

NOYES CAPITAL MANAGEMENT[®], LLC

Wealth Management for Changing Markets

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To: Clients & Friends;

From Scott P. Noyes, CFA[®], CFP[®]

Top Ten Financial Market Concerns – May 2011

For several reasons, the stock market, commodity market and currencies have run out of gas. Since the low in late August 2010, the S&P 500 stock index has rallied by more than 30%. During the last month, this rally has been supported by strong cash flows and positive enthusiasm. In my opinion, the stock market is becoming a mature bull market likely to digest its gains and consolidate over the summer. As a result, I have moved from “very bullish” to “moderately bullish” in my portfolio allocations.

Over the past few weeks, the list of potential negatives has grown to the point that I believe now is time to take some profits and build cash reserves. The following is my list of top ten concerns for the markets which supports my decision to lighten up on equities for the time being:

1. **Earnings season is over.** Earnings reports for the first quarter were generally good with many companies showing improved top-line revenue growth, especially in the economically sensitive sectors. However, a stronger dollar could hurt corporate earnings in future quarters. Good earnings news is always welcomed by the markets and with reporting season behind us, that positive support is no longer a factor.
2. **Europe’s debt problem has not been resolved.** Investors haven’t bought into Europe’s bail-out strategy which relies heavily on the belief that countries receiving funds can fix their problems and pay back their debt. Mandated budget cuts and other austerity measures will only serve to weaken economies that are already on the brink. In addition, the higher cost of borrowing forced upon counties such as Greece by demanding investors creates a vicious cycle of rising debt levels undermining future growth.
3. **Higher interest rates in Asia have knocked the wind out of commodity demand.** In an attempt to stem rising inflation, central banks across Asia have been raising rates. In particular, China’s move to raise reserve requirements, slow its economy and therefore reduce demand has had an unsettling effect on the commodities markets.
4. **The dollar is likely to rally over the next few months.** The dollar has become cheap relative to other currencies and is likely to rebound over the summer. This has negative implications for commodities and resource-based economies, like many emerging markets.
5. **Prices and costs are rising.** The CPI energy index has risen 19.0% over the past 12 months, with the gasoline component increasing 33.1% over the same period. At some

point, these increases have to make their way into the core inflation numbers and the prices we all pay for goods and services. The CPI-All items index is up 3.2% over the past twelve months to its highest figure since 2008.

6. **Credit availability remains tight.** Loan demand has started to decline and credit standards remain more restrictive than earlier in the decade. Both consumer and business loan demand continue to show weakness underscoring the fact that the economic growth is far from robust. It remains very difficult to get a home equity loan and nearly impossible to get a construction loan. Mortgage lending standards are reverting to those of the 1980's and 1990's.
7. **The Federal Reserve's Quantitative Easing 2 (QE2) is about to end.** Bond markets are worried that interest rates will have to go higher to clear the market. The Federal Reserve's program to pump money into the system to spur growth by purchasing government bonds has kept interest rates low and stimulated economic activity. Its absence could reverse these benefits.
8. **Middle East tensions remain high.** While some of the recent turmoil in the Middle East appears to have settled down, potential negative surprises abound. The "Arab Spring" is likely to be a transition to new forms of dictatorship.
9. **Volatility in the commodity markets has increased.** The decline in commodities such as silver, gold and oil over the past few weeks is a combination of overleveraged speculators bailing out and an overreaction to recent moves in the dollar. As is frequently the case with speculative bubbles, this sell-off may get overdone and create a terrific buying opportunity.
10. **The U.S. government is pretending to be fiscally responsible.** There has been much media talk about reining in government spending; however, no real cuts have been made. I would be impressed if both parties stopped posturing and achieved meaningful results. I do not expect this to happen unless the financial markets hold a gun to politicians' heads, as was the case during the banking crisis.

The biggest positive remains the overall flow of funds into equities. There are no good alternatives to buying equities. After the recent real estate crash, investors have shunned and are likely to continue to avoid residential real estate investments. Funds that would have previously moved into this investment space are moving into equities. Since the Federal Reserve is maintaining interest rates at very low levels, real returns from many types of bonds are negative (inflation adjusted after-tax return). This has resulted in flows out of bonds and into equities over the last six months. I believe these positive flows into equities will remain with us until interest rates move meaningfully higher.

Our Market Strategy

While I continue to have a positive outlook for financial assets in the long term, I believe we are likely to see a pause or consolidation over the summer months. Our key recommendation is to stick with your investment plan regardless of the "crisis of the day." During the 2008 crash, the

investors who really lost out were those who sold stocks, moved to CD's, and were on the sidelines during the rebound. When markets rebound, there is no formal invitation telling you to buy back in. We recommend that you remain invested, diversified and patient.

If you don't have an investment plan or believe it is off track, you should get one. At Noyes Capital, we help evaluate your risk tolerance, time horizon and financial needs. These are analyzed to establish an Investment Policy Statement and construct a well-diversified portfolio of stocks and bonds designed to help you achieve your goals. Let us worry about the details for you.

We remain focused on building portfolios that succeed in a global context. In this light we have three biases in our portfolios:

- 1) Add more income investments to portfolios. We seek income opportunities in the form of high dividend stocks, investment grade bonds, municipal bonds and equity income trusts. We believe this strategy adds to portfolio stability and helps meet your income needs going forward.
- 2) Overweight Asia and Emerging Market Equities – We follow the global growth story. China, Brazil, India and Korea are projected to continue on a strong growth path during 2011 and 2012. We like positions in stocks and bonds that profit from their growth.
- 3) Stay with long-term equity holdings. We believe that equities will outperform bonds over the next two years. While holding stocks may feel terrible at times, we believe that you will be rewarded for patience. Stay the course.

Please call me if you have any questions at 973-267-8120

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