

Daily Market Notes

Market Update: After Wednesday's downside disaster, yesterday's market action featured the two dynamics that ultimately determine the direction of the market, in my opinion. And they are the Nasdaq/Dow ratio and the VIX, both of which were on full display yesterday.

DJIA: 11995

S&P 500: 1270

Nasdaq: 2615

10YR T-Note: 2.94%

VIX: 22.31

EUR/USD: 1.429

Gold 1538

Crude Oil: 92.20

Prices Current as of
1:55 PM

Source: CNBC

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Let us see how they played themselves out in determining the direction of the market as the day progressed. After Wednesday's downside debacle, the Dow started out higher yesterday on a calming of the Greek situation and two better economic reports here - a decline in weekly jobless claims and a better May housing starts and building permits number. As a result, the Dow was able to show an early gain of 40 points when the 10am release of the June Philadelphia Fed Manufacturing Survey "unexpectedly" came in lower, similar to the NYState Empire Manufacturing Survey the day before. Of course, the biggest fiasco here is that why would the experts still have their projections for a gain in the Philly report after the awful NY report the day before? In any event, when the poor numbers were released, the Dow turned that 40 point gain into a fast loss of 9 points, which was then reversed once again and then some, as the Dow was able to reach its high of the day with a 92 point gain at 11:30am.

But this is where the use of the two dynamics mentioned above came into play, as it should have been obvious to everyone that this Dow gain would not hold because at the same time that this 92 point gain was reached, the Nasdaq was only able to manage an 11 point advance, much less than the 22% that it has to show. As a result, things headed south, as they inevitably do when the Dow is up in the double-digits and the Nasdaq does not do its part. The Nasdaq went negative first at around 1:45pm while the Dow was still ahead by 30 points or so, and we all know who wins that battle. Naturally, the Dow got dragged down until it made another decline of 9 points at 2:45pm, similar to its morning loss as mentioned above. At the same time, the Nasdaq was showing a large loss of 30 points due to ongoing weakness in its large technology stocks, most of which are now in substantial downtrends, such as the largest Internet search

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engine and the site that allows consumers to name their price, among the other hopeless ones like the three Dow Nasdaq stocks which never go anyplace no matter market conditions are.

But at these lows, the second market dynamic kicked in, namely our old friend the VIX. Let us remember that during Wednesday's stock market beating, the VIX finally did something that it had not been able to do during the first six weeks of the market's recent decline, namely advance by more than the Dow declined, as it rose by a large 3.06 points relative to the Dow's decline. This finally started to create the oversold conditions that could lead to some sort of oversold rally, something that the poor performance of the VIX had not been able to allow up until yesterday. But yesterday's VIX performance relative to the Dow was completely off the wall, as when the indexes hit their lows at 2:45pm as mentioned above, with the Dow down by those 9 points, the VIX rose to an astounding gain of 3.32 points, and just to show how absurd this was, remember that on Wednesday's 179 point Dow loss, the VIX was up 3.06 points as just mentioned, which is much more than it should have. So this is why yesterday's hard to believe VIX advance of 3.32, to 24.65, the highest since the Japanese earthquake debacle in March, really created an oversold condition!

And sure enough, this is exactly what took place, as from those lows the market was able to undergo a general comeback, with the Dow finally ending with a closing gain of 64 points while the S&P advanced by 2 and the laggard Nasdaq still ended 8 points lower, which was certainly an improvement from its worst level. Breadth numbers were still negative at 14/16 and the VIX did end higher, by 1.41 to 22.73, which is still a ridiculous relationship relative to where the Dow closed, but if one wants to put an optimistic spin on this relationship, the fact that it closed higher still creates an oversold condition from which the market might still be able to advance.

And sure enough, this is what we are seeing today, with the Dow ahead by 111

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points at its best level at 10am, when a weaker U. of Michigan Consumer Sentiment Survey pushed things back a bit. What is a bit worrisome is that each successive high for the Dow is reaching lower levels as the day proceeds, and as this is being written, the Dow is ahead by only 37 points, its low of the day. The Nasdaq is lagging once again courtesy of another poor performance from some of the high-priced stocks mentioned above, in addition to a disastrous report from the maker of the Blackberry, but breadth numbers are actually good at a 2 to 1 positive ratio. The Nasdaq/Dow ratio is lagging once again, and this is obviously the reason why the Dow has not been able to maintain its best advances.

The market is getting some support from a better May L.E.I. number, which went positive by more than expectations after it went negative in April for the first time in a year. And since the market has become obsessed with Greece, there was some optimism on that front as it was reported that France and Germany are united behind a new aid package where banks holding Greek debt would voluntarily shoulder some of the burden. This bit of optimism was reflected by the rise of the Euro these past two days from support levels just above 1.40.

One should be positive note is that crude oil prices fell to their lowest levels in almost four months, getting closer to where they should be in terms of the supply and demand situation, and are finally able to separate themselves from the manipulated higher prices they attained earlier in the year when the experts who follow this market were cheerleading prices higher with their exhortations of \$130 prices and above.

For what it is worth and for those really technical types out there, let it also be noted that on yesterday's low of 1258 for the S&P, it held right above what chart-watchers consider support at its 200-day moving average of 1257, so if this does hold, then perhaps the market will have found a near-term bottom.

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And let us also remember that today is the quarterly expiration of the June options series which began last night and which could lead to all sorts of maneuvering at today's close as market makers attempt to move stocks and indexes away from where the largest open interest resides in order to cause the most pain to buyers of various options, and we will list some of these buying disasters in Monday's report. And let it be noted that despite the fact that the market has been in a downtrend for 6 ½ weeks, there will be more than twice as many puts as calls that go out worthless on the most heavily traded option instrument of all, namely the SPY. Of course on the call side, because of the recent declines, the ratio of worthless calls to puts will be in the neighborhood of 20 to 1. In addition, call buying on the large bank stocks are a complete disaster as well.

Since the Nasdaq/Dow ratio is sketchy today, there is the potential for further downside drift as the afternoon wears on, and as this is being written, the Dow has declined to its low of the day with that advance of only 37 points at its worst level, almost a third of what it was on its high, so it would now appear that the early 111 point advance will be the top on the upside, and what is bothersome is that the market usually does not follow the same pattern for two days in a row, and we should think about yesterday's strong late upside advance as the rest of today moves on.

And to repeat what was said recently, the market has now taken on a creepy resemblance to last year, when things reached their highs in late April, and then took a dive in May and June, which marked the lows for the year, and it was the same causes last year as well, with European sovereign-debt issues responsible for much of the comedown, although let us also remember that we started the decline this year from higher levels, which left the market more vulnerable to some sort of setback from the misplaced mind-set of higher commodity prices somehow being good for stocks. Let us hope that this year also sees the market low during this time period as well.

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Since second-quarter earnings will not be a factor until another two weeks, the market will once again concentrate on economic reports next week, and the lineup is as follows: Tuesday – May existing home sales; Wednesday – announcement and statement for F.O.M.C. decision; Thursday – weekly jobless claims, May new home sales; Friday – May durable goods orders. And of course, ongoing developments out of the Eurozone will command center stage as well.

The S&P trades at 12.1 times forward earnings, which could bring a measure of support to stocks. Earnings were \$85 in 2010 and are projected to be \$105 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. Since 2006, the average P/E multiple has been 14.7

For all of 2010, earnings increased by +30%, which was the most since 1995. For 2011, first-quarter earnings gained +15% and are projected to gain +20% for the entire year, as reported by Bloomberg Financial and this would be the largest two-year advance since the period ended in 1995. These projections would equate to around a 14% earnings 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 seven consecutive quarters of positive growth, starting with the third-quarter of 2009, every quarter in 2010 and the first quarter of this year, according to the Commerce Department. For all of 2010, G.D.P. rose at a 2.9% rate, which was the highest since 2006 after a decline of 2.6% in 2009. For 2011, the prediction is still for G.D.P. growth of 3.1% and it is 3.9% in 2012.

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Disclosures

Don Selkin is the Chief Market Strategist at National Securities Corporation, member FINRA/SIPC, (NSC) and provides the Fair Value analysis for CNBC each morning. The commentary provided in this Market Letter is intended to provide our customers with timely market analysis and should not be considered a research report. This Market Letter may contain, and is limited to: Discussions of broad based indices; Commentaries on economic, political or market conditions; Technical analyses concerning the demand and supply for a sector, index or industry based in trading volume and price; Statistical summaries of multiple companies' financial data, including listings of current ratings; and, Recommendations regarding increasing or decreasing holdings in particular industries or securities. This Market Letter does not make a financial or investment recommendation or otherwise promotes a product or service of the firm. This Market Letter contains only news, facts, and commentary on information previously reported from a news source believed to be accurate and reliable by the author. These news sources include the following: {Bloomberg Financial, Reuters, Associated Press}. It is possible that at any given point in time, the author, NSC, or one or more of its employees or registered individuals associated with NSC, may hold a position, either long, or short, as well as options, bonds, or other instruments in the companies noted in this report. This Market Letter is intended strictly for current National Securities Corporation customers only.