure of the equity market has improved substantially during the past three weeks. In our latest monthly report, we displayed charts indicating a large number of equities that were breaking below their 50-day and 200-day moving averages. Today, the technical structure looks much more constructive.



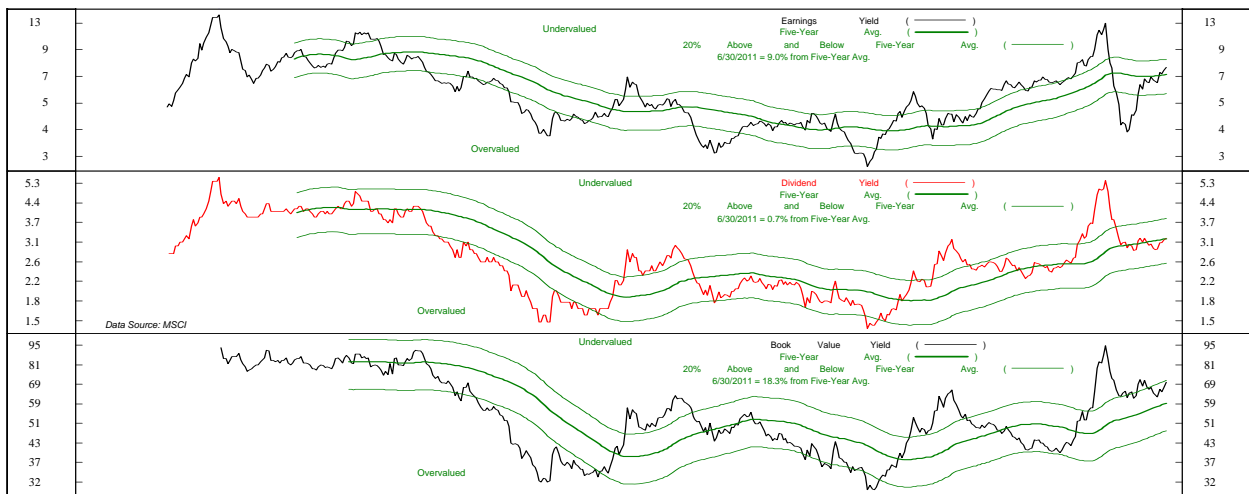
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Valuation

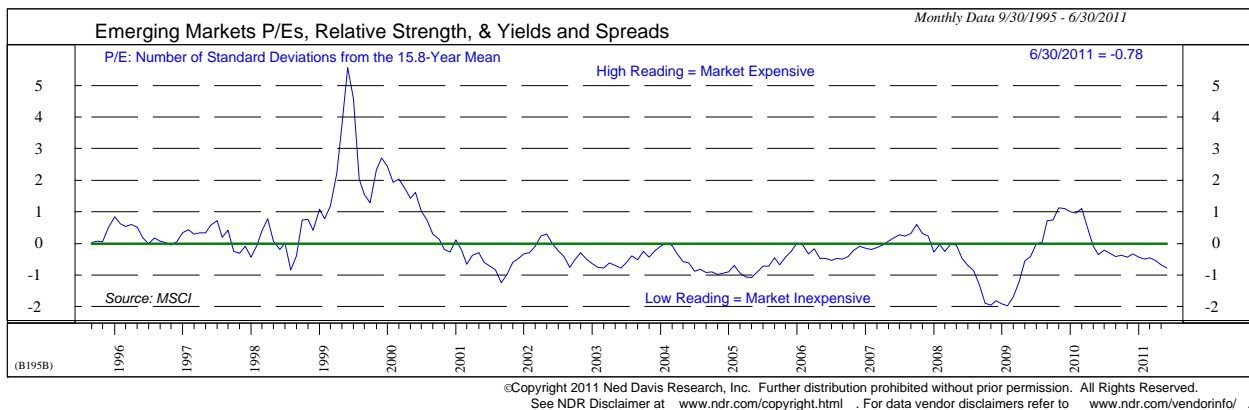
Equity valuations in the United States look to be trading near fair value based on current earnings. On a 10-year normalized price-earnings (P/E), the S&P is above fair value.



European equity markets look fairly valued based on current earnings.

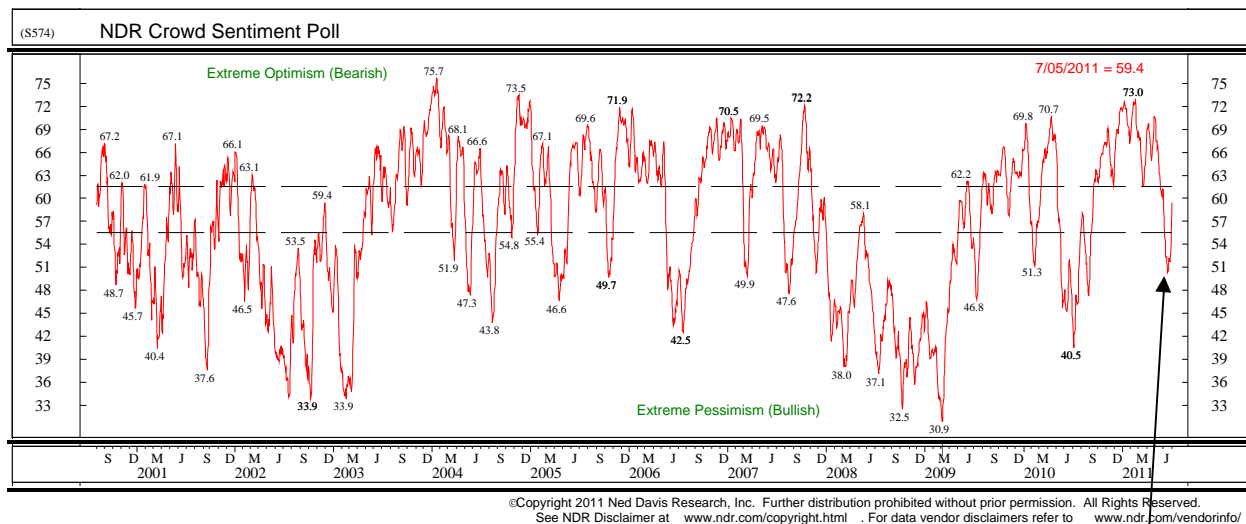


Emerging markets look a little undervalued based on current earnings.



Sentiment

We mentioned in last month’s report that the break down in investor sentiment was most likely setting up for a short-term trade opportunity to the upside as we suddenly had too many investors in the bearish camp. With the recent rally in equities, we have seen investors become more optimistic telling us we may be back to the short-term top in equities.



Finally, a break in investor confidence creating a correction

Sources:

- ¹ Ned Davis Research
- ² Bloomberg
- ³ Zero Hedge
- ⁴ Doug Kass, Seabreeze Advisors, LLC
- ⁵ Labor Department

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