RAYMOND JAMES

Investment Strategy
Published by Raymond James & Associates

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July 18, 2011

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"Worried"

In last Monday's missive I wrote, "So, my sense is that the S&P 500 (SPX/1316.14) will spend a few sessions oscillating between 1320 and 1350 until the equity markets' internal energy is rebuilt for a move higher." Obviously, that view fell apart on the same day when the SPX closed below 1320 last Monday. Subsequently, there have been three attempts to recapture the 1320 level, all to no avail; that worries me. This year the 1320 level has proven to be an important "attractor/repellor" level. One can see that with a quick perusal of the charts. Accordingly, last week's stock market action was not encouraging, at least not to me. It's not that I have given up on the idea the economic backdrop is about to improve despite last Friday's disappointing sentiment figures, I haven't. Indeed, I think a lot of things are geared to go right once the debt ceiling crisis is resolved, which I can't imagine will not happen. To be sure, the Japanese supply side disruptions are abating, as witnessed by last week's numbers. Then too, crude oil prices have declined from~$115/bbl. to ~$97 as the world's "mean men" seem to be falling like dominos. Auto production is slated to ramp by 23%+ this month and capex should surge since the 100% expensing option goes away in 2012. Of course, a resolution of the debt ceiling crisis is likely going to be accompanied by a scaling back in governmental expenditures, which should give entrepreneurs and businessmen the belief that deficits are being tackled. As for the recent employment report, the June employment report is historically fickle. What you have is students leaving jobs taken while attending school and heading for home.

Weakness during job recoveries has happened before. In 2004, 2005 and 2006, which were the second and third years of prior recoveries, there were also monthly disappointments in job growth. Moreover, there were screwy seasonal adjustments in the recent employment data. For example, without seasonal adjustments, payrolls rose by some 376,000. Surprisingly, the government's seasonal adjustments reduced the adjusted employment figures by an eye-popping 358,000. Further, the official employment numbers are in sharp contrast with the ADP employment report. Typically, when I am confronted with such conflicting numbers, I turn to the charts because in this business "price" is reality. So I pose the question, "If the employment numbers, and the consumer sentiment numbers, are so bad why did the S&P Consumer Discretionary Index and the S&P Retail Index tag new all-time highs last week?" Surely, that's a valid question and one worth consideration before one dismisses the U.S consumer as totally kaput.

Over the past three weeks I have traveled through Europe (for two weeks) and spoken at Raymond James' National Conference (last week). My message has been pretty consistent – I have been relatively optimistic on the equity markets, the employment situation, and the economy because of the explosion in corporate profits. In the real world profitable companies hire and unprofitable companies fire employees. Manifestly, the way the world works is that profits explode, fostering an inventory rebuild cycle. With the Inventory to Sales Ratio back down to the recession levels of 2008 it is reasonable to believe we will get some sort of kick to the economy from an inventory rebuild. That in turn drives a capital equipment cycle (capex), which should be enhanced by the aforementioned factors. When companies spend money on capex they typically begin to hire people and the economy improves. So why has job growth evaporated over the past few months? I continue to think it is because of temporary factors like Japanese auto part shortages, surging material and gasoline prices, the world's sovereign debt debacle, and the weird weather.

Recall, it was roughly a year ago when I began talking about the potential for some really weird weather. At the time people dismissed me as another Joe Granville, who lost his stock market guru status by predicting an earthquake that would make Phoenix "beach front" property. Nevertheless, I opined that the La Nina weather pattern, combined with more volcanic ash in the atmosphere than anyone can ever remember, was going to give us a very cold/wet winter with weird weather that should foster droughts, floods, hurricanes, and tornadoes. The culprit driving the weird weather was a huge shift in the Hadley Cell Winds (see previous reports for an explanation), which were affected by said La Nina and volcanic ash. Subsequently, I recommended being "long" energy stocks. While I was laughed at by the folks in the Northeast and Midwest last summer, they are no longer laughing. Regrettably, while the La Nina pattern is going away, it will return this fall. Additionally, while there is little news coverage about another Icelandic volcanic eruption that is four times worse than last year's Eyjafjallajokull eruption, Mount Grímsvötn's eruption has spewed 4x as much ash and chemicals into the troposphere as last year's eruption. This is certain to cause a change to the northern hemisphere's weather. Accordingly, expect a busy hurricane season with damage to oil/gas production facilities in the Gulf of Mexico. Currently, parts of the U.S. and China are being plagued by droughts, while other regions are experiencing floods and violent storms. Expect another very cold winter. Agricultural crop yields, especially wheat, should be affected negatively.

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Interestingly, the drought has caused Norwegian hydro-electric generation to be down by two-thirds with attendant investment implications. Also, the Rhine river (I was just there) is so low barges are operating well below capacity. All of this has major investment implications.

Speaking of major investment implications, I have to ask it again given last week's takeover bid for Petrohawk Energy (HK/$38.17/ Market Perform), "What do major energy companies know about natural gas that many energy analysts don't?" Indeed, there have been numerous takeovers of natural gas companies in the past few years, the most notable being Exxon Mobil's (XOM/$83.00/ Market Perform) acquisition of XTO Energy. Whatever the answer, our E&P analyst John Freeman's favorite small cap name remains Resolute Energy (REN/$17.05/Strong Buy). As John wrote in his July 14, 2011 report:

> "Resolute is one of just two names in our E&P space that trades below its proved-only NAV (~$17/share) using current strip pricing. For reference, our small-mid cap names trade at roughly 2x their proved-only NAV. This gives Resolute zero credit for its ~34,000 net acres in the Bakken, its 115,000 net acres prospective for the Mowry, or its recently acquired Wolfbone position (7,900 net acres) in the Permian."

Plainly, I continue to like the energy sector and especially select MLPs. The reason is because there appears to be "imbedded options" in many of the energy companies that are not being given any value, as John notes in the above comment. My second favorite sector is Information Technology; my third is Materials followed by Industrials. For ideas I suggest consulting our Analysts Current Favorites list, as well as our Canadian affiliate's (Raymond James Limited) recommendations on select Materials companies.

The call for this week: Last Monday proved to be a 90% Downside Day whereby 90% of the total volume traded came on the downside, while 90% of total points were likewise negative. Typically, 90% Downside Days are followed by rally attempts lasting five to seven sessions. Obviously, that wasn't the case last week and it concerns me. Also concerning is the fact the often mentioned 1320 level was violated and despite the three separate rally attempts that were staged to recapture 1320, it was all of no avail. This brings us to this week, where 2Q11 earnings reports will be Wall Street's focus. Worth noting is that of the 31 companies that reported last week, 74% of them beat estimates. Unfortunately, 15 of those "beating companies" rallied, while 17 declined. Still, if the number of earnings "beats" continues, it should provide some kind of downside cushion for equities, provided the debt ceiling "thing" is resolved. Also of note is that there are a host of technical "timing points" due this week. Accordingly, while we are disappointed, we have not given up on our bullish "call," at least not yet. That could change, however, if the SPX breaks back below 1295.

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