August 3, 2010

FTI™ Sector Overview for July

Financials – In the Financial sector, U.S. Bonds and U.S. Notes were mixed in July, with the short end of the yield curve slightly higher (we were long Bond futures and Note futures for July, and remain long both for August). The Federal Reserve's stance of continuing to keep interest rates at historic low levels for "an extended period of time" has limited any selling of Bonds. The FTI™ was long the Japanese Yen, the Swiss Franc, and the British Pound for July while short the Euro (for August we are now long all four currencies). As fears of European economic catastrophe lessened, the U.S. Dollar was weaker for the month against most major currencies. The Canadian Dollar and Australian Dollar were both higher for July as well, with the Australian Dollar the better performer of the two (we were short both for July, but are now long both for August). We believe any developments in China, the Koreas, or the Middle East, any potential increase in terrorist activity, domestic economic news, the global economic situation, political turmoil in Europe, and any major moves in the price of Crude Oil or Gold remain the primary factors influencing the Financial markets.

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News Interpretation and August Outlook

Coming into July, virtually all the important markets pointed to worse GDP numbers than expected and a slowing world economy. The markets reflected this by being in downtrends, except for Gold, Silver, and U.S. Government Bonds and Notes which are all safe havens and deflation hedges. The U.S. equity markets made a low on July 2nd, after confirming a downtrend off the previous important low of June 7th. China has seen its equity market in a bear market for a year, which made an intraday low on July 2nd as well. Volume increased on the way down, which is another important bearish indicator.

However, 3 events caused another intermediate rally in virtually all markets:

1. The Equity markets focused on corporate earnings (instead of GDP), which were better than expected for about 70% of the reporting companies in the S&P 500, mostly due to cost cutting.
2. Chinese Equities rallied sharply off the July 2nd low, lending support to U.S. equity and commodity markets.
3. Europe climbed down from the ledge – so to speak – as concerns over its sovereign default problems began to subside, and consequently the Euro rallied and the U.S. Dollar sank. This added more fuel to the fire on the commodities rally.

The DTI®, CTI®, and FTI™ all declined for July. The rally in stocks involved about half the volume seen during the decline. GDP came in at 2.4% for the 2nd quarter. This was lower than the 1st quarter's 2.7% growth, which has subsequently been adjusted to 3.7% year-over-year due to revising the data from last year downward. This shows the economy slowing, instead of accelerating. Also, the predictions for GDP for the year have been lowered; estimates were in the 3.5% to 4% range, but now the 2nd half is estimated to be 1% to 2% by the bears and about 2.8% to 3% by the bulls.

Although Europe's austerity program has not been reflected in the Euro's economy yet, it will eventually. So long term, the Euro should return to its prior downtrend as this policy will not last. Remember, citizens tend to vote out the old leaders in such situations, and instead vote in new leaders who promise changes from austerity.

The forecasting of a slowdown in the economy has been on the mark, yet corporate earnings had easy comparisons to the weak 1st & 2nd quarters of 2009, and were better than expected. The more difficult comparisons begin with the September 30th quarter. We'll maintain our bearish primary views unless the equity markets can move above the June 18th highs across the board in volume.

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Our indexes were set up to be bearish in July, but are now more bullishly set up. The exceptions are energy (where we remain flat), precious metals, and bonds/notes which still suggest weakness. Trading ranges (i.e. the lack of sustained, directional trends in many markets), along with the accompanying whipsaws, are still causing declines in our indexes and hurting performance. The current market and economic environment is unique in the last 50 years. We believe that when the breakout comes (up or down), it will come as a surprise, be powerful, and our indexes will make up their losses quickly. Therefore, we suggest that a 5-10% allocation in strategies based on our indexes should not be sold in losing streaks, but rather added to. *There can be no assurances that the indexes will achieve their objectives or avoid losses.*

Nothing makes money all the time, and an economic environment with interest rates of practically zero and 80 bps CPI increases is a period in which trend-following indexes and strategies tend to have difficulties. There is nothing new about that. The issue is not about the strategy, but rather what the strategy in this environment reflects, as depicted in the outcomes. To repeat what I have said previously, trend-following indexes and strategies tend to benefit and profit from movements up or down, not from trading ranges. We anticipate that this unusual commodities trading range (Crude Oil is at $78 as I write this, the same as it was over a year ago) will most likely end when least expected.

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