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Wenning Investments, LLC

Wenning Advice

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Is the Stock Market Rally For Real?

We've suggested in past issues that investors should be prepared for an especially volatile market this year.

Sure enough, the market growth that began in March ended when dismal economic news during the first week in July saw the S&P 500 return to its May low of 868.

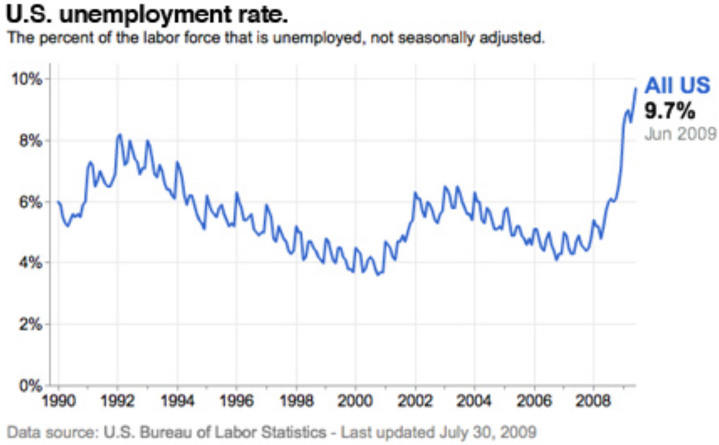
When analyst Meredith Whitney upgraded Goldman Sachs the following week and predicted a surge in the financial sector, the market rebounded, advancing 7% for the week and recovering the losses from earlier in the month. It continued advancing another 4% in the week ending July 25 as leading financial companies reported higher profits.

As of this writing, the market is in the black for the year, the Dow Jones Industrial Average is up over 9000, some of our largest financial service companies have reported better-than-expected earnings and some experts are predicting a recovery during this quarter.

With oil prices jumping back up, inflation has been higher than expected, but when food and energy are excluded, it is up only 1.7% over the past year. However, long-term inflation is expected to be higher.

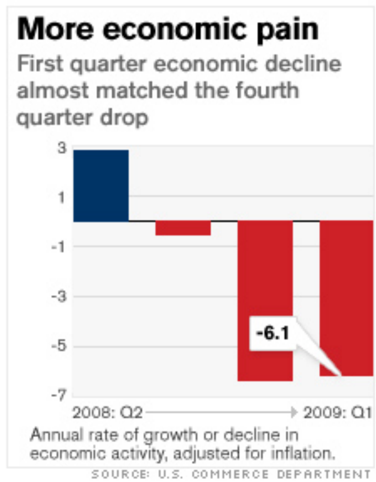
Housing starts and new building permits were also stronger than expected, and the trade deficit has improved slightly, with imports dropping from $150.2 billion to $149.3 billion and exports rising from $121.4 billion to $123.3 billion.

There has been so much bad news in the past year, no one can be blamed for feeling euphoric about any hint of good news. But given how far the market has moved in a short period of time, it is likely to pull back. Remember to protect your profits and use stop losses. There are more economic challenges coming.



Unemployment and Other Problems
The big problem is unemployment, which is approaching 10 percent. Unemployment is a problem because when people are out of work, they spend less. Personal consumption by consumers accounts for 70 percent of gross domestic product (GDP), so when consumers spend less, GDP falls and the economy stagnates.

More than a half million people filed for unemployment during the week of July 4 - and that was considered good news. The 565,000 new claims marked the first week since January in which new claims fell below 600,000. Although the number may have been lower solely because of the holiday, at least it was a move in the right direction. Still, unemployment claims overall stood at a record 6.883 million at the end of June.



The following week, though, claims dropped by 642,000 to 6.273 million, the biggest drop ever in continuing unemployment claims. If that figure holds, it could be good news, indeed. However, experts regarded it with a degree of skepticism.

With the economy stagnating, economic output fell 3.5 percent during the second half of last year and the first half of this year.

With unemployment high, signs of recovery are coming from increased production, not increased consumer demand. With inventories nearing depletion, manufacturers will be forced to ramp up production. That's important, as manufacturing has accounted for 30% of job losses and 50% of the drop in income from wages this year, according to *BusinessWeek*.

In the automotive industry, production dropped 55% and sales of American cars fell 28%. With government support for the auto industry, those figures should improve significantly in coming months. Again, though, much depends on consumers having the money to spend. And if they do, will they spend it on new American cars?

A recovery led by a boost in production is unlikely to last. Once goods are restocked, the recovery will wane, unless consumers begin spending again.

Regulatory reform and proposed healthcare reform may also have an impact on the market and could play a role in stalling the recovery.

Impact On Investors

What does all of this news mean for investors?

It's during markets like this one that an active investment strategy pays off.

Passive buy-and-hold managers stick to a set asset allocation even when signs are clear that the market is in for a tough period. But if, for example, a strategy calls for no more than 20 percent of assets to be in cash, the investor doesn't have a great deal of downside protection if the market plunges.

Many investors who made money by taking risks when the market began rising in March stand to lose even more by continuing to take the same risks during a volatile market. They likely lost out when the market reversed direction in June, then made up the difference when the market recovered in July.

Remember that your total return depends not only on what your investments earn, but on what you don't lose.

Investors should be taking advantage of the market rally. Diversification is in order, too, as some foreign markets - China, for example - appear to be recovering more rapidly than the U.S. market.

If the recovery stalls, though, it may be better to sit on the sidelines, making small returns on money market funds and bonds, rather than being heavily invested in stocks.

Q&A

How does trading affect prices of securities and commodities?

Prices are, of course, always affected by supply and demand. You likely know that heavy buying of a stock will increase its price and heavy selling will decrease its price.

There has been significant debate recently about the impact that options traders are having on the price of oil. Blaming excessive speculation for rising oil prices, some are seeking greater regulation of the industry.

However, a study of the impact of trading on last year's surge in oil prices shows that, if anything, traders were short-selling oil options as prices were rising. Shorting oil options should have caused prices to drop or at least rise at a slower rate. The study found that the cause of the rise in prices was, instead, a low supply in relation to rising demand.

The study also found that price volatility is greater in markets where futures trading is not allowed.

Learning From Your Investing Mistakes

Active investment management requires the investment manager to stay focused on market activity and to act based on market expectations. Yet buying and selling of securities is determined by specific market conditions.

Active managers may not hold the same stocks for many years, like "buy-and-hold" investment managers, but we don't trade constantly, like day traders. We trade when market conditions warrant it.

Mistake #8: Short-term Trading. Only the truly skilled trader - or the very lucky investor - succeeds with short-term trading. For most investors, transaction costs and losses typically outweigh any gains.

Successful short-term trading isn't just a matter of logging on to an online brokerage account once in a while and buying and selling. It requires a significant investment of time and research, and an understanding of market fluctuations and historical trends.

Remember the "day trader" phenomenon? Those who tried it in many cases lost everything. If you are not trained in short-term trading techniques, don't even think about trying it.

Keep in Touch

Have an idea for a future issue of *Wenning Advice*? Are you interested in active investing or would you like to refer a friend who may be interested?

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