



Weekly Commentary January 25, 2010

The Markets

Our Weekly Market Commentary last week was titled “Short Week, Big Doings.” We got the short week right, but should have titled the report “Really Big Doings.” The GOP victory in the Massachusetts Senate race was a major surprise to most and created a degree of gridlock in Washington that is usually popular among investors. So what did the stock market do? In only three sessions, the DJIA collapsed 5.1%, the biggest selloff since last March. The big questions are what happened and where do we go from here? Most assumed that President Obama would sit back and see if any adjustments should be made to achieve his health care and financial controls proposals. Instead, the president came out bashing banks and proposing severe restrictions on their ability to take risk. Yes the banking and financial system need some changes, but the timing and vehemence of the president’s proposals surprised most. That was one of the “big doings” of the week.

Another “biggie” was a report that China is taking steps to cool down its economy. This conjured up fears that other countries would follow China, and world trade is critical to our own economic recovery. But hold on, more pretty surprising “biggies” also hit investors. The nomination of Fed Chairman Bernanke for another term became more questionable. In a nutshell, there was major political confusion in Washington that hit a stock market that was stretched out and “cruising for a bruising.” We did advise short-term caution in our Commentary last week based admittedly on, hopefully, an educated gut feeling. OK, that’s history. What should investors do now?

The political environment in Washington will probably stay confused for quite some time. Whether President Obama moves somewhat to the middle is unknowable but, no matter what one’s party affiliation, the market would like it. Meanwhile, the real mover of the stock market, the economy, continues to show signs of further growth, albeit modest. The December leading economic indicators index increased 1.1%, the ninth consecutive monthly increase. The December core producer price index was unchanged from November. For the past 12 months, the core PPI increased only 0.9%. The economy is going the way the bulls want and the outlook for corporate earnings in 2010 remains positive. The overall market is selling at a very reasonable 13.6 times a popular estimate of \$80.00 a share for the S&P 500 this year. We look at last week as a normal time-out and not a top-out for the stock market. Thus investors are advised to do some partial buying into pullbacks. Oh yes, one more “biggie” this week – the President’s State of the Union speech Wednesday, Jan 27. We are borrowing a quote from President Harry S. Truman for all politicians – “It is amazing what you can accomplish if you do not care who gets the credit.” We hope for some bipartisanship in Washington. The people and investors would love it.

Index Performance Statistics – January 25

Index	Close	Day Change	Day % Change	% YTD Change	52 Wk % Change
DJIA	10196.86	23.88	0.23	-2.22	25.64
NASDAQ	2210.80	5.51	0.25	-2.57	48.43
S&P 500	1096.78	5.02	0.46	-1.64	31.10

Source: Bloomberg

*Price return — does not include dividends

Fed Weighs Interest on Reserves as New Benchmark Rate

Federal Reserve policy makers are considering adopting a new benchmark interest rate to replace the one they've used for the last two decades. The central bank has been unable to control the federal funds rate since the September 2008 bankruptcy of Lehman Brothers Holdings Inc., when it began flooding financial markets with \$1 trillion to prevent the economy from collapsing. Officials, who start a two-day meeting today, have said they may replace or supplement the fed funds rate with interest paid on excess bank reserves.

"One option you might want to consider is that our policy rate is the interest rate on excess reserves and we let the fed funds rate trade with some spread to that," Richmond Fed President Jeffrey Lacker told reporters on Jan. 8 in Linthicum, Maryland. The central bank needs to have an effective policy rate in place when it starts to raise interest rates from record lows to keep inflation in check, said Marvin Goodfriend, a former Fed economist. Policy makers are concerned that the Fed funds rate, at which banks borrow from each other in the overnight market, may fail to meet the new target, damaging their credibility and their ability to control inflation as the economy recovers.

Last Week

It was a wicked bad week for Wall Street. At first, the market looked set for a reversal of last Friday's slide. Healthcare stocks sparked a rally on Tuesday as the polls showed Republican Scott Brown was staging the biggest comeback the Commonwealth of Massachusetts had seen since the Red Sox in October 2004. Investors cheered his eventual win over Democrat Martha Coakley of the state's vacant U.S. Senate seat, as it would help to block the proposed overhaul of the healthcare system.

However, the bears cut the victory celebration short. Stocks slipped on disappointing fourth-quarter earnings reports from the likes of IBM, Google and Morgan Stanley. In addition, commodity-related stocks fell after investors grew increasingly concerned over China's attempt to slow down its economic growth. Shares of the financials weighed on the major indices as President Obama added to his proposed reform measures for the banking industry to prohibit proprietary trading and investing in hedge funds and private equity firms. As a result, the S&P 500 index was down for the week and its gains for 2010 were erased. It is also worth noting that volatility has increased recently with the CBOE Volatility index up over 26% off its one-year low of 17.55 on Jan. 11.

There was some positive news on the economy this week as the PPI data showed inflation is benign and the leading indicators index rose for a ninth consecutive month. Next week's calendar has plenty of key events, with updates on housing, consumer confidence and durable goods providing warm-ups to the important first look at the fourth-quarter GDP number on Friday. Currently consensus expects the economy to have grown a sequential 4.5% (annualized) from the prior quarter. Keep an eye out for the Fed's thoughts about the economy following the conclusion the Federal Open Market Committee (FOMC) meeting on Wednesday. Along with the Fed's comments, investors will be interested in what President Obama has to say in his State of the Union address later that evening.

On the earnings front, current expectations by analysts are for earnings of the S&P 500 index to grow 67% compared to the same period a year ago, according to Bloomberg. If the index produces positive earnings growth, it will stop the string of consecutive quarterly losses at nine. Next week, fourth-quarter earnings season heats up. Some of the important releases that could determine the near-term direction of the market include Halliburton, Johnson & Johnson, Apple, Microsoft, Yahoo!, AT&T, Procter & Gamble, Altria, and Amazon.com.

Weekly Focus – Think about it

"Whichever party is in office, the Treasury is in power."
~ Harold Wilson

Best Regards,

Jim, Aaron & Angela
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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.

* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.

* Bloomberg is the source for any reference to the performance of an index between two specific periods.

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