



Weekly Commentary November 1, 2011

The Markets

The sovereign debt problems of Greece and other European countries are a reminder that the United States could face similar problems if U.S. debt levels continue to rise faster than the U.S. economy expands. Consequently, it is critical for Congress to reduce the deficit. Back in August when Congress finally passed its deficit reduction and tax ceiling extension legislation, legislators agreed to create a bi-partisan Super Committee to propose an additional \$1.5 trillion in deficit reduction above the less than \$1.0 trillion of deficit reduction agreed to over the summer. If the Super Committee failed to reach an agreement, \$1.2trillion of mandated cuts would reduce spending on defense and important social programs.

The logic was that the automatic spending cuts would be so undesirable that the Super Committee would agree to other deficit reduction that would-be more acceptable. Unfortunately, it will not be easy to find large savings without sacrifices. Therefore, the next few weeks of deficit negotiations are likely to be difficult.

This past week, initial proposals were submitted by both the Democrats and the Republicans. As expected, the Democrats' plan included tax increases and was therefore opposed by Republican members who do not want to raise taxes in a weak economy.

Between now and late November, investors may begin to worry about the deficit reduction talks. If it looks like very little progress is being made, investors could turn negative, and the stock market could weaken again. Alternatively, if the Super Committee were to announce that negotiations were going well and members were making good progress toward reaching a deficit reduction proposal, investors would probably be relieved and the stock market could rally further. Given the sharp increase in the equity markets during the past month, the greater risk is that investors would be disappointed, causing the market to give back some of its recent gains.

Investors will also be watching for the details of the recently announced agreement to contain the European debt crisis. If the details show that the measures do not have much substance behind them, then global stock markets could also be subject to profit taking and weakness. Investors have been very skeptical about European policymakers' ability to contain their growing financial crisis. Without a cohesive central European government, the Europeans seem to be falling short of the necessary measures to address their problems. Last week's announcement may be more substantial than previous efforts if the details of the proposal do not dilute it too much. If investors do not have confidence in the latest proposals, global stock markets could suffer another setback.

Finally, the rally in the U.S. stock market during the month of October has left the market overbought. Buyers appear to have pushed the stock market up at an unsustainable rate in a rush to get back into the market or to cover short positions. As a result, the U.S. stock market is vulnerable to a pull back during the next few weeks as lingering uncertainties temper last week's positive sentiment.

In summary, it is encouraging to see the U.S. economy still expanding despite the shock to confidence this past summer. Last week's gross domestic product (GDP) report showed the economy expanded at an inflation-adjusted 2.5% annual rate during the third quarter. This is only slightly below the 30-year average rate of 2.7% GDP growth. This shows that the economy is

fairly resilient although it is not very strong. Unfortunately, the U.S. economy still faces many problems.

Index Performance Statistics –November 1

Index	Close	Day Change	Day % Change	% YTD Change	52 Wk % Change
DJIA	11657.96	-297.02	-2.48	0.69	4.19
NASDAQ	2606.96	-77.45	-2.89	-1.73	2.90
S&P 500	1218.28	-35.02	-2.79	-3.13	2.07

Source: Bloomberg

*Price return — does not include dividends

Fed Lays Ground for Large-Scale Asset Buys

Federal Reserve officials are probably engineering a third round of large-scale asset purchases, while they are unlikely to announce a decision today, according to economists in a Bloomberg News survey. Sixty-nine percent of those surveyed say Chairman Ben S. Bernanke will embark on a third round of quantitative easing, or QE3, with a plurality of 36 percent predicting the move in the first quarter of next year, according to the poll of 42 economists from Oct. 26-31.

“We are becoming increasingly persuaded that QE3 is coming, this time focused on purchases of mortgage-backed securities,” said Dana Saporta, U.S. economist at Credit Suisse in New York. “The best guess is at this meeting they’ll try to build some consensus around the idea and lay the groundwork for eventual purchases.”

Fed officials are weighing further easing even after economic growth last quarter accelerated to the fastest pace in a year. Vice Chairman Janet Yellen and Chicago Fed President Charles Evans said in speeches last month that more action may be needed to reduce an unemployment rate stuck around 9 percent or higher for 30 months. Governor Daniel Tarullo said the Fed should consider buying housing debt to lower mortgage rates and spur growth. Three regional bank presidents have dissented against two easing steps since August, posing the strongest opposition among policy makers since 1992. Bernanke hasn’t publicly said whether he believes a third-round of asset purchases is necessary. In a speech last month in Boston, he said the Federal Open Market Committee is exploring ways to better communicate its goals, including through its forecasts and policy statement.

Last Week

No tricks, only treats for Wall Street this week. Stocks rallied as European leaders finally concocted a potion to ward off the region's debt crisis. Ingredients included an increase of the rescue fund's size to 1 trillion euros, bewitching Greek debt holders into a 50% haircut and a recapitalization of European banks. In addition, the International Monetary Fund may play a larger role in the rescue effort, the European Central Bank will continue to buy bonds in the secondary market, and Italy will step up austerity measures.

Along with the news from across the pond, positive corporate and economic news calmed fears of another recession. Third-quarter earnings season results have been generally positive with 70.9% of companies in the S&P 500 index posting results ahead of analyst expectations. Also encouraging were announced takeover bids by Oracle (ORCL \$33.66) and Cigna (CI \$47.37). Initial readings on third-quarter GDP showed the economy grew at a 2.5% annualized rate - its fastest pace in over a year. Because of the witch's brew of good news, the S&P 500 index is up 13.5% in October and back in the black for the year by 2.1% as of Thursday's close.

Meanwhile it was boo-hoo over in bond land. Treasuries sold off sharply as stocks surged on European's policymakers' plan to stem the region's debt crisis. As a result, the yield benchmark 10-year note rose to 2.40% on Thursday, its highest level in 2 months. In the commodity pits, crude oil advanced despite an unexpected rise in the weekly inventory report. Gold regained some of its luster as the yellow metal moved back above \$1700 an ounce.

With a plan to solve Europe's debt crisis finally on the table, investors will likely shift their attention back toward our shores. Investors will look for signs from next week's FOMC meeting and Chairman Bernanke's press conference that follows for signs the Fed may need to wave its magic wand over the economy. Friday's employment reports will also loom large over the market. Current expectations are for non-farm payrolls to show 100,000 jobs were added in October as the unemployment rate holds steady at 9.1%. In addition to the Fed and employment figures, we receive readings on manufacturing and services as well as updates on retail and auto sales.

Earnings season begins to wind down as we get set to enter November. Next week's calendar shows 114 companies in the S&P 500 index and 2 Dow Jones Industrial Average components scheduled to post results. It will be busy in the energy patch with releases due out from the likes of BP PLC (BP \$45.43), Marathon Oil (MRO \$27.76), Transocean (RIG \$59.29) and Apache (APA \$102.84). Other notable companies expected to report quarterly results include Qualcomm (QCOM \$53.51), Pfizer (PFE \$19.84), CVS Caremark (CVS \$37.28), MasterCard (MA \$349.15), Clorox (CLX \$67.43), Sysco (SYY \$27.63), Kraft (KFT \$35.47) and Kellogg (K \$55.07).

Weekly Focus – Think about it

“Wealth can only be accumulated by the earnings of industry and the savings of Frugality.”
~ John Tyler

Best Regards,

Jim, Aaron & Angela
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- * The Markets prepared by Gary Thayer, Chief Macro Strategist, Wells Fargo 10/31/11
- * Fed Lays Ground: Joshua Zumbrun, Bloomberg 11/2/11
- * Last Week cited from Dean Meehan, Market Analyst, Wells Fargo Advisors 10/28/11.
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