Lindisfarne Investments, LLC
An island of safety in a sea of risk

Market Update
July 11, 2014

The Market

Last week was not the best week for the market with the S&P 500 dropping 0.9%. This was the fourth worst week so far this year. The larger down weeks occurred in January and April, both losing 2.6%. This was followed in severity by the first week of March where it dropped 2.0%.

There was a lot of bad news this last week. The most significant was the re-emergence of European banking problems with the spotlight being on Portugal. Of course, fighting continued in the Ukraine and Iraq, Israel and Hamas were launching rockets at one another, the Afghan election is being contested and the US government continued to squabble over everything but jobs and the economy. And, 16 or so states are pushing for a constitutional amendment that would “undefined” corporations as a person.

But here in Cleveland, the news was all good. Cleveland beat out Dallas for the 2016 GOP convention. This should bring a nice boost to the local economy. Along with that, we now have LBJ back. (No, Texas, not Lyndon Baines Johnson, but Lebron James). He will return here for at least two years to play for the Cavaliers who are now odds on favorites to win the 2015 NBA championship.

So it appears that like politics, all good news is local, especially this past week.

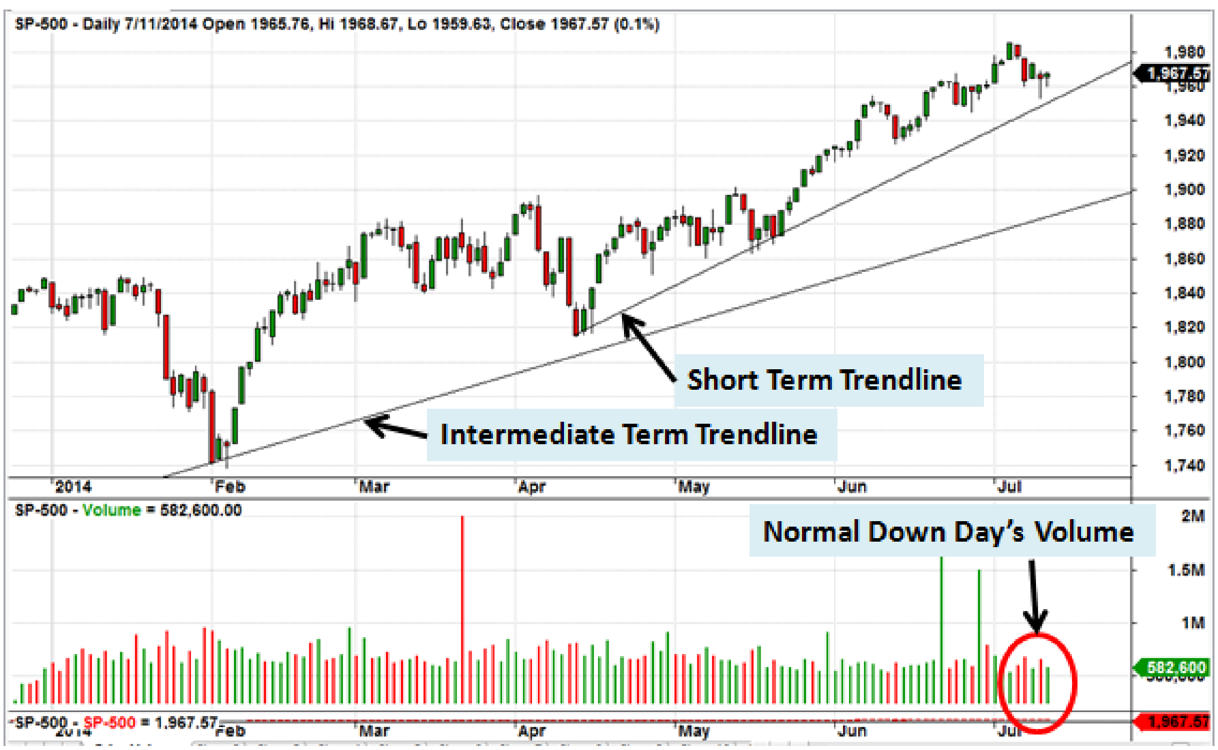
The important point is not what is going on in the world, but how the market reacts to it. Let’s look at the charts to see what the reaction has been and see if we can draw some conclusions.

First looking at the S&P 500 for this year, we see that the last week's reaction is by no means atypical of any of the down moves we have experienced so far this year. As mentioned earlier, the larger down moves were 2.6%, 2.6% and 2.0% while last week's was 0.9%. And the market's volume was about average for any week of the year.

More importantly, we remain comfortably above the long term (not shown), intermediate term and short term trendlines. As long as we remain above the short term trendline (approximately 1,960 on the S&P 500), we should continue at the current up-pace. If we break this level, then I would expect a move down to the 1,900 area (4%) where the intermediate term trendline is located.

What could cause such a down move? We are just starting earnings season where the sins and victories of the 2nd quarter will be disclosed. More important will be the forward guidance that is given. At the end of 2013 and through the slow 1st quarter (weather related???), the predictions were for a pickup in the second half of the year. We are now there … forward guidance should reflect improving economic conditions.

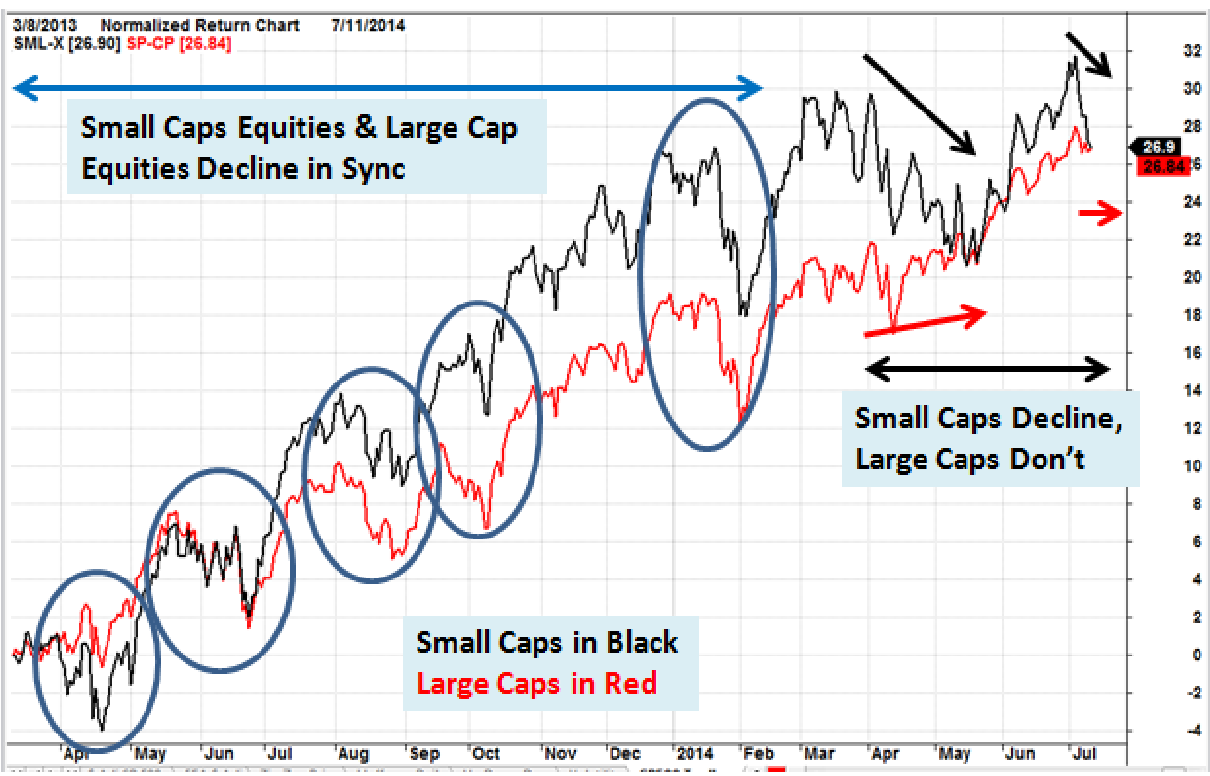
S&P 500 Daily Chart



If there is one recent disturbing behavior in the marketplace, it is shown in the next chart which compares the performance of the large cap stocks vs. the small caps. As you can see, when large caps have a decline, typically the small caps also decline. But starting in April, their relative behaviors diverged. Large caps, as reflected in the S&P 500, have basically held steady while small caps have shown a drop. Typically, when small caps are performing well, it is a sign that the economy is healthy. They may be telling us something here.

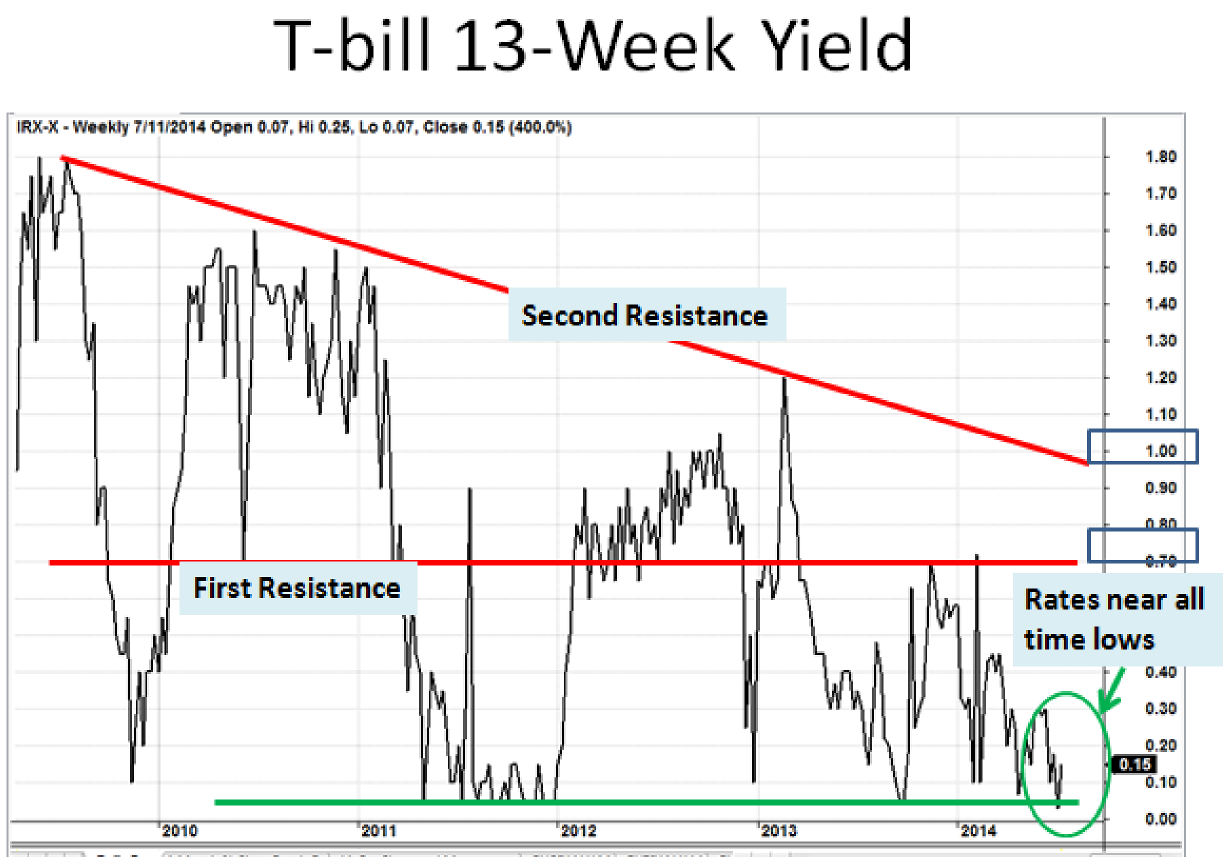
We would see the same comparison if we compared large caps to mid caps, technology or emerging markets. When sectors become disconnected, it is a warning sign. Strength is being concentrated in fewer and fewer areas of the market. We can be fooled if we only look at the major market indices while deterioration occurs “behind the curtain”. This is something to watch closely.

Small Cap vs. Large Cap



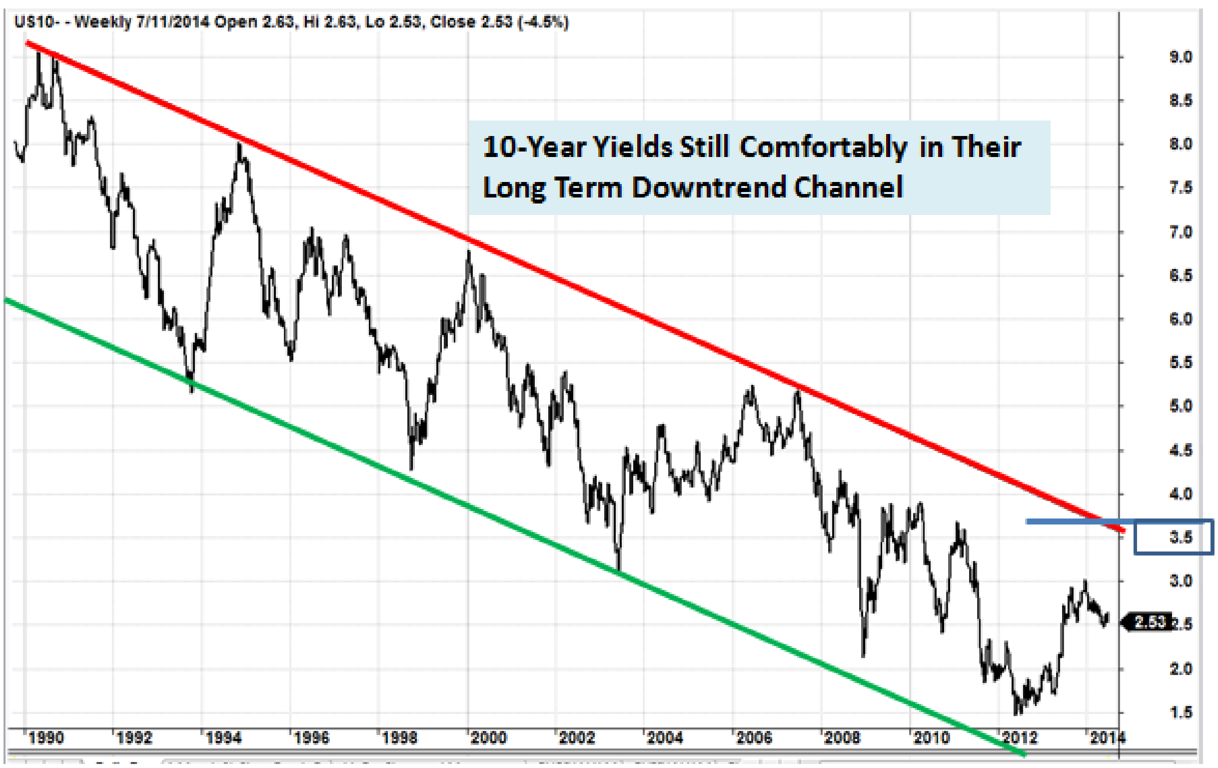
Interest Rates

The other item that is in the back of everyone's mind is the effect of the Federal Reserve's policy of removing their stimulus from the economy and when they will start to raise interest rates. Typically, the yield on the 13-week T-bill will move upward as much as a week or two before any official announcement by the Fed. The next chart shows that we are near all time lows on the 13-week's yield. Until the yield breaks the first resistance at 0.70%, I would not expect the Fed to raise rates.



Finally, the yield on the 10-year remains in its long term downtrend channel. A breakout above 3.5% would break this downtrend and indicate higher rates ahead. Using the 10-year as a proxy for mortgage rates, it appears that there is still time to refinance any long term debt that you might hold. Will rates again drop to the bottom of the channel which would put mortgage rates in the 3% range again? Possibly, but I wouldn't count on it.

Treasury 10-Year Yield



Should we be worried that the market is going to finally have that 10 to 15% correction that many have been forecasting for at least a year? The market has so far discounted all the international events that are taking place. There remains the possibility of a major event that would impact the market, most likely in the energy arena. Withstanding that, there is some deterioration in certain market sectors which raise the risk level for a decline to happen. As mentioned, 2nd quarter earnings and forward guidance are all important here.

We will continue, as always, to monitor the markets and modify our portfolios as needed to keep our risk levels low and achieve reasonable gains.

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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