# Peter's Weekly Market Analysis

*December 22, 2014*

## Commentary At-a-Glance

**Important tax reminder at the bottom**

- Last week was one of the wildest weeks we have seen in the financial markets in a long time.
- Oil continued to be the focal point of many investors moving around assets.
- Cuban cigar anyone? If only Russia could afford them.
- Language change from the Fed—but it said almost nothing new.
- Economic news releases came in below market expectations.

## Market Wrap-Up

Needing a major boost from Santa this year to see a positive return for the major indexes in December, the markets' wish came true last week as a potential Santa Rally flew in the face of central bank uncertainty, falling oil prices and several geopolitical hotspots; the global financial market rallied higher. The charts below are of the three major US indexes in green with their respective level of support being draw by the red lines, as well as the VIX and the average level of the VIX over the past one year draw with a red line on the lower right chart:

After starting last week looking technically very weak and weakening into the start of the week on Monday and Tuesday, the US financial markets saw their best two day stretch in several years on Wednesday and Thursday with the Dow gaining more than 700 points in just two days. It is truly amazing how fast money can be made or lost in the financial markets and last week was an extreme week for movements that happened to end positive for investors who stayed the course. So what caused the rally last week? The Fed statement and Chair Yellen's Q&A seemed to mark the timing for the turnaround, but the statement's new language held no new information. Oil's decline slowed after West Texas Intermediary oil (WTI) hit $55.30 and gas prices in a few states went below $2 per gallon, but it still moved lower for the week. Russia saw no new developments despite President Putin taking aim at the rest of the world in his three hour address to the Russian people. Lastly, Washington didn't really have anything they were able to mess up last week so they could not have been the cause of the market moving higher. That leaves Santa and the somewhat famous Santa Rally that has been known to take place in December for the US financial markets.

December is typically a good month for the financial markets, in part because of the holiday shopping season and the money being spent by the US consumer. Perhaps more important, December is when many forecasts come out for the next year and these forecasts are normally positive, or at least the forecasts picked up by the major media are positive. There are a few outliers who forecast doom and gloom just about every year, but they have their following and are relatively small groups. More market-moving releases come in terms of bulls calling for a great year ahead, largely looking at historical figures, which would tell anyone able to do simple math that the average return for the S&P 500 in any given year is about 7.5 percent. Many individuals projecting returns for the next year add small tweaks to this or that, but starting at 7.5 percent makes it pretty difficult to pull that number negative, no matter how many bad things are factored in. Not wanting to miss out on a potential good year starting on January 1st, many investors buy stocks during December, especially during the latter part of December. This also happens to be a time of year when large money managers are not participating much in the markets, thus volume is normally fairly low. With a number of individual investors buying and institutions largely done making changes for the year, the markets move slowly higher through the end of the year. Will this be the case this year?

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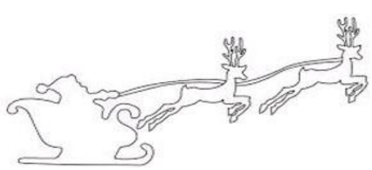
Going into last week I would have said it is highly unlikely. In fact, I mentioned last week the markets had dug themselves into a pretty big hole, if they were still going to make a positive return for December. But last week the markets proved very resilient, easily jumping higher and moving through the previous resistant levels, as indicated by the red lines above. Both the Dow and the S&P 500 (upper charts above) are now both reasonably within range of closing out the year at new all time highs, with the Dow in particular looking able to close over 18,000 for the first time. The NASDAQ (lower left pane above) also looks strong, but has a little further to go before it retakes the all time highs made at the height of the Technology bubble back in 2000. With two typically low volume weeks to go it could get interesting between now and the end of the year, but there seems to be more than just financial reasoning driving these markets higher.



## National News

National news last week focused on three main topics, one being the hack of Sony by North Korea (or at least it appears to be North Korea), the US relationship with Cuba and Fed Chair Yellen's change to the Fed statement. The hack of Sony pictures has been in the headlines because this was the first major time a hack had been undertaken for a very specific purpose, in this case to stop the release of a movie. The movie is titled "The Interview" and it depicts an assassination attempt by two reporters on North Korean leader Kim Jong Un. This plot,

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of course, made North Korea upset and they supposedly hacked into Sony's computer systems and stole a lot of information, including personal e-mail, movies, personal pay information and movie scripts. This is a major feat for a country that struggles to keep electricity running in many parts of the country. North Korea denies it is behind this "righteous attack," but the US thinks they have enough information to definitively point the finger at the North Koreans as being the culprits behind the attack. So what does this have to do with the financial markets? The North Korean attack has very little to do with the financial markets, but it represents a big step forward in cyber attacks. Now companies have to worry about rogue countries having the ability to not just steal customer information for monetary gain, but for companies to literality be held hostage by cyber attackers who may demand that certain things be done. This could be the dawn of a whole new era of cyber attacks, an era that may actually lead some companies to take a step back, such as using pen and paper to send sensitive information rather than sending an e-mail and believing no one other than the intended recipient will ever be viewing the e-mail. The other impact we could see in the financial markets is much higher expenses for companies to combat cyber threats, whereas it is normally not a major line item because the costs are relatively low. Moving forward, we could start to see increasing amounts of money allocated to defensive measures as companies have to evolve to the new world we find ourselves in.

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Cuba was another major news story last week as President Obama announced that he was going to be undertaking a normalization of relationships with Cuba after nearly 50 years of bad relationships. The announcement comes as a US citizen was released from a Cuba jail after being there for 5 years and the US released three Cuba convicted criminals. While plans to move forward are still in the very early planning phase, it looks like (at least for now) the US will be moving toward a more normal relationship with Cuba, even going as far as to invite Cuba to the Summit of the Americas, which will be held next year. Travel has also been eased between the US and Cuba with airlines and cruise ships now able to move freely between the two countries just as they would with any other foreign country. This move by President Obama drew criticism from some members of Congress on both sides of the aisle, but this anger seems to be mellowing as time moves on.

The final topic of the week last week was the US Federal Reserve and the change made to the statement on monetary policy released after the December meeting, held on Tuesday and Wednesday of last week. The question going into the release was whether the Fed would remove the "extended period of time" language from the statement when talking about how long interest rates would remain low. They did remove the line, replacing it with even more nebulous wording saying the Fed can be "patient" in its approach to raise interest rates. The word "patient" drove some Fed watchers nuts on Wednesday as they are now no closer to knowing when the Fed may raise interest rates than they were under the previous term, "extended period of time." Fed watchers were not the only ones who criticized the move as three voting members of the FOMC dissented during the vote with the main concerns being that the changes to the language of the statement were considered by some members to be clumsy. In the end, rates are highly likely to be higher at the end of 2015 than they are right now and the timing of such movements really should not matter to the markets as much as it appears to be weighing on them.

## International News

Aside from Cuba, last week the international news seemed to focus on Russia and a few of the other counties that are struggling heavily with oil prices being so low. Last week Russian President Putin gave a lengthy speech (three hours) to the Russian people on both TV and radio. He used the time to blame the rest of the world for Russia's problems caused by lower oil prices and made it clear that Russia would persevere as it has when faced with these same types of issues in the past. He even used lines as colorful as saying the US is trying to defang and declaw the Russian bear. The speech really seemed more intended to let the people of Russia know that Putin knows hard times have come to many of them, but that the hard times will not last. One interesting aspect of the speech on Wednesday was the part where President Putin

> *…President Putin called on Russian multinational companies to repatriate (bring their earnings abroad back to Russia)…*

called on Russian multinational companies to repatriate (bring their earnings abroad back to Russia) and buy the Ruble in an attempt to help keep its value from falling further. He said this as the value of the Ruble dropped by more than 20 percent last week and many Russians were lining up to pull money out of the banks in order to hold on to actual bills, so the value of their savings dropping may slow down. To help combat the flight of money out of Russia, the Central Bank in Russia raised the interest rate on Russian deposits from 10.5 percent to 17 percent overnight, but this action also failed as it was seen as evidence of fear that something far worse would be coming. The effects of the falling currency are starting to be seen in everyday life as foreign companies that sell goods in Russia are ceasing sales because of the wild fluctuations in the Russian currency. Apple, Land Rover and BMW are just three to name a few that have stopped sales of goods into Russia as the currency risk bore by these companies to sell high dollar products are just too great. These bans imposed by countries are unlikely to stop the flow of goods; Russia is notorious for its black market where anything can be bought for the right price.

## Market Statistics

### Equities

After a very rough start to the week last week all three of the major US indexes managed to pull off a turn around that seemed very unlikely following the accelerating declines on Tuesday. After seeing the worst weekly decline of the past two years two weeks ago, the markets moved into rally mode last week, providing hope that the markets could still end December higher than they started. Volume was extremely high on both the S&P 500 and the Dow and very high on the NASDAQ. We have not seen higher volume in aggregate on both the Dow and S&P 500 since 2011 and the NASDAQ saw the second highest weekly volume that we have seen since 2011:

| Index | Change | Volume |
|---|---|---|
| S&P 500 | 3.41% | Extremely High |
| Dow | 3.03% | Extremely High |
| NASDAQ | 2.40% | Very High |

It is amazing what a single week can do for financial indexes, as we have now flipped from technical weakness to technical strength, all in the span of about two days. At this point, as mentioned above, all three of the major indexes look very close to equal in technical strength.

When looking at sectors, the following were the top 5 and bottom 5 performers over the course of the previous week:

| Top 5 Sectors | Change |
|---|---|
| Energy | 11.92% |
| Oil & Gas Exploration | 11.64% |
| Natural Resources | 9.53% |
| Telecommunications | 5.12% |
| Software | 5.00% |

| Bottom 5 Sectors | Change |
|---|---|
| Utilities | 0.53% |
| International Real Estate | 0.53% |
| Consumer Discretionary | 0.76% |
| Financials | 1.02% |
| Consumer Staples | 1.12% |

Everyone had been waiting for the time when oil and gas companies would snap back from the downward trend they have been stuck on since Thanksgiving and few thought a snap back would be anything other than lightening fast. Still, the move last week seemed to catch everyone off guard. The reason for it catching everyone off guard was the fact that oil moved lower for the week; granted it may have put in a bottom during the middle of the week, but it still moved lower over the course of the week. As moves off the bottoms of performance go, however, the more than 10 percent jump in energy last week was impressive with how fast it moved. On the flipside, it was not surprising to see sectors like Consumer Staples and Utilities see the lowest performance of the week as both of these sectors are defensive sectors of the market, areas of the market that had money flowing out of them to move back into energy over the course of the previous week.

## Fixed Income

With the Fed statement and a press conference by Chair Yellen last week it was not surprising to see bonds really move around over the course of the week, even if they did end the week relatively close to where they started:

| Fixed Income | Change |
|---|---|
| Long (20+ years) | -0.34% |
| Middle (7-10 years) | -0.75% |
| Short (less than 1 year) | 0.00% |
| TIPS | -0.38% |

Last week the US dollar increased in value by 1.45 percent against a basket of international currencies as the Fed left the new language in the statement purposely vague. All of the major global currencies fell against the value of the US dollar last week with the Canadian Dollar falling the least of the group (-0.19 percent) and therefore being the strongest of the currencies. The weakest of the major global currencies was the Swiss Franc last week as it fell by 2.07 percent, while the Euro declined by 1.92 percent again the US dollar. As the ECB starts their next rounds of easing, the Euro and the Swiss Franc are likely to continue to move lower as international investors rush to the US dollar where the prospects for higher rates are very real over the coming year.

## Commodities

Commodities were mixed last week as oil moved slightly lower (compared to a few of the past weeks), while the metals moved noticeably lower.

| Metals | Change |
|---|---|
| Gold | -2.25% |
| Silver | -5.58% |
| Copper | -1.42% |

| Commodities | Change |
|---|---|
| Oil | -1.69% |
| Livestock | -1.55% |
| Grains | 1.59% |
| Agriculture | 0.95% |

The overall Goldman Sachs Commodity Index turned in a loss of 0.18 percent last week, while the Dow Jones UBS Commodity Index declined by 1.73 percent. As mentioned above, oil declined last week, but the decline was nothing like the drops we have been seeing with some regularity over the past few weeks. Gold, Silver and Copper all moved lower last week as fears of inflation were nowhere to be seen in the major developed economies and demand for the more industrially used Copper was called into question in China. The “soft” commodities seemed to perform well last week with agriculture in general moving higher along with grains.

## International Performance

China saw its financial markets jump higher last week for the fourth week in a row with the Shanghai based SE Composite Index gaining 5.80 percent. We have now seen the Shanghai Se Composite Index move higher by more than 35 percent since the middle of October, representing the strongest moves anywhere in the world over that time period. The worst performance of the week last week was found in Russia with the MSCI Capped Index declining by 1.74 percent, despite President Putin giving a 3 hour address on public TV and radio and still maintaining an approval rating of 81 percent.

## Volatility


Last week the VIX gapped lower and did so in a very big way over the course of the last three trading days of the week. After briefly hitting the second highest point of the year on Tuesday, the VIX proceeded to fall by more than 30 percent, ending the week with a decline of 21.8 percent. As you can see in the chart to the right, this latest spike in the VIX now appears to be over and the collapse of the VIX looks strikingly similar to the decline in October that ended the VIX spike. This type of spiky movement in the VIX is usually representative of a market that is searching for direction as news breaks about one thing or the other and everyone jumps on board before all bailing out at about the same time, sending the VIX moving much lower. At the current level of 16.48 the VIX is implying a move of about 4.75 percent over the course of the next 30 days. As always, the direction of the move is unknown.

## Performance

For the trading week ending on 12/19/2014, returns in FSI's hypothetical models* (net of a 1% annual management fee) were as follows:

| | Last Week | Year to Date |
|---|---|---|
| Aggressive Model | 2.43 % | 7.68 % |
| *Aggressive Benchmark* | *2.08 %* | *2.18 %* |
| Growth Model | 2.31 % | 8.42 % |
| *Growth Benchmark* | *1.62 %* | *1.81 %* |
| Moderate Model | 2.09 % | 8.45 % |
| *Moderate Benchmark* | *1.16 %* | *1.40 %* |
| Income Model | 2.03 % | 8.10 % |
| *Income Benchmark* | *0.58 %* | *0.85 %* |

**Model performance does not represent any specific account performance but rather a model of holdings based on risk levels that are like our actual holdings, the hypothetical models are rebalanced daily to model targets.*

With the decline and rally we saw over the course of the past week, we took the opportunity to make a few adjustments to our model allocation. Our first change was to move out of the Rydex Pure MidCap Growth Fund (RYBHX) and move the proceeds into a Schwab midcap ETF, ticker SCHM. The move was made as we did not feel taking a side on the growth versus value play in midcaps was paying off and because the performance of SCHM has recently been better than RYBHX. SCHM is also on the list of ETFs at Schwab that incur no trading costs whatsoever to buy and sell on the Schwab platform. Our next two moves were to readjust risk in our models. We moved to a full position from a partial position in Semiconductors through the purchase of Profunds Semiconductor Fund (SMPIX) and we initiated a position in Biotechnology through the use of Rydex Biotechnology, ticker RYOIX. To fund the two purchases of SMPIX and RYOIX we sold various low volatility positions such as Nuveen Preferred Securities Fund (NPSAX) and the Powershares S&P 500 Low Volatility Fund, ticker SPLV, depending on which model held which of the low volatility assets.

# Economic News

## Week in Review

Last week saw manufacturing in the spotlight with one figure missing expectations by a very wide margin, highlighted in red below, while the other releases were pretty close to expectations:

| Economic Impact | Date | Economic News Release | Date Range | Actual | Expectation |
|---|---|---|---|---|---|
| Negative | 12/15/2014 | Empire Manufacturing | December 2014 | -3.6 | 14.0 |
| Neutral | 12/15/2014 | NAHB Housing Market Index | December 2014 | 57 | 58 |
| Neutral | 12/16/2014 | Housing Starts | November 2014 | 1028K | 1035K |
| Neutral | 12/16/2014 | Building Permits | November 2014 | 1035K | 1060K |
| Slightly Negative | 12/17/2014 | CPI | November 2014 | -0.30% | -0.10% |
| Neutral | 12/17/2014 | Core CPI | November 2014 | 0.10% | 0.10% |
| Neutral | 12/18/2014 | Initial Claims | Previous Week | 289K | 292K |
| Neutral | 12/18/2014 | Continuing Claims | Previous Week | 2373K | 2510K |
| Neutral | 12/18/2014 | Philadelphia Fed | December 2014 | 24.5 | 26.5 |

*Data for table from Econoday.com, Bloomberg and Yahoo Finance*

Last week started out with a thud, as the Empire Manufacturing Index for the month of December fell like a rock. Expectations had been for an increase from the November reading of 10.2 up to a level of 14.0, but instead the index turned in a ***negative 3.6***. This decline was totally unexpected and was partially what helped drive the US financial markets lower during Monday trading. Adding to the negative news of the day was the NAHB Housing Market Index, which slipped a little during December. With how bad the manufacturing data was, however, it almost looked positive on the housing front. On Tuesday two more housing related figures were released with housing starts and building permits both coming in below expectations, but not by enough for the market to really take notice. On Wednesday the Consumer Price Index (CPI) showed that prices at the consumer level declined by three tenths of a percent, thanks in large part to a decline in the cost of gasoline and other energy related products. Core CPI, however, remained steady at one tenth of a percent, signaling that the Fed still has room to keep interest rates artificially low as inflation does not appear to be a problem yet. On Thursday the standard weekly unemployment related figures were released and both came in better than expected, but not by enough for the markets to take notice as they were too busy moving higher on speculation that the oil bottom had been achieved. Wrapping up the week on Thursday was the release of the Philadelphia Fed's Manufacturing Index for the region and unlike the empire figures earlier in the week, it did not fall off a cliff. While it came in a little under expectations it was close enough that the markets seemed to breathe a sigh of relief that it was not negative like the Empire release earlier in the week.

## Upcoming Releases

This week is a typical week for economic news releases, but they are all crammed together during the first three trading days of the week because of the holiday on Thursday; the releases highlighted below have the potential to move the overall markets:

| Date | Release | Release Range | Market Expectation |
|---|---|---|---|
| 12/22/2014 | Existing Home Sales | November 2014 | 5.20M |
| 12/23/2014 | Durable Orders | November 2014 | 2.60% |
| 12/23/2014 | Durable Goods -ex transportation | November 2014 | 1.00% |
| 12/23/2014 | GDP - Third Estimate | Q3 2014 | 4.20% |
| 12/23/2014 | University of Michigan Consumer Sentiment Index | December 2014 | 93.8 |
| 12/23/2014 | Personal Income | November 2014 | 0.50% |
| 12/23/2014 | Personal Spending | November 2014 | 0.50% |
| 12/23/2014 | New Home Sales | November 2014 | 460K |
| 12/24/2014 | Initial Claims | Previous Week | 290K |
| 12/24/2014 | Continuing Claims | Previous Week | 2358K |

*Data for table from Econoday.com, Bloomberg and Yahoo Finance*

This week starts out on Monday with the release of the Existing Home Sales figure for the month of November, which is expected to be a little over 5 million units. Significant deviation from this figure could cause the market to move, but such a deviations is unlikely. On Tuesday durable goods orders for the month of November are set to be released and expectations are for an increase of 2.6 percent, thanks in large part to auto sales. When auto sales are excluded, expectations are for only a 1 percent increase. Likely overshadowing the durable goods orders on Tuesday is the third and final estimate of GDP for the third quarter of 2014, which is expected to come in at 4.2 percent growth during the quarter. Also released on Tuesday is the University of Michigan's Consumer Sentiment Index for the month of December (final), which is expected to show no change over the mid-month estimate provided two weeks ago. With this being the holiday season we could see this release surprise to the high side as holiday sales have been revised higher than first expected. Wrapping up the day on Tuesday is the release of personal income and spending as well as new home sales, all for the month of November and all expected to be very dull releases. Wrapping up the week on Wednesday this week will be the release of the standard weekly employment related figures with expectations that initial jobless claims will be about the same as last week and continuing jobless claims will have declined slightly.

## Fun – or Not So Fun -- Fact of the Week

*You only have two more weeks to make many tax adjustments, such as Roth conversion and other tax mitigation strategies for 2014. If you are not sure what, if anything, you should do, please contact your CPA and see if there is anything they recommend. If you do not have a CPA that does your taxes, feel free to give us a call and we can recommend one for you to speak with.*

Merry Christmas and have a great week!
Peter Johnson

*"A referral from a client is a tremendous compliment and a huge responsibility that can never be taken lightly"*

If you would like to unsubscribe to this weekly commentary just let me know.