September 16, 2011

Dear Investors:

Last week, it looked as though downward wave 5 started when the Dow Jones Industrial Average plunged 422 points on Thursday and Friday. However, after this week’s five day winning streak, it is clear that we are still in the midst of the final stages of upward wave 4. Based on this week’s five day rally you would think that the U.S. and European economic troubles were solved and global economic growth is just around the corner. The real truth is that this is a classic technical rally within a larger pattern that will only become clearer with the passing of time. There was no resolution to the European banking woes and almost all of this week’s U.S. economic data were at or below expectations. Right now it looks to be part of an upward wave 4 that should be followed by a steep downward wave 5. Last week, I said that wave 5 could take the markets another 5%-10% lower by the time that it was finished. After this week’s gains, wave 5 is more likely to drop 8%-12% from this week’s close. However, it is important to realize that another fictitious round of economic steroids or quantitative easing could derail the projected technical pattern.

After an early morning selloff on Monday morning the markets recovered to post their best weekly gain since July. The Dow Jones gained 516.96 points, or 4.7%, to close at 11,509.09, and is down only 0.5% for the year. The S&P 500 added 61.78 points, or 5.4%, this week to close at 1,216.01, and is down 3.3% for the year. The NASDAQ Composite jumped 154.32, or 6.25%, this week to close at 2,622.31, which is down 1.15% this year.

So why did the markets post a five day rally? It was not because of improving economic data. On Tuesday, we learned that the August Treasury budget deficit was wider than expected by more than $2 billion. On Wednesday, the Commerce Department reported that August Retail Sales were flat, but that economists were expecting a rise of 0.2%. On Thursday, seasonally-adjusted first-time unemployment claims jumped to 428,000. After billions of dollars in government spending and “stimulus” plans, first-time unemployment claims were only 22,000 less than they were for the same week last year. We also learned that the August Consumer Price Index rose 0.4%, which is 0.2% more than the “experts” were expecting. In summary, government spending is increasing, retail sales are sluggish, unemployment claims are increasing and monthly inflation is increasing.

Many Wall Street observers believe that the five day rally is in anticipation of the Federal Reserve’s next trick to save the slowing economy. The “twist” is a form of quantitative easing that extends the duration of the assets held by the Federal Reserve without increasing the dollar amount. Unlike QE2, where the Fed was printing money to buy U.S. Treasuries, a simple explanation is that the Treasury is only going to offer long-term Treasuries to the Federal Reserve. The Federal Reserve will use the proceeds from short-term Treasuries to buy the longer term obligations thus taking them away from other investors seeking long-term security. Pimco’s senior strategist, Tony Crescenzi, said, "The Fed will likely attempt to spur another leap of faith, pushing investors to move out of the risk spectrum and away from riskless assets, and deposits, to support asset prices, boost wealth and aid the deleveraging process." Like the QE2 policy, the Federal Reserve is trying to create artificial wealth to spur the U.S. economy. However, this is a dangerous “twist” of the truth on the American people almost forcing retirees and those nearing retirement to put money into more risky investments.

This “Operation Twist” failed 50 years ago when the Kennedy Administration tried it. In 1961, we were coming to the end of the Baby Boom and we did not have the largest single demographic of the economy retiring at an estimated pace of 10,000 people each day. The Wall Street Journal recently reported that in 2004, Mr. Bernanke (then a Fed governor) and Fed staffers Vincent Reinhart (now at Morgan Stanley) and Brian Sack (now running the New York Federal Reserve Bank market desk) wrote, "Operation Twist is widely viewed as a failure." They noted that Nobel laureate Franco Modigliani described the impact as "moderate at best," estimating that it cut long-term rates by 0.1 or 0.2 of a percentage point. Times have changed. A recent re-examination by a San Francisco Fed economist is cited as proof that Twist was a success, even though it found that rates were reduced by only 0.15 of a percentage point. Any move by the Fed to pull long-term bonds away from investors' hands (driving down the yield) would be diluted if the Treasury sold more of them. "The Fed would need to coordinate with the Treasury," Mr. Bernanke wrote in 2004, "to ensure Treasury debt-issuance policies did not offset the Fed’s actions.”

It will be interesting to see how this week unfolds. We are coming upon a Fibonacci turn window, which means that based on prior numerical days several phi mate dates appear over the next two weeks. Therefore a change in direction could occur at any time. After this cluster of dates, the next Fibonacci phi mate date is November 11th. At this point in time, there is a higher probability that the markets should turn lower over the next week to 10 days and continue their downward trend into November. At that time, the markets could kick off the 40%-60% retracement rally that appears to be on the horizon. The other, less likely alternative, is that we are in the midst of the larger retracement rally and the markets continue upward into November.

I welcome your comments and enjoy reading your feedback regarding my letters. I want to thank you for your referrals and confidence. A referral is the greatest validation of our service and commitment. If you have any questions, please do not hesitate to call.  Our mission is to be your trusted financial professionals dedicated to delivering a high level of service to enhance your lifestyle and provide peace of mind.

﻿﻿Best Regards,

 **Vincent Pallitto, CPA, CFP®**

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