March 21, 2011

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Daily Market Notes

Market Update:

DJIA:	**12042**
S&P 500:	**1298**
Nasdaq:	**2690**
10YR T-Note:	**3.30%**
VIX:	**20.58**
EUR/USD:	**1.420**
Gold	**1428**
Crude Oil:	**103.00**

Prices Current as of 1:22 PM

Source: Bloomberg

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After finally finding its upside footing on Thursday after being lower for seven out of the past nine days and undergoing a 7% correction from the February 18th S&P intraday high of 1334 to the 1249 intraday low on March 16th, stocks once again were able to put in good gains on Friday as well. Despite these gains, the major averages did finish lower for the third week out of the past four, which means that the February 18th highs might be difficult to overcome for a while, as pointed out in the special report that I wrote on March 11th, which outlined that scenario.

And some of the same dynamics that we saw in the higher market on Thursday were apparent again on Friday as well. For instance, despite the generally higher market, the Nasdaq/Dow ratio was poor for the second day in a row, the result of selling in some of the leading technology issues. The Dow was able to record an early gain of 153 points at its best level, but then went into a choppy drift lower as the session progressed, ending with a closing gain of 84 points. The Nasdaq, which lagged for the second day in a row, ended up by only 7 points due to the aforementioned technology weakness.

Of course, the primary reason for the inability of the major averages to hold their best levels of the session was that Friday was the important quarterly expiration of the March option series, which accounted for the huge volume for the session, with a large percentage of the trading done in the runoff on the close as various strategies were executed. Of course, as I have pointed out many times in the past, the function of an options expiration is to cause as many buyers of both calls and puts to lose all of their money, and there were numerous examples of this on Friday. For instance, the low-priced third-largest bank had no less than an astounding 2.25 million calls at 4.50 and above go out worthless, in addition to 430,000 4.50 puts. And notice how the stock closed at exactly 4.50 to inflict the maximum pain on call and put buyers at that strike. The largest bank of all and a Dow component had 705,000 calls go out worthless at 14 and above, and even those who bought the 14 calls got a whopping .04 cents for their troubles. And how about the large mobile

telecom and computer stock, which was maneuvered to 330 on the close, and caused the maximum pain for call buyers at that level and above. Finally, despite the fact that the major averages were lower for the third week out of four and the S&P hit its correction low of 1249 as mentioned above, a 7% decline, there were still 4 million puts on the stock that represents 1/10th of it that expired worthless, in addition to 1.8 million calls that had no value at the close.

The VIX, which had been climbing merrily higher as stocks plunged on Tuesday and Wednesday, closed lower than it should have relative to the Dow closing gain of 84 points, with a loss of 1.93, down to 24.44. Let us remember that it got as high as 31.28 during the worst of Wednesday's downside panic as people paid very high prices for the honor of "buying downside protection", and this was the highest level for the VIX since last July 2nd, right after the European debt crisis induced the May and June selloff, and right before stocks themselves had a terrific month of July, before collapsing again in August.

The financial stocks actually did very well after the Federal Reserve allowed them to either re-institute or raise their dividends or institute share buybacks. This helped the overall market to make a higher close as well, in addition to massive G7 intervention against the Japanese yen, which had risen to a record high against the dollar. This was the first co-ordinated G7 currency intervention since 2000 when they supported the Euro, which had been falling dramatically since its 1998 inception. The fear was that a too-strong yen would undermine the ability of Japan to expand its export capacity in order to try to get its economy to recover from the recent disasters. In addition, the markets seemed to be somewhat calmed by the cease-fire declared by the Libyan government after the U.N. authorized a no-fly zone against the Qaddafi forces.

If one looks at the recent correction in light of other market corrections since late 2002, there have been 15 of them that have been 5% or worse, with the average correction being 7.4%. The most severe one since that time was

the 16% May-June downside panic last year due to the supposed European debt crisis as mentioned above, and the unfounded fears at the time that the U.S. economy was about to slip into a double-dip recession.

So after the early panic of last week and late in the week recovery, stocks are rallying strongly today, with the Nasdaq finally holding more than its weight after lagging on the first two days of gains last Thursday and Friday. In fact, as of now the market is undergoing its best three-day rally since early December - take that to those investors who panicked into paying very high prices for supposed "downside protection" as described above as the VIX got a bit out of control on the upside.

The reasons offered for the continued recovery are the proposed takeover by the second largest large telecom company of the fourth-largest wireless provider, as well as the calming of the Japanese situation as the Prime Minister said that progress is being made in restoring power to two reactors at the Fukushima nuclear power plant. In addition, in Libya, allied officials said that air and missile strikes had effectively grounded Qaddafi's air force. So in a sense, there was some resolution to the two issues that spooked the market last week.

No less an authority than Warren Buffett said that Japan is a buying opportunity and that the U.S. economy is improving except for the housing market. This was certainly brought home by today's February existing home sales report, which showed a decline of 9.6% and a drop in the median price of a house to the lowest level since April 2002.

The bank stocks started out higher on the news that the low-priced third-largest bank is going to do a reverse 1 for 10 split and then pay a rousing .01 cent dividend after the split on the fewer shares that a person will now hold – thanks a lot guys. This is perhaps the reason why the stock is sagging after a strong start and the other large financial stocks are also lower on this after

doing well on Friday. And naturally the same stocks that do well on these strong up-days, namely the industrials, resource and energy stocks, are doing well once again today, as the Dow is being led by its components in those areas.

The bond market is selling off on a day when the stock market is rising , following the usual pattern of less risk aversion, and in addition, the government said it plans to wind down its holdings of mortgage-backed securities which were acquired at the depths of the financial crisis. The yields on the 10-year Treasury Note continue to vacillate in the recent range, from last week's panic-induced low of 3.14% to the recent high of 3.57%, and should trade within those parameters for the foreseeable future.

And with the Dow up on either side of a large 200 point gain, the VIX once again is collapsing fast, which just goes to show how unsustainable its advance last week to the highest level since last July was, and it further shows the foolishness of paying these high prices for so-called "downside protection." It is lower by 3.88 to 20.56, once again moving by twice the amount that it should, and we have now seen this for those two large down days last week and the past three subsequent up-days as well.

Breadth numbers are stronger than they were on the prior two up-days, at a positive 5 to 1 ratio, and that is courtesy of the better Nasdaq/Dow ratio that we are seeing, as opposed to a weaker one on Thursday and Friday.

The first-quarter earnings season is underway, and today we saw TIF report good results. The rest of this week's calendar is the following – Tuesday: WAG, JBL, ADBE, CCL; Wednesday: GIS; Thursday: ORCL, FINL, BBY, DRI, CAG.

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The S&P trades at 13.3 times forward earnings, and 15.3 times current earnings, as 2010 earnings are going to be $85 for the S&P and $99 for 2011, according to the analysts who follow these companies. The average P/E multiple for the S&P going back to 1954 has been 16.2.

For all of 2010, earnings increased by +30%, which was the most since 1995. For 2011 the analysts are forecasting increases of +17%, as reported by Bloomberg Financial and this would be the largest two-year advance since the period ended in 1995. This means that S&P earnings for 2010 were $85 and projected to be $99 in 2011. This would equate to around a 17% gain this year. The highest ever earnings for the S&P in one year took place in 2006, at $88.

After four consecutive quarters of negative G.D.P. growth, we now have five consecutive quarters of positive growth, starting with the third-quarter of 2009 and continuing with every quarter in 2010 according to the Commerce Department. Economists now predict that G.D.P. expanded 2.8% in the fourth quarter. For 2010, G.D.P. rose at a 2.8% rate, which was the highest since 2006 after a decline of 2.6% in 2009. For 2011, the prediction is G.D.P. growth of 3.5% and it is 3.9% in 2012.

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