The Summer of Discontent

[Bottom Line]: As I write this Thursday evening July 12, the stock market has been down 6 days in a row. In my last review, I suggested the markets’ hope for more Fed stimulus was would be a catalyst for a turn. There was a letdown when all that was received at the last fed meeting was a continuation of operation twist. The announcement on June 29th of bailouts for Spanish banks caused a rally that helped to reduce the negative numbers for 2nd Quarter performance of the major stock indices. This rally carried into July 3rd and the markets are now starting to focus on earnings. The issues now currently affecting the market include earnings, economic data, and downgrades in credit quality of European sovereigns. With negative news prevalent, the markets hoped for hints of stimulus to come from the Fed minutes this Wednesday only to find the Fed “remains divided over whether it should try with similar urgency to return the economy to prosperity.” This summer is shaping up to look similar to last. Is it going to be another summer of discontent? Next week we start with Empire State Manufacturing index. This will provide another look into the economy and then we get earnings from Intel on Tuesday after the close. Reaction to these will help provide the short-term direction.

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<th>Price As of 7/12/2012</th>
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|                        | WTD    | MTD   | QTD   | YTD    | 1 Yr.
| Broad U.S. Indices    |        |       |       |        |      |
| Dow Jones Industrial Average | 12573 | -2.38 | -2.38 | 2.91   | 1.02 |
| Nasdaq Composite       | 2866   | -2.35 | -2.35 | -2.35  | 10.02| 3.03 |
| S&P 500 Index          | 1335   | -2.01 | -2.01 | -2.01  | 6.14 | 1.61 |
| Russell 2000           | 789    | -1.11 | -1.11 | -1.11  | 6.57 | -4.84|

Source: Morgan Stanley Research

Strategy ...
Churn... The markets have been moving in a fairly wide range over the last several weeks. The news flow has certainly been negative for the economy and markets have helped up as of Thursday’s low the early morning appears to have given way to a short term rally.

Much to stay on top of here...

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1 The Federal Open Market Committee action known as Operation Twist (named for the Twist dance craze of the time[1]) began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. It performs the 'twist' by selling some of the short term debt (with three years or less to maturity) it purchased as part of the quantitative easing policy back into the market and using the money received from this to buy longer term government debt.

Markets now Turning Toward Earnings

Sure, it's early, but companies that have reported since earnings season began on Monday have disappointed big time. Just ONE company has beaten estimates of the sixteen that have reported, while TWELVE have missed.

And the price action in response to these earnings has been equally as bad. The average one-day change for these stocks on their report days has been -5.45%.

Analysts have slashed earnings estimates in recent weeks leading up to this reporting period, but there was still a big question over whether they had slashed estimates enough. At least for the companies that have reported, they clearly did not.

Negative Preannouncements Are At Multi-Period Highs

It should be noted that last earnings season started out extremely positive, with nearly every company beating estimates. As the season progressed, the beat rate dropped and dropped, and the season ended up being very weak. The bulls are hoping the opposite occurs this time around.

Negative pre-announcements are at multi-period highs. As we approach Q2 earnings season, companies have been guiding negatively and cautiously managing expectations. The ratio of negative to positive is the highest since 1Q10.

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3 A Tough Start to Earnings Season Wednesday, July 11, 2012 Bespoke Investment

Sam Valeo, CIMA®, CFP®
Senior Vice President – Wealth Management, Financial Advisor
**On the Economy… What if**

Lakshman Achuthan, the co-founder of the Economic Cycle Research Institute, which publishes a widely followed economic metric called the Weekly Leading Indexes, was on Bloomberg TV recently discussing his firm's call last year that the U.S. economy would enter recession in the first quarter of 2012. "In other words, I think we're in recession already. As I said back there, it's very rare that you know you're going into recession when you're going into recession. It often takes some big hit on the top of the head. In the last recession it took Lehman to wake people up. In the recession before it took 9/11."

> The global economy skirted closer to stagnation at the end of the second quarter. Growth slowed in the service sector and manufacturing production fell back into contraction territory.

Rightly or wrongly, policy-makers in Europe and the US are under pressure to tighten fiscal policy. Tightening has started in Europe, and is a looming issue in the US. The reduced willingness or ability to provide ongoing fiscal support is shaping up as a major difference between the current cycle and Japan’s experience. The monetary policy response was also faster and more aggressive in the US and Europe than in Japan. It’s not clear how important this distinction is, in our view. It’s clear that deleveraging blunts the effectiveness of monetary policy (particularly in contrast to what went before: monetary policy is unusually effective through leveraging cycles). Certainly, long-end yields have followed the Japanese template. It’s a matter of debate whether this is principally due to central bank action, or because investors are pricing in a Japan-style macro environment.

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6 News Release MARKET SENSITIVE INFORMATION 5 July 2012, JPMorgan and Markit

Sam Valeo, CIMA®, CFP®
Senior Vice President – Wealth Management, Financial Advisor
Either way, it’s been as dangerous to forecast the trough in long-end yields in this cycle as was the case with Japanese government bonds through the 1990s. Also, the decline in long-end yields has not been particularly supportive for risk assets. In particular, equities continue to de-rate.

This is the big if… IF the current expansion falters then the core CPI trajectory in the developed world may resume a Japan-like deceleration. As we’ve noted, the current growth scare is more worrisome than the set-backs seen in the middle of 2010 and 2011. Leading indicators have fallen further than in the prior two years. The graph at right overleaf shows the OECD’s leading indicators as an example.

A return to recession would be worrying given that policymakers now have less room to respond than policy-makers did at the same stage of the Japan cycle. Short rates are already near zero; long end yields are lower; and, as noted above, there are more constraints on deploying fiscal policy.

For now, our economic team does not expect renewed recession, although it sees the risks to its numbers slanted to the downside. Equity markets continue to be in a post-bubble pattern of swinging with the economic cycle. While the two cycles are not repeating, there is an element of rhyme.  

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7 July 12, 2012 Cross-Asset Strategy The End of AAA Earnings? Morgan Stanley research
Sam Valeo, CIMA®, CFP®
Senior Vice President – Wealth Management, Financial Advisor
Beginning to look like Last Summer

Dow Industrials Weekly Chart

- The Dow peaked at the beginning of May 2011 and then posted an interim low in the middle of June
- This year, to date, we also peaked in the first week of May and posted an interim low in June
- The bounce from that June 2011 low came to an end at the beginning of July. This year so far we posted what looks to be an interim high last week – the first week of July
- The parallel lines show the similarities in the correction up suggesting the next leg.
- A similar follow through should send the Dow Jones down to the 200 week moving average at 10,717 (nearly 15% below current levels)
**Fixed Income**

Short term breaks have already taken place opening the way for lower yields
- We would also suspect this could mark the next stage of the trend that should ultimately see U.S. 10 year yields in the 1.15%-1.20% area over the medium term (by year end).

U.S. 10 year yield and 30 year yields – Breached the base of the range

- Both 10 year yields and 30 year yields have breached the base of what had been a range for the past month
- The short term support level on 10 year yields was 1.55% and the support level on 30 year yields was 2.64%
- As a minimum in the short term we expect a test of the trend lows in both markets over the coming days
- The overlay of U.S. 10 year yields with what was seen in 1993 (U.S> housing and Saving and loans crisis etc) suggests that this could mark the beginning of the next stage of a trend that should see 10 year yields at 1.15%-1.20%
Enjoy the weekend,
Sam

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Diversification does not guarantee a profit or protect against a loss

Dow Jones Industrial Average is a price-weighted index of the 30 “blue-chip” stocks and serves as a measure of the U.S. market, covering such diverse industries as financial services, technology, retail, entertainment and consumer goods. An investment cannot be made directly in a market index.

The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. As of May 2005 the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. An investment cannot be made directly in a market index.

The MSCI World Index is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of 23 developed-country markets. An investment cannot be made directly in a market index.

NASDAQ Composite Index is a market-value-weighted index of all NASDAQ domestic and non-U.S. based common stocks listed on NASDAQ stock market. An investment cannot be made directly in a market index.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 11% of the total market capitalization of the Russell 3000 Index. An investment cannot be made directly in a market index.
Russell 2000® Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. An investment cannot be made directly in a market index.

Russell 2000® Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. An investment cannot be made directly in a market index.

S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

S&P MidCap 400 Index is an unmanaged total return index of 400 domestic stocks measuring the performance of the midsize company segment of the U.S. stock market. An investment cannot be made directly in a market index.

S&P SmallCap 600 Index is an unmanaged index representing the aggregate market value of the common equity of 600 small-company stocks. An investment cannot be made directly in a market index.

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