

## 3<sup>rd</sup> QUARTER 2010

The stock market, as defined by the S&P 500 Index, closed the 2<sup>nd</sup> Quarter by breaking through the key 1040 technical level I've been discussing in my bi-weekly e-mails (see Page 4). I believe the bull cycle from March 2009 peaked at the intraday high of 1219 on April 26. On an intraday basis, the S&P 500 Index is now down - **15.67%**, excluding dividends, from the April 26 peak to the June 30, 2010 close of 1030. Year-to-date, the S&P 500 Index is down - **7.60%**, also excluding dividends.

Is this the beginning of something worse? Or, is it just a normal pullback before the stock market moves higher? I agree with Jonathan Tepper of Variant Perception, a research firm in London, when he recently said:

“Investors are good at absorbing short-term information, but they are much less successful at absorbing bigger structural trends and understanding when secular breaks have occurred. Perhaps investors are like the proverbial frogs in the frying pan, who do not notice the slow, incremental changes occurring around them.”

Most investors struggle with hearing the daily market news and trying to make sense of it. As Tepper stated, investors have a hard time “*absorbing bigger structural trends*” and “*understanding when secular breaks have occurred.*” The stock market, however, doesn't have that problem. It has historically shown us clear, long-term trends – both bull trend and bear trends.

How do we know?

Go back ten years to June 30, 2000. The S&P 500 Index closed at 1454. Over 10 years later, as of the June 30, 2010 close of 1030, the stock market is still down - **29%**, excluding dividends, on a buy-and-hold basis. In this bear trend, we've seen two bull cycles and two bear cycles. I believe we have started the third bear cycle on April 26 which will be the third leg down. This is why I have positioned our portfolios accordingly. Yes, I was early by five months. It was frustrating, too, as the market kept making new highs in the first quarter of 2010. However, the end of the second quarter has brought all three of our model portfolios into positive territory so far in 2010. The major stock market indexes are all negative year-to-date.

### ***Correction or New Bear Cycle?***

Corrections are typically defined as - 10% pullbacks while bear markets are typically defined as - 20% or more pullbacks. While the major stock averages have only reached “correction” territory so far, several indicators are suggesting the bull cycle that started in March 2009 ended on April 26. Of course, the stock market doesn't always move exactly the way we think it should or exactly when we think it should. There are always issues that either hasten or delay its direction regardless of what the technical and fundamental indicators may be suggesting.

According to Bespoke Investment Group, there have been 58 corrections of 10% or more in the S&P 500 Index since 1927. In 33 of the 58, the corrections fell short of the - 20% “bear cycle” level. Interestingly, 25 of the 58 did go beyond a - 20% loss into a full-blown bear cycle.

Let's drill deeper. Of the 33 corrections that fell short of the - 20% “bear cycle” level AND had a pullback as deep as the one we've just had (- 14.40% from April 23 to May 25 on the S&P 500 Index) -- **26** of the 33 corrections saw declines extend *beyond* - 20% into a full blown bear cycle. Bespoke said the average bear cycle decline for those 26 periods was - 35.50%.

It's my opinion that protecting your money is most important at this juncture. This is why I have positioned our models so defensively. Rest assured there will be an opportunity to fully reinvest in our models – but not right now. We've just finished a bull cycle. Now, it's time for a bear cycle and I have our models currently positioned for it.

### ***Health Care Reform Adds Two New Taxes***

The recently passed health-care reform bills will add two new Medicare-related taxes. These new taxes take effect in 2013 and they will target high-income earners. Here's what you need to know:

(1) Beginning in 2013, a new 3.8% Medicare contribution tax will be imposed on the unearned income of high-income individuals. The tax is equal to 3.8% of the lesser of:

Your net investment income (generally, net income from interest, dividends, annuities, royalties and rents, and capital gains, as well as income from a business that is considered a passive activity or a business that trades financial instruments or commodities), or

Your modified adjusted gross income (basically, your adjusted gross income increased by any foreign earned income exclusion) that exceeds \$200,000 (\$250,000 if married filing a joint federal income tax return, \$125,000 if married filing a separate return).

Effectively, you're only subject to the additional 3.8% tax if your adjusted gross income exceeds the dollar thresholds listed above. It's worth noting that interest on tax-exempt bonds, veterans' benefits, and gains from the sale of a principal residence are excluded from gross income and are not considered net investment income for purposes of the additional tax. Qualified retirement plan and IRA distributions are also not considered investment income.

(2) Beginning in 2013, the hospital insurance (HI) portion, which is 1.45% of wages now, will be increased by 0.90% to 2.35% for high-wage individuals to 2.35%. High-wage individuals include married filing jointly if your combined wages of you and your spouse exceeds \$250,000. If you're married but file a separate return, the additional tax will apply to wages that exceed \$125,000. For everyone else, the threshold is \$200,000 of wages. If you're self-employed, the additional 0.9% tax applies to self-employment income that exceeds the dollar amounts above (reduced, though, by any wages subject to FICA tax). The kicker is self-employed individuals won't be able to deduct any portion of the additional tax.

Together, these two new Medicare-related taxes are expected to provide a major source of revenue to finance other parts of health-care reform. Get ready folks, I believe this is only the beginning of higher taxes in the future.

### ***Medicare Spending Cuts and Part D Changes***

Not surprisingly, the concerns of retirees and seniors generally center on potential cuts in Medicare benefits. At the outset, the new legislation does not affect Medicare's guaranteed benefits. However, a goal of the new health-care legislation is to slow the increasing cost of Medicare premiums paid by beneficiaries, and to ensure that Medicare will not run out of funds. To help achieve these goals, cuts in Medicare spending will occur over a ten-year period, beginning in 2011, particularly targeting Medicare Advantage programs -- Medicare programs provided through private insurers but subsidized by the federal government. These cuts could reduce or eliminate some of the extra benefits Medicare Advantage plans may offer, such as dental or vision care, and some insurers may choose to increase premiums. But Medicare Advantage plans cannot reduce primary Medicare benefits, nor can they impose deductibles and co-payments that are greater than what is allowed under the traditional Medicare program for comparable benefits. And, some of the federal funds previously earmarked for Medicare will be reallocated to doctors and surgeons as an incentive to treat Medicare patients.

Medicare Part D Changes -- beneficiaries may be surprised to find that they have to pay for the entire cost of prescription drugs out-of-pocket after reaching a gap in their annual coverage, referred to as the "donut hole." Currently, if you're a Medicare Part D beneficiary, you may pay up to an additional \$3,610, out-of-pocket, for medicines after reaching an initial threshold of \$2,830 in total prescription drug costs (including Part D payments, beneficiary co-pays, and deductibles). But, beginning in 2010, beneficiaries who fall in the donut hole will receive a \$250 rebate, and, in 2011, they will receive a 50% discount on brand-name drugs. By 2020, a combination of federal subsidies and a reduction in co-payments will completely eliminate the donut hole. However, individuals with annual incomes greater than \$85,000, and couples with incomes exceeding \$170,000, will see their Part D premiums increase as the federal subsidy offsetting some of the cost of Medicare Part D premiums is reduced. Once nice addition from the legislation is Medicare beneficiaries will receive free wellness and preventive care beginning in 2011. There are certainly a lot of changes on the horizon for entitlement benefits.

### ***Greece Not the Only Country in Trouble***

The stock market correction has been blamed on Europe's debt problems – primarily Greece. On June 14, Moody's downgraded Greece's debt to "junk" status, following S&P's downgrade a couple of months ago. But if you look closer, it isn't just Greece who has problems. Here's how other countries that affect the U.S. economy are doing – including an update on how the United States is handling our own debt issues.

#### **Ireland**

With over 4 million people, this country has traditionally focused on agriculture. However, the industrial sector now contributes almost 50% to Ireland's GDP. In 2009, Ireland's fiscal deficit topped almost 12% of its GDP. Ireland's leaders have taken drastic steps by severely cutting the pay of public employees, reducing welfare benefits, and increasing taxes. All of this has hurt Ireland's consumer driven economy and spending. Their central bank expects GDP to fall 1% this year.

#### **Italy**

Italy's GDP shrank 4.9% in 2009, the worst since 1971. In 2009, Italy's public debt expanded to 115% of GDP. Lack of growth continues to hurt Italy. From 2001-08, economic growth (during relatively good times) only averaged 0.8%.

#### **Japan**

While a lot of people look at Europe as the main problem, the ticking debt time bomb may be Japan. We're not the only country spending our grandchildren's money -- Japan projects to borrow \$10.7 trillion by March 2011. That's huge. In fact, it's more than the combined economic output of France, Italy and the United Kingdom – three of Japan's fellow G7 members. In January 2010, S&P warned it would cut Japan's current AA credit rating if its government didn't come up with a fiscal plan to reduce debt. The only silver lining to Japan's debt is that 95% of it is owned by domestic investors so the "contagion" part should they default would not hurt the U.S. as much.

#### **Portugal**

The Portuguese government reported its 2009 budget deficit was 9.3% of GDP. Portugal is mainly a service-based economy (71.4% of GDP). It relies on hotels, tourism, restaurants and transportation. The European Commission gave Portugal a 2013 deadline to bring its deficit below the 3% of GDP threshold required by EU rules.

#### **Spain**

As the euro zone's fourth largest economy, Spain's problems are starting to weigh heavily on the entire region. The country's unemployment rate is almost 20% but it's 48% for males between ages 20 and 48. The housing market is in horrible shape and Spain's budget deficit is 11.4% of GDP. The Wall Street Journal recently stated that, "A bailout of Spain's \$1.6 trillion economy would be nearly double those of Greece, Portugal and Ireland combined – and it would be far costlier."

#### **United Kingdom**

The UK's budget deficit is 12.5% of its GDP. Like a lot of these financially strapped countries, the UK will have problems in the future selling its public debt at today's interest rate levels.

#### **United States**

The U.S. government has been solely focused on deficit spending. Eventually, Congress must stop "drugging" our economy with stimulus money. It is estimated the 2010 budget deficit in the U.S. will grow to 10.6% of GDP. Foreigners own around 25% of all outstanding Treasury notes with China being the primary purchaser of our bonds. Get this -- Moody's recently warned the U.S. and other western nations that credit rating downgrades are what lies ahead if financial restraint isn't applied. We need our government to stop giving our economy drugs to mask the problem. Our economy needs medicine. Medicine can fix the problem; drugs simply prolong it.

**CONCLUSION**: So who do you think is going to lead the global economic recovery when some of these nations may not be able to even rescue themselves? There are still a lot of issues in these countries, as well as our own, with respect to entitlement programs, taxes, and debt. This is yet another reason it's hard to be bullish on the stock market right now.

### **Stock Market Forecasters**

The famous economist John Kenneth Galbraith once said, "We have 2 classes of forecasters: Those who don't know... and those who don't know they don't know." Here is an interesting quote regarding this from the June 8, 2010 edition of Barron's:

"Week in, week out, Bloomberg taps Street analysts for their prognostications of where they expect the S&P 500 to wind up the year. Despite the turmoil in the markets, those stalwarts -- 13 of them -- have steadfastly held to their prophecies. They labor for Deutsche Bank, UBS, JPMorgan, Oppenheimer, HSBC, Bank of America, Credit Suisse, Goldman Sachs, RBS, Barclays, Bank of Montreal, Morgan Stanley and Citigroup. After glancing over this sterling cadre and their predictions, we can report that their expectations vary rather widely. **The most bullish is looking for a gain of around 26% and the least bullish one of nearly 8%.**" (BOLD is my emphasis)

Not one of these analysts is bearish. Year-to-date, as of June 30, the S&P 500 Index is *down* - **7.60%**, excluding dividends. That means the stock market will need a major rally from here for those analysts to be right.

### **Bi-Weekly E-Mails**

As mentioned on Page 1, I started sending out e-mail commentaries to you in late April. These e-mails are the result of several clients requesting more frequent information as to what I'm seeing, what I'm thinking, and why we're positioned the way we are in our model portfolios. If you are not receiving these e-mails, please e-mail me at **matt@matthewmontgomery.com** (or call me) so that I make sure I have your correct e-mail address.

That's it for now. As always, please call me if you have questions or concerns. I appreciate your business.

*--- Matt Montgomery*

## **Newsletter Sources and Disclaimers**

CNBC, June 2010

<http://research.stlouisfed.org/fred2/>

<http://www2.standardandpoors.com>

Mauldin, John, Millenium Wave Investors  
www.IRS.gov.

Barrons, June 10, 2010

<http://www.bloomberg.com/apps/news>, May 12, 2010

U.S. Department of Commerce: Bureau of Economic Analysis

U.S. Department of Commerce: Department of Labor Statistics

U.S. Department of Commerce: Bureau of Economic Analysis

[www.taxfoundation.org](http://www.taxfoundation.org) [www.usgovernmentsspending.com/downchart](http://www.usgovernmentsspending.com/downchart)

David Rosenberg, Gluskin-Sheff, [www.tradersnarrative.com](http://www.tradersnarrative.com), March 2009

#### **Index Disclaimers:**

\* An Index is a portfolio of specific securities (common examples are S&P, DJIA, NASDAQ), the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. Indexes are un-managed portfolios and investors cannot invest directly in an index. Past performance is not indicative of future results. The Wilshire 5000 measures the performance of all U.S. equity securities, and so serves as an index of all stock trades in the U.S. The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents 98% of the investable U.S. equity market. \*\* Past performance is not indicative of future results.

#### **Benchmark Disclaimers:**

The Conservative Model Benchmark: 35% 30-Day Money Market Yield Index; 35% Barclays Aggregate Bond Index; 30% S & P 500 Composite Index, excluding dividends. This portfolio focuses on protecting the principal within the portfolio from loss of value. Income generated by the portfolio is of secondary concern. The Balanced Model Benchmark: 20% 30-Day Money Market Yield Index; 20% Barclays Aggregate Bond Index; 60% S & P 500 Composite Index, excluding dividends. This portfolio is designed to provide both current income and growth of portfolio assets and has moderate risk. An equal emphasis is placed on both earning current income and asset growth. The Growth Model Benchmark: 10% 30-Day Money Market Yield Index; 10% Barclays Aggregate Bond Index; 80% S & P 500 Composite Index, excluding dividends. The assets used are generally more risky. The majority of the assets do not pay current income as their primary purpose is strictly capital appreciation. Some of the assets are very volatile and often a loss of capital may be experienced.

#### **DISCLAIMER**

In general, the bond market is volatile, bond prices rise when interest rates fall, and vice versa. The effect is usually pronounced for longer term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Technical analysis and resulting conclusions and observations are based upon historical patterns. In effect, TA is a study of probabilities. What has happened 75% of the times in the past does not mean it will ALWAYS recur in the future. It logically follows that historical precedent does not guarantee future results. Investors should be aware that there are risks inherent in all investments like fluctuations in investment principal which may result in a loss of principal. Bear in mind that there is no guarantee that any specific goal will be met. Past performance is not a guarantee of future results. Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as tax, legal, or investment advice. Although the information has been gathered from sources believed to be reliable, please note that individual situations can vary therefore, the information should be relied upon when coordinated with individual professional advice. Securities offered through Royal Alliance Associates, Inc. Member FINRA/SIPC. Investment Advisory Services offered through Matthew L. Montgomery, DBA Montgomery Financial Designs, a registered investment advisor not affiliated with Royal Alliance Associates, Inc.