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# Daily Market Notes

**Market Update:**

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| **DJIA:** | **11881** |
| **S&P 500:** | **1264** |
| **Nasdaq:** | **2633** |
| **10YR T-Note:** | **2.98%** |
| **VIX:** | **20.71** |
| **EUR/USD:** | **1.417** |
| **Gold** | **1527** |
| **Crude Oil:** | **96.02** |

Prices Current as of 1:30 PM

*Source: CNBC*

**Donald M. Selkin**
Chief Market Strategist
(212) 417-8017
dselkin@nationalsecurities.com

**After six weeks of a steady move to the downside, stocks finally were able to make a decent move higher yesterday, in a classic example of a "Turnaround Tuesday". But what was a bit troubling about the rally were the reasons offered for the general up move in stocks. In my opinion, both were unfortunately not really valid explanations for why things put in a strong day, in fact the best performance for the S&P since April 20th, when everything looked great as the market was on its way to its yearly highs, commodity prices were flying to the upside (supposedly "good" for stocks), and market experts were falling all over each other to predict ridiculous upside targets.**

**And those reasons, referred to in yesterday's daily market notes as "sketchy", were firstly the fact that industrial production in China rose by more than expected, up 13.3%, but consumer prices also rose by the highest level in three years and their government raised the reserve requirements for banks by another 50 basis points, the ninth time since last October. And as also mentioned, what is so bullish about this, as other times when the reserve requirements for banks was raised, our stock market sold off on the "China is slowing down theme" because of these higher rates. The second reason offered for the advance was that May U.S. retail sales declined by only half of what the experts said they would, a loss of -0.2%, which was the first loss in 11 months (what was so great about that?) and if ones excludes auto sales, which declined by almost 3%, the retail number was positive but at the slowest rate since last July. It was pointed out that perhaps a better explanation for yesterday's advance was that the VIX had finally reached enough of an oversold condition on Monday, advancing as high as the recent 20 resistance area to finally allow for some upside movement in stocks.**

**The Dow opened higher and never looked back, advancing to a gain of as much as 168 points at 3pm, from which level it went into a slow fade into the close, ending with an advance of 123 points and the Nasdaq finally cooperated with a strong advance of 39 points, which meant that the Nasdaq/Dow ratio supported the overall market for the entire day. As a result, breadth numbers**

**were a very strong 5 to 1 positive ratio to the upside.**

**Leading the way higher were the energy, industrial and materials stocks in a day reminiscent of the first four months of the year when the main "justification" for these stocks doing so well was that energy and minerals prices were also going higher, which is a dubious argument for higher stock prices, and we have all seen how this nonsensical argument has played out. Also doing well were those beaten-down Chinese stocks, and the newer, trendier ones that recently went public at what turned out to be ridiculously high valuations, also rallied, at least for one day. Most retail stocks also did well on the positive interpretation of the sales report. On the other hand, those awful bank stocks, which had the nerve to rally for two days in a row, decided that making their shareholders happy for a third day was too much of a burden to bear, so after a higher start to entice in buyers who thought that the tide had finally turned for this beleaguered group, they ended up selling off within the context of an otherwise strong day for the overall market, which is not a good sign.**

**The VIX, which has been trading away from its traditional 1 to 100 inverse ratio to the Dow lately, and we have detailed how this has been the main factor causing stocks to not be able to rally on a consistent basis, finally did what it is supposed to do, namely end at the correct ratio, with a decline of 1.35 points against the Dow's closing advance of 123.**

**And sure enough, today we are seeing a case of the chickens coming home to roost, as a poor combination of economic reports here plus increasing worries out of Europe have caused stocks to more than lose the gains that they were able to achieve yesterday. If one followed the course of the various stock index futures before the market opened, Dow futures were lower by around 60 points due to weakness in the Euro on concerns that Moody's may cut the ratings of French banks because of their exposure to Greek debt, as the amount of their exposure is around $65 billion. German banks have around $40 billion of this**

debt and banks in the U.S. hold around $41 billion. Then just before the 8:30am release of economic data here, the Dow futures declined further, to a loss of around 85 points as some investors were so smart that they "knew" that the May NYState Empire Manufacturing Survey would be bad, and sure enough this prescience on the part of those who sold the stock futures down lower turned out to be correct, as the report came in negative for the first time since last November, which then sent the Dow futures down to further losses of around 115 points before the opening.

Things were not helped by the May C.P. I. report which showed that the core rate of inflation, which excludes food and energy, rose by the highest amount in three years due to increases in motor vehicle and apparel prices. This latter item is worth noting because let us once again remember that the goal of QE2 was to raise prices of all assets because of the Fed's misplaced fears of deflation, so when stocks and commodities were both flying to the upside between last September and this April, everyone was cheering because of the misplaced argument that higher commodity prices were bullish for stocks because they somehow showed "worldwide economic growth" instead of really being a case of speculation in commodity prices because of the weaker dollar. So in these two reports we had the worst possible combination of circumstances, namely slower economic growth and higher inflation, thank you Mr. Bernanke.

Then we had three companies issuing profit warnings, namely the second largest automobile company, a manufacturer of glass packaging products, and a marketer of branded consumer lawn and garden products – as higher costs were part of the reasons offered by all of them for the future shortfalls. This is a potential danger for the few weeks before the official start to the second-quarter earnings season, as the analysts still insist that S&P earnings are going to come in at $105 a share, which would make the S&P appear to be "cheap" at current levels. The only problem is that if the earnings do not reach this target, then stocks are not as cheap if this $105 forecast turns out to be

**too optimistic.**

**After a lower opening loss of those 115 Dow points as the futures were indicating, things actually had the nerve to improve, as by 11am the Dow was able to cut its loss to "only" 62 points before the Euro turned lower as well, another case of our stocks being held hostage to what is happening overseas, with the Dow declining to a loss of 200 points to the low as this is being written. And if one looks at an intraday chart of the Euro, one can see that stocks here are basically just following what the Euro is doing, as it is making new lows as concerns about Greek problems intensify. The Prime Minister of that country offered to resign and then Moody's put Portuguese banks on review for possible future downgrades. An emergency session of E.U. finance ministers failed to reconcile a German-led push for bondholders to shoulder part of the cost of a new Greek aid package.**

**And we are getting the usual side effects in other markets, as bonds are rallying strongly on the flight to safety mentality after declining by a lot yesterday, and today's rally has pushed the yield on the 10-year Treasury Note once again to below 3%. And naturally crude oil prices are also lower on that sick positive relationship between energy prices and stocks, so instead of celebrating that consumers will pay less for gasoline, the market once again interprets lower energy prices as bearish.**

**And for the first time in a long time, the VIX is rising by much more than it should have, as for instance when the Dow was on its low of being down by those 200 points, the VIX rose by 2.99, to 21.25, its highest level since the third week in March, right after the Japanese earthquake. It is currently up by 2.45 relative to the Dow's decline of 170 points as this is being written.**

**The market has now taken on a creepy resemblance to last year, when things reached their highs in late April, and then took a dive in May and June, which marked the lows for the year, and it was the same causes last year as well, with**

**European sovereign-debt issues responsible for much of the comedown, although let us also remember that we started the decline this year from higher levels, which left the market more vulnerable to some sort of setback from the misplaced mind-set of higher commodity prices somehow being good for stocks. Let us hope that this year also sees the market low during this time period as well.**

**Since earnings are no longer a factor as the second-quarter reporting period will not be with us for another three weeks (but there is always the potential danger for profit warnings like we saw today), economic reports will have some influence and there were quite a few of them this week. The lineup finishes the week with: Thursday – May housing starts and building permits, June Philadelphia Fed Manufacturing Index; Friday – June mid-month U. of Michigan Consumer Sentiment Survey, May L.E.I. and the monthly June options expiration series.**

**The S&P trades at 12.1 times forward earnings, which could bring a measure of support to stocks. Earnings were $85 in 2010 and are projected to be $105 for 2011, according to the analysts who follow these companies. The average P/E multiple for the S&P going back to 1954 has been 16.2. Since 2006, the average P/E multiple has been 14.7**

**For all of 2010, earnings increased by +30%, which was the most since 1995. For 2011, first-quarter earnings gained +15% and are projected to gain +20% for the entire year, as reported by Bloomberg Financial and this would be the largest two-year advance since the period ended in 1995. These projections would equate to around a 14% earnings gain this year. The highest ever earnings for the S&P in one year took place in 2006, at $88.**

**After four consecutive quarters of negative G.D.P. growth, we now have six consecutive quarters of positive growth, starting with the third-quarter of 2009 and continuing with every quarter in 2010 according to the Commerce**

**Department. For all of 2010, G.D.P. rose at a 2.9% rate, which was the highest since 2006 after a decline of 2.6% in 2009. For 2011, the prediction is G.D.P. growth of 3.1% and it is 3.9% in 2012.**

**Donald M. Selkin**

## Disclosures

*Don Selkin is the Chief Market Strategist at National Securities Corporation, member FINRA/SIPC, (NSC) and provides the Fair Value analysis for CNBC each morning. The commentary provided in this Market Letter is intended to provide our customers with timely market analysis and should not be considered a research report. This Market Letter may contain, and is limited to: Discussions of broad based indices; Commentaries on economic, political or market conditions; Technical analyses concerning the demand and supply for a sector, index or industry based in trading volume and price; Statistical summaries of multiple companies' financial data, including listings of current ratings; and, Recommendations regarding increasing or decreasing holdings in particular industries or securities. This Market Letter does not make a financial or investment recommendation or otherwise promotes a product or service of the firm. This Market Letter contains only news, facts, and commentary on information previously reported from a news source believed to be accurate and reliable by the author. These news sources include the following: {Bloomberg Financial, Reuters, Associated Press}. It is possible that at any given point in time, the author, NSC, or one or more of its employees or registered individuals associated with NSC, may hold a position, either long, or short, as well as options, bonds, or other instruments in the companies noted in this report. This Market Letter is intended strictly for current National Securities Corporation customers only.*