Lindisfarne Investments, LLC

An island of safety in a sea of risk

Market Update
October 12, 2012

General Market Conditions

The market has stalled since the announcement of QE3 by the Federal Reserve on September 13th. Many days start with a move higher intraday, but by the market close all gains have been given back and we end either at where we started or with a loss. This lack of follow through doesn't bode well for the future.

The Fed's large scale effort to invigorate the economy, Romney's debate win, European leaders apparently cooperating to save Spain and Greece are all generally viewed as positives. But the market is saying that these events are not enough to convince it that the future is bright.

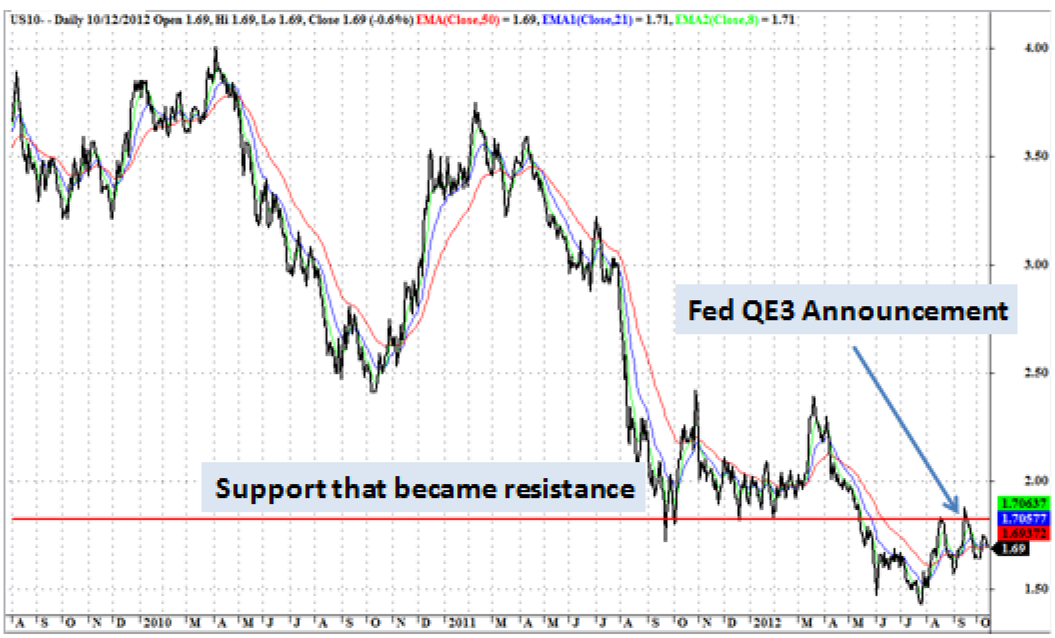
On Saturday, Reuters published a story excerpted below:

> **Wall Street Week Ahead: Investors turn wary as earnings picture dims**
>
> By Ryan Vlastelica
>
> NEW YORK (Reuters) - Earnings season is heating up, but investors' feet are getting cold.
>
> Central bank-fueled gains took markets within reach of five-year highs in September, but now U.S. stock market participants are shifting their focus back to corporate outlooks, and the picture is not pretty.

Let's look at the charts and see what they are telling us. First, how has the bond market reacted to QE3? As you can see below, there has been no appreciable reaction. Prior resistance remains in effect for both the 90 day T-Bill rates and the longer term 10 year rates.

90 Day T-Bill Yields

10 Year Bond Yields



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The S&P 500 has behaved similarly. On the 17 years of history chart below, you can see that we are bumping up against the previous highs that were formed in 2000 and 2007. The 2007 high is 7% away from our current value. Only time will tell if this area will once again repel the market's advance and send it lower (possibly back to the lows around 800).

S&P 500 (17 Years)

Shorter term, the market has moved sideways to down since the Fed announcement. A holding pattern seems to be the operative description of what the market is doing.

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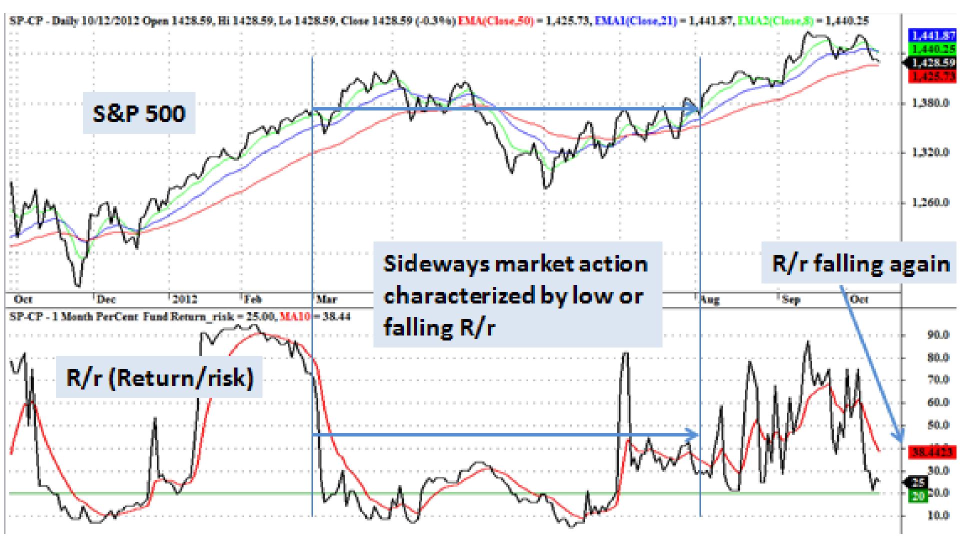
S&P 500

Looking at our proprietary R/r (Return over risk) indicator in the next chart, we can see that a low or falling R/r does not see positive market action ahead. In fact, this is exactly what is shown between March and August of 2012. During this time of low R/r, the market moved exactly sideways.

Notice that R/r is currently low and has been falling since September.

S&P 500 with 1 Month R/r



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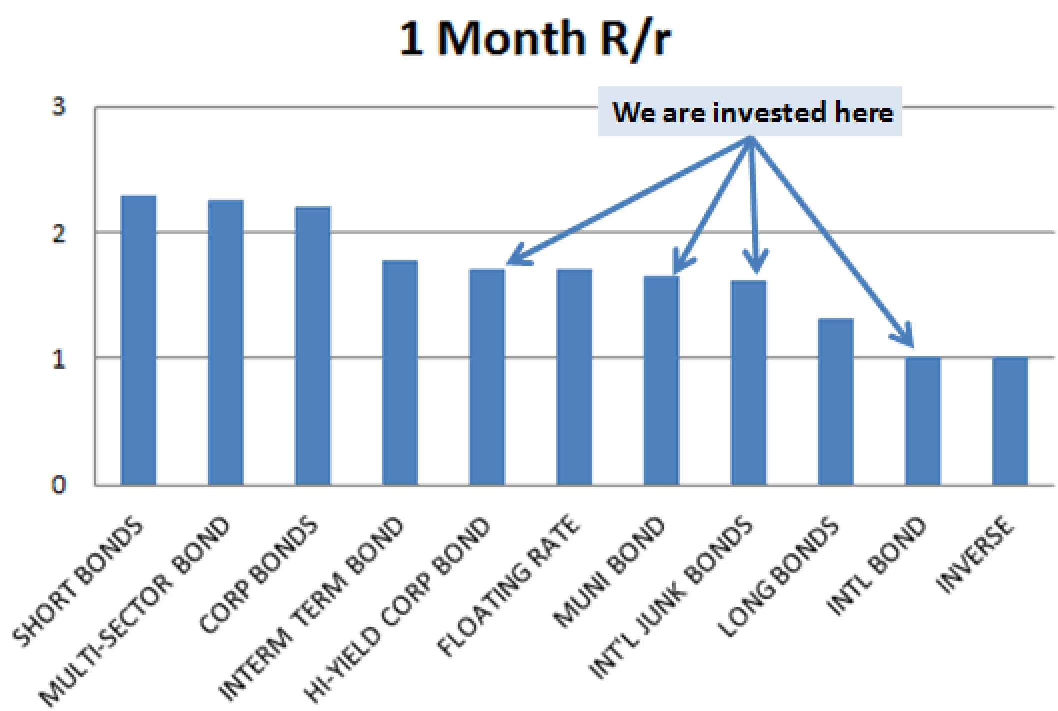
What Is Doing Well

Another way that we use the R/r indicator is to see which economic sectors are doing the best in the current market. We use a value of R/r = 1 as our cutoff. Sectors that have R/r greater than one are giving us more than a unit of return for each unit of risk that we are taking. An R/r less than one says we are taking more risk than the market is compensating us for.

Right now, 25% of the market sectors have an R/r greater than one as shown by the black line in the previous chart. A value of 20% says the market is too narrow in its participation and we should not believe that it is healthy. We are almost there. One more week of current market deterioration should take us there.

So what groups pass our R/r greater than one test? They are shown in the next chart.



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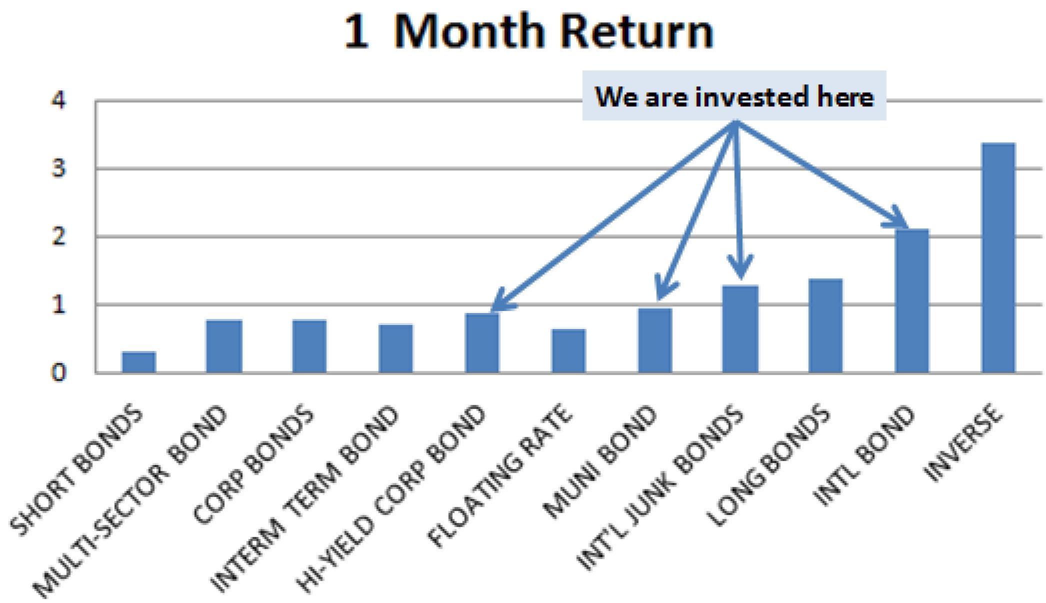
And the returns that these groups have had over the last month are:



Please note that the higher performance of the Inverse group comes from the leveraged funds that are included in its calculations.

Overall, we are invested in the safer sectors of the market and garnering the returns that are available. Of course, the market can always change its nature tomorrow. We will continue to monitor it for any such occurrence and take the necessary actions.

Please feel free to pass this update on to anyone that you think might be interested in it. If they wish to be on the mailing list or would like more information about the services of Lindisfarne Investments, we can be contacted by phone at (440) 623-0775 or by email at bill@lindisfarneinvestments.com .

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