



More Good News – Economy Weaker

This past week was filled with more good news for “*drug addicted*” stock market bulls as a slate of economic data came in much weaker than expected. As I discussed last week, the “*bad news is good news*” mantra continues to push asset prices as weaker economic data raises hopes that the Federal Reserve won’t pull the “*punch bowl*” away too soon.

This past week saw the Empire State Manufacturing index drop by 8 points to near contraction levels as the Philadelphia Fed Manufacturing Index plummeted by 15 points to a contraction level of -6.3. The housing market was battered as the NAHB homebuilders index collapsed by 10 points, Mortgage applications drop by 4% last week as is down 17% over the last year. Housing starts slid to just 880k (annual rate) from 1.04 million last month, and existing home sales missed expectations at 4.62 million down from 4.87 million last month.

While the Leading Economic Indicators rose by 0.3% in the latest month the internals were very weak. More importantly, the coincident to lagging ratio, which is like a book-to-bill for the economy, fell further into recessionary territory.

Of course, all of the weakness is being blamed on the weather. However, there are two points to be made here. In many cases the data was weakening well before the cold weather set. Secondly, the data is already “seasonally adjusted” to account for the normal tendency to have inclement weather during the winter months. It is interesting that nobody questioned the “*better than expected*” data over the last two years as the “seasonal adjustments” boosted the reported data sharply as unseasonably warm winter prevailed?

This week we will review the market conditions and what stock market bulls should be somewhat cautious of at this juncture.

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- [Willis Report: Just Weather](#)
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A Short Trip Used A Lot Of Gas

I have often discussed that the overbought/oversold indicator, as shown below, is like a “fuel gauge” in a car.



When stocks are extremely oversold, on a short term basis, the “negative sentiment” allows stocks to rise. The more negative the sentiment the more “fuel” that exists to drive asset prices higher. When stocks get much overbought the tank is “empty” and is refilled by the next market decline.

As with your car, when the “low fuel” indicator light first comes on it doesn’t mean the car is about to immediately run out of gas. In fact, as illustrated by one of my favorite Seinfeld episodes, your car can generally go much longer than you think. [\(Click Picture To Watch Video\)](#)



However, like in the video, the trick in investing is to try and determine just when the engine is beginning to sputter and the car starts to lose momentum.

As shown in the “close up” view below, the market got extremely oversold on a short term basis in January but has now gotten back to overbought.

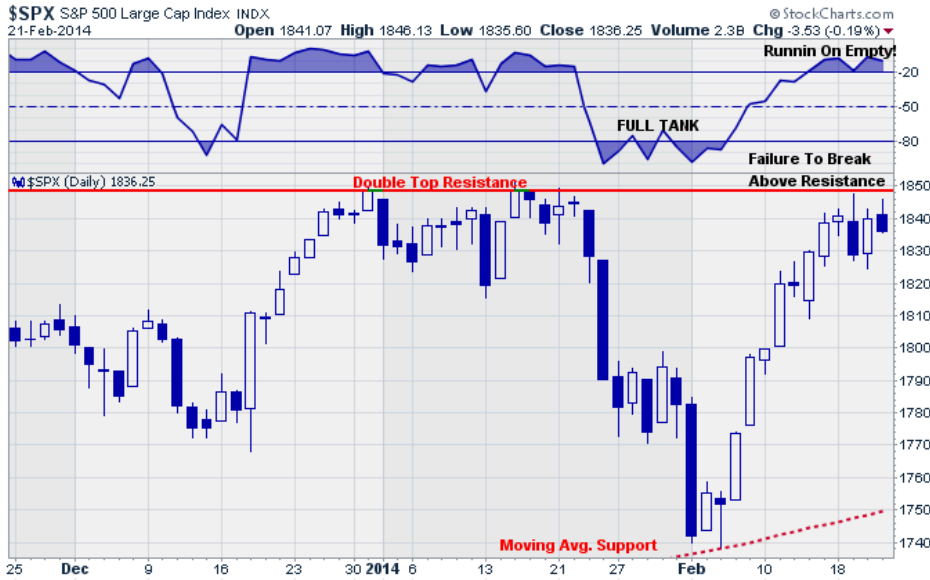
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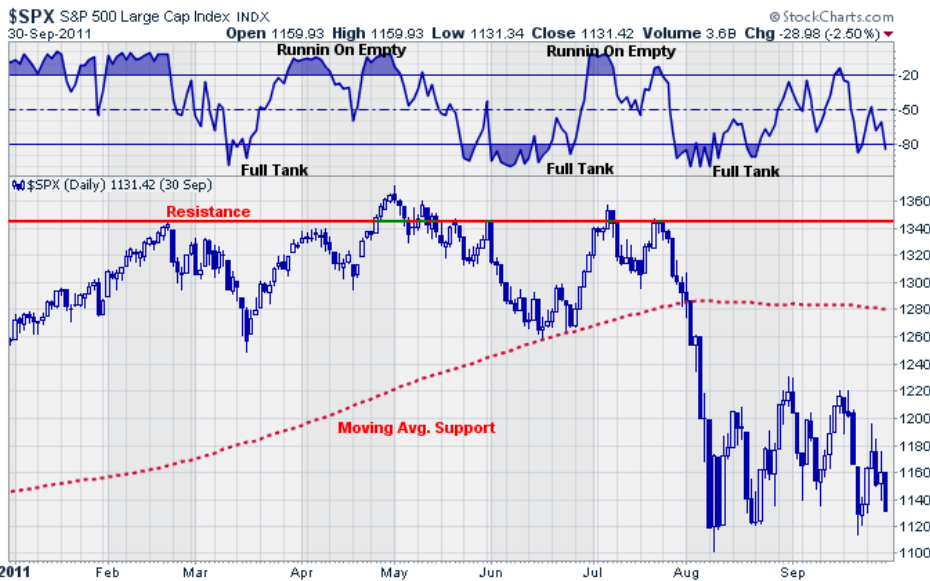
FEEDBACK

CLICK TO SEND COMMENTS

Importantly, this overbought condition occurred without the market attaining a new high in the process.



As I discussed recently in *"Is The Market Tracing A Top"*, the last time that the market went from oversold to overbought without **maintaining** a new high in the process was in the early months of 2011.



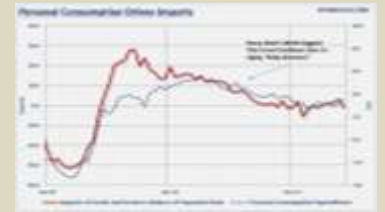
From this [past week's missive](#):

"What is interesting about the chart below is that in late 2010 the markets were rising strongly as the Fed's second quantitative easing program was fully engaged. Complacency among investors was high as the economy plugged along. Much the same as we are witnessing currently. Then, in March of 2011, the Japanese trifecta of economic disaster struck as an earthquake caused a tsunami which led to a nuclear plant chain reaction. The only thing missing was a 90 foot tall lizard sending citizens fleeing from the city.

RECOMMENDED READING

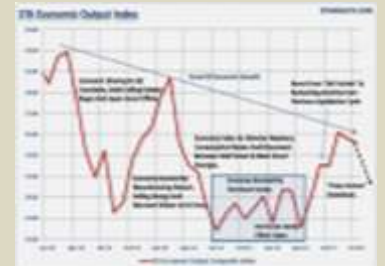
[5 Things To Ponder: Sex, Money & The Carry Trade](#)

Economics of Sex and how the carry trade actually works.



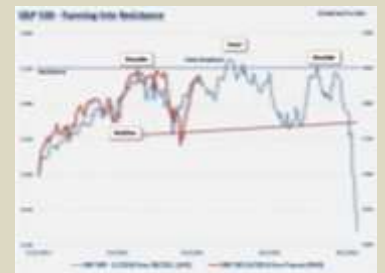
[FBN Willis Report: Is It Really Just The Weather?](#)

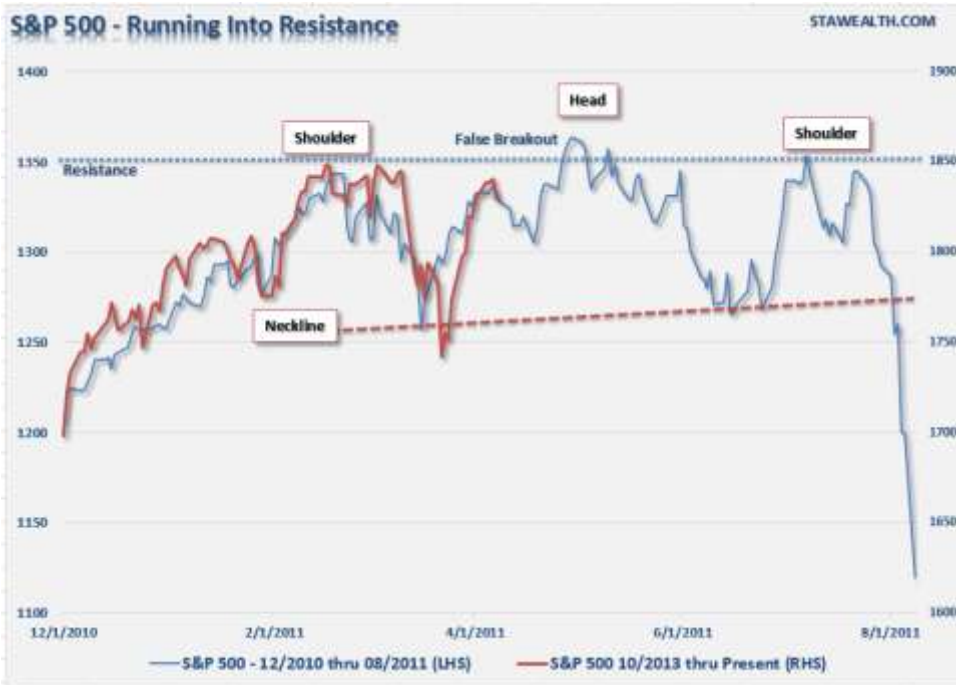
Is the weather really fully to blame for the economic softness?



[Chart Of The Day: S&P Tracing A Top?](#)

Is 2014 a similar set up to 2011?





RECOMMENDED READING

[5 Years Later: What Did The ARRA Achieve?](#)

5 years and \$830 billion later – what did Obama’s ARRA bailout achieve?



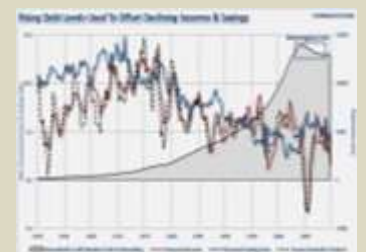
[Is Housing Set To Lift Off?](#)

There are many hopes that housing will support the economy in 2014. Will that really be the case?



[Will Consumers Drive The Next Economic Boom?](#)

Consumers make up 70% of GDP – will they be able to carry the load?



The domestic economy was quickly impacted by the shutdown of Japanese manufacturing. Economic data began to wane at the same time as the Fed’s liquidity program approached its early summer expiration. As the market anticipated the reduction in liquidity flows from the Federal Reserve, stock prices began to struggle. However, for a while they managed to hold above important support. Then, in the middle of summer, President Obama squared off with Congress over a heated debt-ceiling debate. Threats of a government default filled media headlines while market participants watched helplessly from the sidelines. While there was never any real threat of a default, as witnessed by the plunge in U.S. interest rates to record lows at the time, the markets plunged sharply over just a few short weeks causing investors to flee for safety.

That was then. Interestingly, we are currently witnessing similar events. The Fed is once again tapering their current liquidity program. The most recent commentary from the Federal Reserve suggests that the current path of reduction in bond purchases will continue which suggests the program will end by October, 2014.

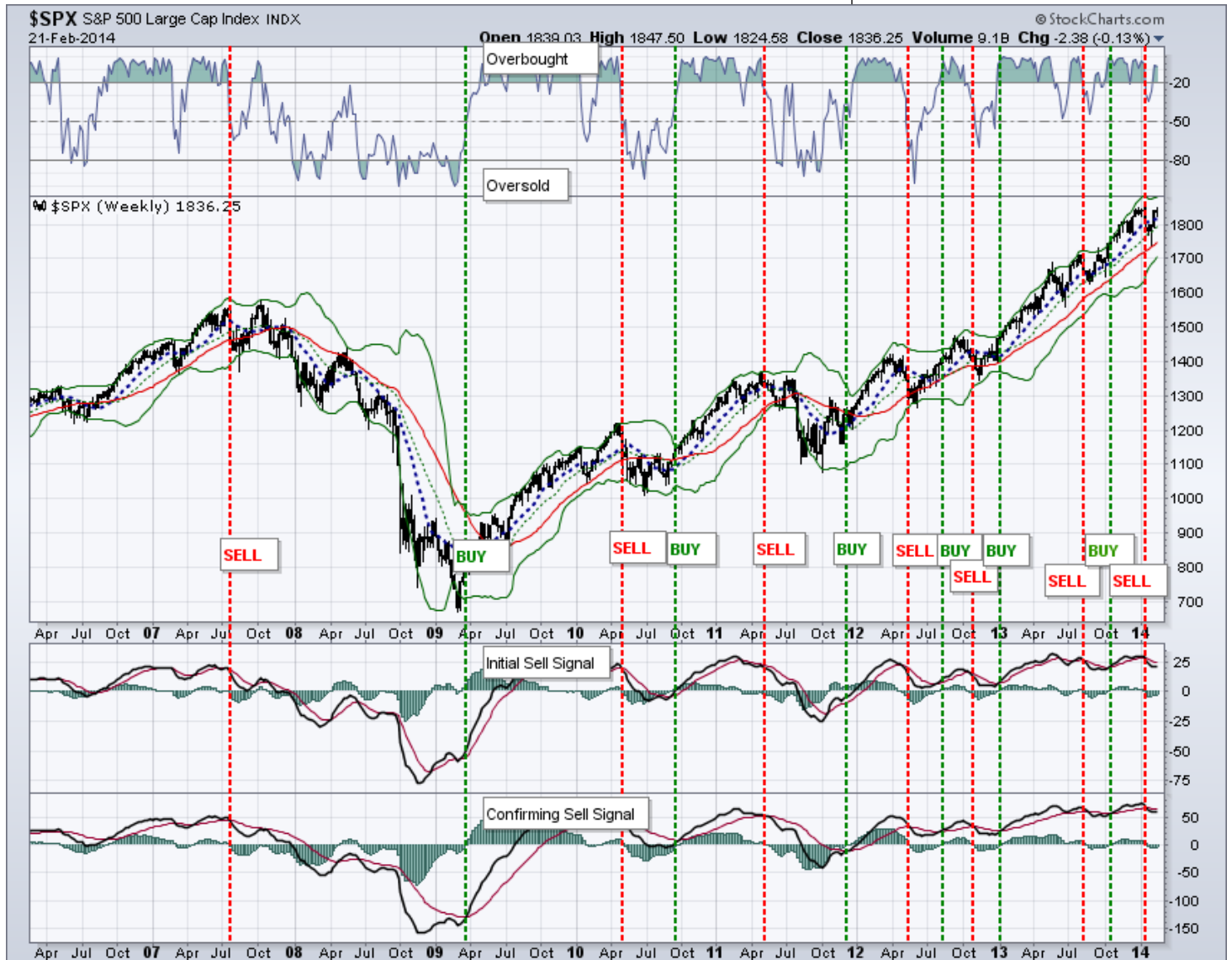
While the U.S. has not yet witnessed an “abominable snowman” threatening Manhattan, the series of “polar vortexes” are exacerbating already weaker trending economic data.”

So, while the market has rallied over the last couple of weeks it has in effect been a very short trip that used up almost all of the “gas in the tank.” And, yes, just as with Kramer and the car salesman, the car can certainly push limits beyond what we should reasonably expect. However, eventually, the car will meet with the inevitable lack of combustion to propel it forward.

Therefore, it will be increasingly important to monitor to turn down the noise (media) and listen for the sputtering and knocking of an engine that is starving for fuel.

Maintaining Allocation Model For Now

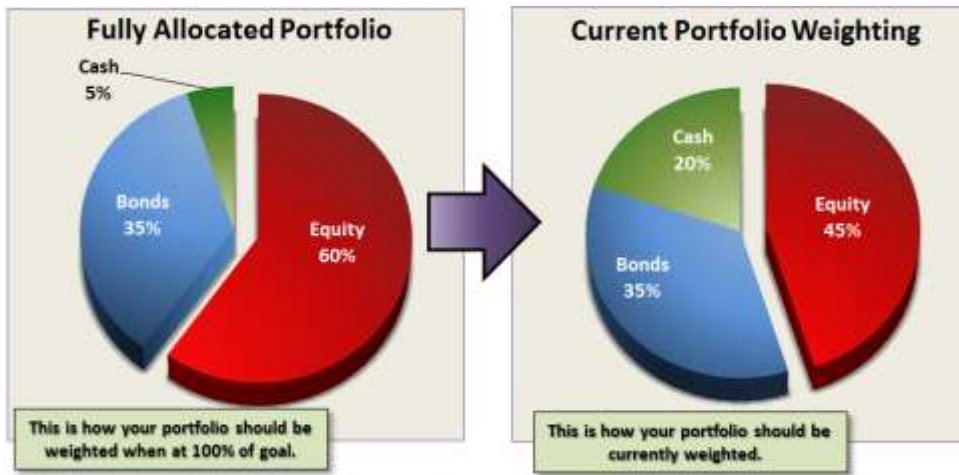
As shown in the chart below, the market currently remains on an initial “SELL” signal. While the market has rallied over the last couple of weeks it has not been enough to reverse either of the initial portfolio risk management signals (lower two graphs of initial and confirming sell signals).



This is where investment discipline gets very tough for individuals. When the markets begin to rally after a correction, individuals tend to want to disregard their discipline to jump back in. However, this is where the “traps” are usually set for unsuspecting individuals. When emotions are used to make investment decisions it usually leads to “buying high” and “selling low.” It is the historical, behavioral tendencies of investors throughout history.

However, by allowing the market to “TELL” you what it wants to do the emotional guesswork is somewhat mitigated. No, you will not buy the bottom or “top tick” the market when you sell. However, what you will achieve by following a strict discipline is the ability to capture the bulk of the upside and miss a majority of the downside **OVER THE LONG TERM (defined as 5 years or more.)**

Therefore, with both signals still in place we will continue to watch the markets for a sustained “breakout” above resistance that is maintained before raising equity allocations back to full exposure. This leaves the current portfolio weighting at 75% of the target allocation as shown below.



Why This Model

I have gotten a lot of emails lately asking me what the best allocation model is for some certain age. The truth is that the 60% equity and 40% fixed income model has absolutely the best returns long term over any other allocation model for any age bracket when accounting for behavioral actions of investors. Below are three different allocation models (via Vanguard) showing historical risk/return from 1926-2012.

100% bonds



Historical Risk/Return (1926–2012)	
Average annual return	5.5%
Best year (1982)	32.6%
Worst year (1969)	-8.1%
Years with a loss	13 of 87

60% stocks / 40% bonds



Historical Risk/Return (1926–2012)	
Average annual return	8.7%
Best year (1933)	36.7%
Worst year (1931)	-26.6%
Years with a loss	21 of 87

100% stocks



Historical Risk/Return (1926–2012)	
Average annual return	10.0%
Best year (1933)	54.2%
Worst year (1931)	-43.1%
Years with a loss	25 of 87

As you will notice the 60/40 model has delivered an 8.7% annualized rate of return since 1926 while the 100% stock model delivered 10%.

Immediately, this would seem to disprove the argument that the 60/40 allocation is an all-around better allocation model for individuals over the long haul. However, not so fast.

There are TWO very important flaws in the analysis above.

1) Unless you have discovered the fountain of youth – you did not invest your money on a compounded basis for 86 years. Even if you started working when you were 16 years of age and investing in the market – you are likely dead by now.

2) The second is the volatility. As we already know from numerous studies on investor behavior, the likelihood of you holding the 100% stock portfolio over the “long term” is highly unlikely. The drawdown years that exceed 20% likely would have had you panic selling the bottoms and buying the tops.

As evidence of this investor trait, Dalbar did a study of investor returns during the secular bull market of the 80’s and 90’s only to find that while the market returned roughly 15% annualized during that period the average investor averaged about 4%.

While the 60/40 allocation may have lower returns over the last 86 years – the reality is that in more realistic investment time frames, particularly those where higher volatility exists, a model that reduces overall portfolio deviations will produce better returns. I have demonstrated this in previous articles but the chart is reproduced below.



The chart is a raw dollar (not adjusting for inflation) run of 5 different allocation models. Over the last 13 years there is only a NEGLIGABLE difference in total return between the 100% stocks and 60/40 allocation model.

In the real world of investing, it is highly likely that 100% stock investors sold near the market lows of 2002 and 2009 as stocks were crushed. However, those investors with the lower volatility 60/40 allocations were much more likely to emotionally ride out the drawdowns.

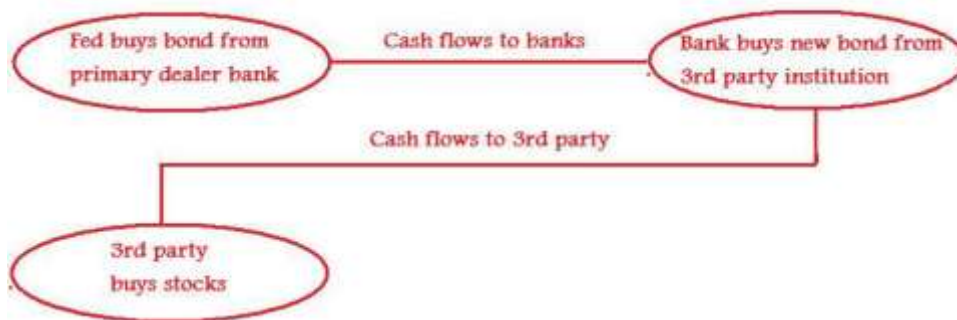
This is why, regardless of whether you are 20 or 60, I continue to recommend the 60/40 allocation model over all others. It is survivable.

Also, it is worth noting that when the 100% stock portfolios have previously caught up with the 60/40 allocation model – it was near a market peak.

3 Things I Am Watching

In the coming months there are 3 very important issues that are worth watching as it will likely have a major impact on the “bull market” argument.

1) The Federal Reserve seems very committed to “tapering” the current liquidity program and exiting “QE” entirely as early as October of this year. Despite rhetoric to the contrary that “tapering” is not the same as “tightening” - it is. The extraction of liquidity will reduce the carry trade that has been fueling stocks during the last year. For more on how QE works read this past week’s [“5 Things To Ponder”](#)



2) As I have been beating the table with over the past few months the economic data trends continue to show signs of weakness. [IF the economic data does NOT improve as the weather warms](#), meaning that it was more than “just the weather,” this could shock the financial markets more than currently expected.

3) Finally, the upcoming mid-term elections could spook the markets particularly if it looks like the Republican conservatives could take the Senate and keep the House. This would raise concerns about deeper “austerity” measures and a crackdown on the current Government subsidy dole that is supporting 1 in 3 Americans currently.

The outcome of the next few weeks, and months, is only a guess at the moment. However, I will continue to update and revise the analysis as the data presents itself.

Have a great week.
Lance Roberts

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What makes us different?

It's really pretty simple. We believe that managing risk is the key to long term success. Conserve the principal and the rest will take care of itself.

Risk = Loss

Seems like a simple concept – yet most people take way too much risk in their portfolio which is fine as long as the market goes up. The problem comes when it doesn't.

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By applying varying levels of risk management to a portfolio of assets the potential for large drawdowns of capital is reduced thereby allowing the portfolio to accumulate returns over time.

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We believe that portfolio should be designed for more than just capital appreciation. There are times when markets do not rise. During those periods we want income from dividends and interest to be supporting the portfolio.

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Sector Analysis

Major Markets

S&P 500

Analysis: Hold

The market held support during the January correction but is now wrestling with resistance at old highs. As discussed above we are going to maintain a slightly underweight allocation until the current situation resolves itself.



International Markets

Analysis: Hold

Like domestic stocks, industrialized international markets held support and are currently testing overhead resistance. Economic and fundamental data continue to deteriorate in the Eurozone so some caution is advised.

However, the recent agreement to allow the ECB to make unsanitized purchases of bonds potentially allows for a melt up in international stocks. For now, hold exposure and await confirmation of a breakout.



Emerging Markets

Analysis: Sell On Rallies

Emerging markets are under considerable pressure both economically and fundamentally as US imports fall due to a weakening consumer.

These markets remain a sell and rallies should be used to eliminate holdings for the time being.



S&P 500 Strong Sectors

(Sectors That Outperformed The S&P 500 Over The Last 60 Days)

Health Care

Analysis: Hold

Healthcare remains one of the strongest performing sectors even during the recent correction. Hold current exposure for now and look to add to the sector on corrections to the bullish uptrend.



Technology

Analysis: Hold

Technology, like Healthcare, remains a strong performer. The recent breakout and test of previous resistance, now support, keeps the bullish trend alive and well.

However, there is a concern about the return of valuation metrics last seen at the "tech bubble." Instead of "eyeballs per page" it is now users – even if the users generate no money. There are many similarities between now and the "tech bubble" – one of which is the tacit denial that there is no similarity.



Utilities

Analysis: Hold

As discussed four weeks ago Utilities broke out of a long consolidation range to the upside with the drop in interest rates as the Fed began to taper its liquidity injections. Now, extremely overbought, it is not the time to be adding to the sector.

Hold for now and look to add to holdings on pullbacks to the \$39 neighborhood.



S&P 500 Weak Sectors

(Sectors That Underperformed The S&P 500 Over The Last 60 Days)

Consumer Staples

Analysis: Reduce/Hold

Staples are a very weak performer. For the time being underweight staples in portfolios.

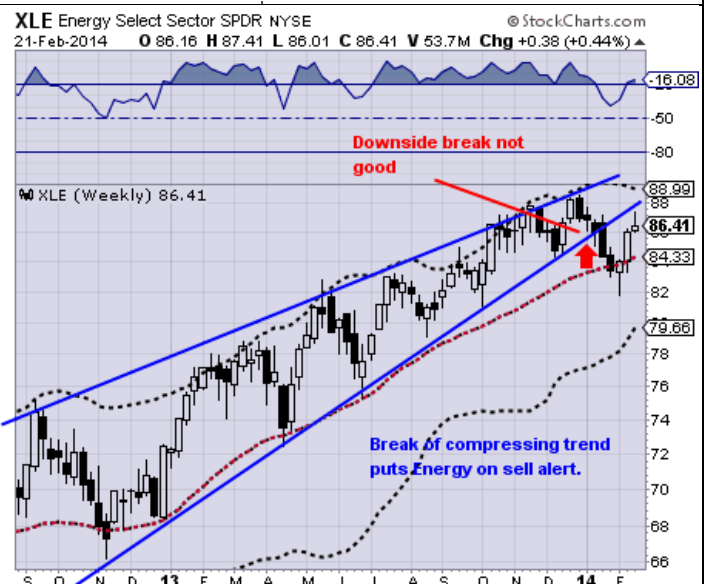


Energy

Analysis: Reduce/Hold

Energy stocks remain below their bullish trend line and continue to perform much weaker than the broader market. Like staples – underweight the sector in portfolios.

The same goes for MLP's.



Financials

Analysis: Reduce/Hold

Financials also have performed worse than the broader market over the last 60 days. With financials now below their bullish trend line – reduce the sector accordingly in portfolios.



Interest Rates

Analysis: Trending Lower

Interest rates have not corresponded with the recent rally in stocks as money flows have continued a flight for safety in the last couple of weeks.

Interest rates have been trend lower since the Fed started their "tapering" in December as I expected. With rates currently wrestling with resistance the next most logical target is 2.47%.



Gold

Analysis: Still A Sell

There has been much hope as of late that the recent spike in gold prices signals the end of the bear market in precious metals. This is not likely the case as of yet.

The recent spike, like the one seen in July of last year, is an oversold bounce that is currently contained within the downtrend. This is an opportunity to SELL holdings that should have been sold a long time ago.

Gold will need to move to roughly \$1400 and confirm a bullish breakout before a buying opportunity occurs.



US Dollar

Analysis: Going Lower

The extraction of liquidity in the markets by the Fed is going to likely suppress the dollar further as the USD/JPY carry trade is unwound. With a failure at the long term moving average the dollar looks to retest lows at \$79.04 on the index.





As stated above we are leaving the allocation model unchanged this week as the market wrestles with previous overhead resistance.

Both sell related signals are still intact which suggests higher levels of risk at the moment.

Please review the article above for more detail on the current analysis. However, the recent rally does provide a decent opportunity to rebalance portfolios to the model if you are currently overweight equities.

If you need help after reading the alert; don't hesitate to [contact me](#).

[Suggestions Wanted]

I am in the process of revamping the newsletter and the 401k plan manager for the new website. If there is anything that you would like to see added to the 401k plan manager [please email me](#).

Common 401K Plan Holdings By Class

Cash	<ul style="list-style-type: none"> Stable Value Money Market Retirement Savings Trust Fidelity MIP Fund G-Fund Short Term Bond 	Equity	<ul style="list-style-type: none"> Vanguard Total Stock Market Vanguard S&P 500 Index Vanguard Capital Opportunities Vanguard PrimeCap Vanguard Growth Index Fidelity Magellan Fidelity Large Cap Growth Fidelity Blue Chip Fidelity Capital Appreciation Dodge & Cox Stock Hartford Capital Appreciation American Funds AMCAP American Funds Growth Fund Of America Oakmark Growth Fund C-Fund (Common Assets) ALL TARGET DATE FUNDS 2020 or Later
Fixed Income	<ul style="list-style-type: none"> Pimco Total Return Pimco Real Return Pimco Investment Grade Bond Vanguard Intermediate Bond Vanguard Total Bond Market Babson Bond Fund Lord Abbett Income Fidelity Corporate Bond Western Asset Mortgage Backed Bond Blackrock Total Return Blackrock Intermediate Bond American Funds Bond Fund Of America Dodge & Cox Income Fund Doubleline Total Return F-Fund 	Balanced Funds	<ul style="list-style-type: none"> Vanguard Balanced Index Vanguard Wellington Fund Vanguard Windsor Fund Vanguard Asset Allocation Fidelity Balanced Fund Fidelity Equity Income Fidelity Growth & Income American Funds Balanced American Funds Income Fund ALL TARGET DATE FUNDS 2020 or Sooner

The above represents a selection of some of the most common funds found in 401k plans. **If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.** All funds perform relatively similarly within their respective fund classes.

I will modify this list over time as the asset allocation model changes to reflect international holdings, emerging markets, commodities, etc. as the model changes to reflect the addition of those holdings.

[Email me](#) if you need further assistance.

Small/Mid Cap	<ul style="list-style-type: none"> Vanguard Mid Cap Growth Fidelity Mid Cap Growth Artisan Mid Cap Goldman Sachs Growth Opportunities Harbor Mid Cap Growth Goldman Sachs Small/Mid Cap Opp. Fidelity Low Price Stock Fund Columbia Acorn US Federated Kaufman Small Cap Invesco Small Cap
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Current 401k Allocation Model

20.00% Cash + All Future Contributions
Primary concern is the protection of investment capital
 Examples: Stable Value, Money Market, Retirement Reserves

35.00% Fixed Income (Bonds)
Bond Funds reflect the direction of interest rates
 Examples: Short Duration, Total Return and Real Return Funds

45.00% Equity (Stocks)
The vast majority of stock funds track an index. Therefore, select on ONE fund from each category. Keep it Simple.

25% Equity Income, Balanced or Conservative Allocation
 20% Large Cap Growth (S&P 500 Index)
 0% Mid Cap Growth

Current Portfolio Weighting



This is how your portfolio should be currently weighted.

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