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Searching for the Market Bottom

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The markets have reminded us that the financial crisis is not over and the risk of deflation is rising. Since the Dow Jones stock market index peaked on April 23 at 11,204 it has swiftly declined by 11.6% to 9,899, erasing the gains for the year - plus a little more. Since the beginning of the year, the US dollar has rallied against the Euro by 16%. Commodity prices, including oil, copper and grains, have dropped sharply in two months. US Treasury 10 year interest rates peaked in late March at 4% and have declined to 3.2% as a flight to quality and a rally in the dollar ensued. Rapid market moves have become more common in today's electronic world. Hopefully, this correction shall pass.

Recent memories of the collapse in 2008 have caused investors to be wary of a reason that could lead to the next collapse. While there is a long list of problems and concerns, in my opinion, none should be of the magnitude to repeat that financial market debacle. Fresh concerns include:

- Fear that European debt problems could derail the global recovery;
- Deep concerns over the out-of-control oil spill in the gulf;
- Fundamental concerns about a jobless recovery in the US;
- Fear that Chinese credit restrictions will lead to a slowdown in Chinese property markets and commodity demand.

While these problems all create the risk of a slowdown in the global economy, they are more likely to affect the economic growth rate rather than create a systematic risk of principal loss.

In my opinion, the financial markets evaluate problems through a fear vs. greed prism (run vs. attack). During periods of stability (low volatility) the market trades on objective metrics such as earnings growth, company fundamentals and cash flow models. When we move to a fear mode (high volatility), subjective herd behavior takes over. Investors want to run with the pack, either to the greener fields or away from the unseen predators. Investors use information to rationalize their emotional imperatives. Once the herd is moving it runs until it finds a fence or obstacle to stop its' path. These fences are value points at which astute investors step in to buy or sell. My best guess is that we are approaching one of those value point fences that will corral the bearish herd. Then the pundits will rationalize why the market is rising.

The Euro Matters

During the 1930's, European bank defaults were transmitted to US banks and helped create the Great Depression. There is a risk that the problems in Greece could affect Portugal and Spain – then the UK and Japan – then us. The default of a sovereign country could lead to massive loan write-offs for European banks. These banks would then be at risk of their own default and the losses could transmit to the US banks through financial counter-party relationships. Contagion from the European banks remains a concern.

Over the past 70 days, the Euro has become suspect as a global reserve currency. The events in sovereign debt markets have exposed serious flaws in Europe's single currency union, and we believe they will doubtlessly lead to profound changes in the way the eurozone operates. Some believe the severe pressure being put on the financially weaker members of the eurozone argues for its breakup. Others, however, trust the huge political energy that has been poured into the euro project makes this unlikely in the short to medium term. Instead, the Greek crisis may lead to closer fiscal and financial integration. For our part, we think the euro is likely to remain a viable currency and that countries in the eurozone are likely to have 5 to 10 years to undertake the necessary reforms. We view it as very unlikely that any country will leave or be forced out of the eurozone.

However, the crisis in Greece could push other eurozone countries to accelerate fiscal consolidation, thus casting a doubt on the pace of European recovery. Indeed, restrictive fiscal policy combined with weak consumer spending and severely rationed bank lending could delay a sustained upturn in member state economies. With European economic recovery currently slow and under threat, we remain more positive on prospects for the U.S. dollar for cyclical reasons—essentially because the U.S. economy continues to recover more strongly—and on emerging market currencies for more structural reasons.

Reasons to be Optimistic

For all the negative concerns, several positive forces are coming back into the markets:

1. **Inflation should remain low.** For the time being, the inflation/deflation debate has been won by the forces of deflation. Low inflation is good for the economy and savers. Low inflation is bad for debtors.
2. **Interest rates should remain low.** The Federal Reserve is likely to maintain a low interest rate policy well into 2011. This is good for mortgage borrowers, home buyers and those who can obtain credit.
3. **Oil prices have dropped from \$90 barrel to \$70 barrel.** This savings is good for consumers and economic growth.
4. **Risk-taking is better rewarded.** The value of risk has increased in the market place. Riskier assets have cheapened relative to “safer” investments making them more attractive to purchase. For some reason, stocks are one of the purchases that people do not want to make when they are “on sale” (i.e. herding instinct).

5. **Fiscal responsibility is returning globally.** A new dawn of fiscal responsibility is entering the political calculus of both parties. No country wants to become the next Greece.

The Computer Upgrade Cycle is Under Way

The Tech sector continues to benefit from global easy money and massive fiscal stimulus. Companies and individuals are upgrading their computers and infrastructure to the latest products. The corporate PC upgrade cycle has just begun and Microsoft's well-regarded Windows 7 operating system and Office 2010 are key factors. Apple, IBM, Dell, HP and Intel are examples of firms that benefit from this upgrade cycle. We continue to believe this sector will remain strong relative to the overall market for the balance of the year.

Why Emerging Markets Remains a Winning Investment

The long term prospects for Emerging Markets are still favorable. However, in the short-run they are dependent upon exports and are suffering from the Euro crisis. We believe that emerging economies will grow at a substantially higher average growth rate than the developed world for the foreseeable future. At some point, we anticipate adding to our clients' exposure in this area.

Bank Stocks Remain Interesting

On the positive side, bank stocks are tremendous beneficiaries of easy money and near-free liquidity. They can lend at a fat spread and make a big profit. The negative side is that they will continue to struggle with loan losses and businesses and homeowners suffer from the burden of excessive debt. Banks do have the luxury of determining the timing of write-offs now that loan valuation accounting has been modified. Overall, I believe the big banks can manage their balance sheets to create the earnings necessary for their stocks to improve.

The Gulf Disaster's Impact on Energy Markets

The world will continue to consume energy in increasingly larger quantities as developing countries improve their lifestyle and catch up to consumption levels of the developed world. Green, clean and energy efficient technology will be key drivers for the upgrade cycle in the energy sector. Over the near term, I expect that we will see three outcomes from the disaster in the Gulf:

1. More restrictive deepwater drilling;
2. Increased use of natural gas, solar and possibly, nuclear energy;
3. Increased emphasis on energy efficiency and clean technology;
4. Tax breaks to support more efficient uses of energy.

The Bond Market is Behaving Normally

The biggest difference between the current market decline and the market crash in 2008 is that the bond market is behaving appropriately. US Treasuries and high quality corporate bonds are

going down in yield and up in price. Below investment grade bonds are modestly declining as they are affected by the increased price of risk. Foreign bonds have declined due to the rally of the US dollar. Overall, the bond market is behaving as they should when global stock markets decline.

Interest rates remain generally low as the economy is perceived to be slowing and inflation expectations have collapsed. It is hard to believe that US Treasuries hold value at 3.20%, down from 4.00% in early April. I see little chance of a fed tightening before 2011.

My Market Outlook

Over the past two months we have reduced our clients' risk exposure as volatility (VIX) has increased with a particular emphasis on international equity exposure. However, we have maintained the majority of our US large cap equity exposure and suffered the consequences of the market decline. The gains from the first half of the year have been eroded.

My best guess is that the stock market will find a new low in the Dow Jones 9,000 to 9,400 range during the summer and rally higher into the fall. I favor additional investments in emerging markets, large cap international equities, global clean technology and investment grade bonds. We expect to add positions to our portfolios over the next month or two.

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

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