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www.NoyesCapital.com

(973) 267-8120

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2011 Update – Correction in a Bull Market

By Scott P. Noyes, CFA® CFP®

The stock market rally that started in early October has continued without letup into mid-February. Money poured out of bonds and into equities on a daily basis. The U.S. stock market has outpaced both the European stock markets and those of the emerging world. The political crisis in Egypt has led to unrest and regime change in Libya and may spread to other Middle Eastern countries. The market fears a summer of discontent. These concerns have resulted in the first meaningful stock market correction since October. While I suspect this correction could be very painful in the short-run, I believe the primary trend for the market remains bullish and I will invest accordingly.

Corrections in a bull market can be quite ferocious. This is caused by the absence of ‘shorts’ to support the market. A meaningful correction may last several weeks and hopefully will evaporate once the overbought condition of the market is eliminated. I would not be surprised if the market corrects back to support around the 200-day moving average, a ten percent correction from current levels. But one never knows.

Bond markets have been in retreat since October. As the economy improved, interest rates have slowly moved higher. Even though the Federal Reserve continues to buy U.S. Treasuries on a weekly basis through its second round of Quantitative Easing (QE2), investors have been selling bonds and moving into the U.S. equity market. As long as the economic outlook remains positive, this flow of investment money should continue to move out of bonds and into stocks. Our strategy for bonds is to play defense, moving out of U.S. Treasuries and into higher yielding corporate bonds and foreign bonds.

Inflation Is Likely To Remain Low

Commodities are only about one-third of the inflation index. The balance reflects the price of labor and the price of housing, both of which are experiencing little or no inflation. Commodity prices follow a predictable pattern over the standard business cycle. Commodities such as oil, copper and wheat are currently on the upswing and this trend, which usually lasts longer than most expect, should continue until economic growth slows down. I do not expect a slowdown to occur until next year unless a major global political or economic crisis arises. I expect that inflation will continue to remain below 2% in 2011 and 2012. Low inflation is typically good for both the bond and stock markets.

If the economy continues to improve throughout 2011, it is unlikely that the Federal Reserve will renew its QE2 policy in June. Anticipation of the end of QE2 may result in an increase in U.S. Treasury interest rates in the 2-10 year maturity range, and may have already started. If the economy starts to grow at a strong sustainable pace, fear of actual rate hikes from the Fed could panic both the bond and stock markets.

The Financial Crisis In The European Union Is Not Over

It is likely that The European Monetary Union (EMU) will face another round of crises tied to the rollover funding needs of its weaker governments in early 2011. With debts coming due from March through May, the crisis seems much more predictable than in 2010. We will watch to see if the European Central Bank continues to support the bond markets for European sovereign debt. I would not be surprised to see a country fail to make an interest payment on its bonds, which would result in eviction from the European Union. Greece, Ireland and Portugal are candidates for this treatment in 2011.

Eventually, the euro zone may be forced to agree on greater fiscal integration for a core set of countries. This would not be a full fiscal union but some greater sharing of responsibilities for each other's debts. In addition, the European Central Bank will receive greater authority to buy up government bonds as needed. If countries cannot conform to budget rules, then they would not be included in the new EMU.

During 2011, the European crisis should continue to drive capital into safe stock and bond investments in both the U.S. and Asia. However, once the European crisis abates, the dollar is likely to see a nasty outflow as capital moves out of the U.S. because of our unwillingness to face our deficits responsibly.

The U.S. Structural Deficit Needs To Be Repaired

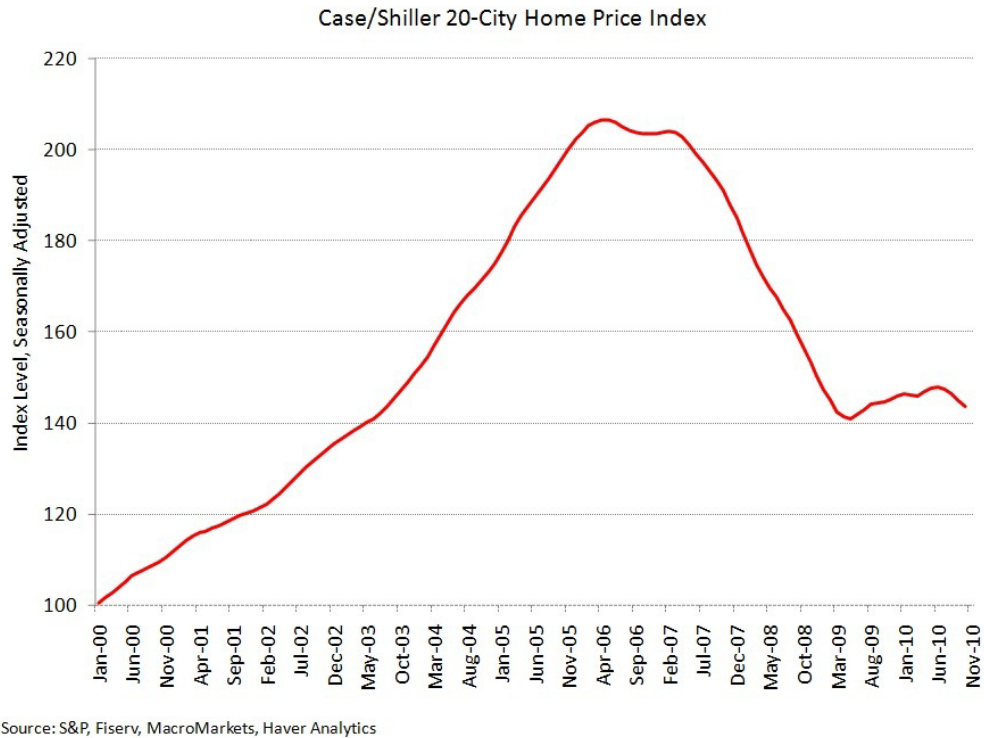
U.S. government debt is currently 97.5% of GDP and Moody's is threatening a downgrade to a double-A credit rating. Overall, the advanced G-20 countries, including the United States, are in the worst condition while the emerging market countries and resource countries (Canada and Australia) have the lowest debt as a percent of GDP figures. American politicians act like the U.S. has an irrevocable special privilege because we issue the dollar, and are therefore different from Europe. This behavior may work for a few more years before our special privilege is revoked. While I hope that our politicians will take preemptive action and cut military spending and entitlements, I would not be surprised if they wait until forced by the financial markets to act. Over time, excessive debt slows economic growth and forces a debt crisis in excessive-borrowing countries.

In the short run, the dollar may perform well against the Euro. Over time it would be wise to invest more heavily in non-US bonds, particularly those of strong-currency countries – Asia, Australia, Canada. Due to this imbalance, emerging market currencies are likely to increase in value against the Dollar and Euro over time. Bill Gross, co-CEO of PIMCO and manager of the world's largest bond fund, stated recently that a critical strategy going forward will be to get out of dollar-denominated securities and hold bonds of strong countries like Brazil, Canada and certain emerging economies.

The Housing Market –Unlikely To Improve In 2011

Home price data for the month of December was released in January, showing no meaningful bounce since the market bottomed in May of 2009. In fact, there has been a rollover in pricing in recent months. October marks the fourth month in a row of falling home prices and a negative reading for the year (Exhibit 1). With recent increases in mortgage rates and continued tight lending standards, improvement in the housing market remains suspect for 2011. Hopefully, consumer confidence from QE2 will spill over to the housing market encouraging those who can qualify to purchase a home.

Exhibit 1 - U.S. Housing Prices Show No Signs Of Rebounding.



Short-Term Timing And Waiting For The “Fat Pitch”

In my opinion, current conditions in the stock market are a bit too frothy. There is a surprisingly bullish unanimity among market experts – a dangerous sign. After all, the financial crisis is still with us and money is still hard to borrow. In my opinion, much of the anticipated improvement in the economy has been priced into the market. The market could move in several directions:

- Stocks could continue higher based upon the reality of an improving economy and strong corporate earnings reports.
- It could consolidate the gains of the recent run-up by trading in a sideways band for the next few months.
- It could go down if either the economic data is less robust going forward or the debt crisis re-awakens.

I do not have a strong bias towards any of these short-term outcomes but believe the long-term prospects for the stock market in 2011 and into 2012 remain positive. While I am keeping current equity portfolios fully invested, I would be patient when adding money to the stock market at these levels. Since the effects of the financial crisis remain with us, I continue to favor an income equity strategy with an international bias. I would not be surprised if the market declined early in the year, giving us a “fat pitch” to purchase stocks at better prices.

My Market Strategy

My key recommendation is to stick with your investment plan regardless of the “crisis of the day.” During the 2008-09 crash, the investors who really lost out were those who sold stocks, moved to CD’s, and did not recover financially during the rebound. When markets rebound, they do not ring a bell to let you know it is time to get back in. We recommend that you remain invested, diversified and patient.

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

I remain focused on structuring portfolios that succeed in a global context and have built three strategies into client portfolios:

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

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

Scott P. Noyes, CFA[®], CFP[®] is the President of Noyes Capital Management, LLC, an independent fee-only wealth management firm based in New Vernon, New Jersey. www.noyescapital.com

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