Market Brief

October 10, 2005

By: Robert Kennedy, CIO

The views and opinions contained in this market brief are those of Capital Allocation & Management, Inc. and have been researched and analyzed by Robert Kennedy, CIO, Capital Allocation & Management.

	7-Oct-05	30-Sep-05	Weekly % Change	YTD % Change	12 month % Change
Nasdaq Composite	2,090.35	2,151.69	-2.85%	-3.91%	8.87%
S&P 500 Index	1,195.90	1,228.81	-2.68%	-1.32%	6.57%
Dow Jones Industrial Average	10,292.31	10,568.70	-2.62%	-4.55%	2.36%
MSCI EAFE (Intl.)	1,585.55	1,618.84	-2.06%	4.62%	18.15%
Wilshire 5000	11,953.84	12,289.26	-2.73%	-0.14%	9.02%
10 Year U. S. Treasury Yield	4.37%	4.33%	0.92%	NA	NA
30 year U.S. Treasury Yield	4.57%	4.57%	0.00%	NA	NA

Halloween began early for the financial markets as equities endured a vicious sell-off and Treasury yields moved up to test key resistance levels. No doubt that various Fed Heads played a roll in the markets' turmoil as several members made hawkish statements last week. Indeed, the Fed Heads seemed to time their statements to offset rally attempts. While we doubt this was the case, it was readily apparent that this was a coordinated effort by the Fed to begin talking the markets lower. Their statements indicated a renewed attack on inflation trends and, consequently, suggested that they plan to continue raising interest rates over the coming weeks/months. They may be attempting (by their statements) to push longer-term yields higher in order to offset the potential for the dreaded yield curve inversion. That's a dangerous game and the markets did not like it.

If there was anything positive about last week's sell-off, it was that we *may* have seen a capitulation day. Those occur when 90% of the market volume and stocks decline. That occurred Wednesday. If the bulls can manage a sharp rally over the next couple of days, it may signify that the worst is over (however, a low retest would still be likely). On the other hand, the sell-off could mark the beginning of something more ominous. As such, this week has become very important for the overall direction of the equity markets through the end of the year. An interesting aspect of the sell-off, that has not seemed to have gotten much attention, is that it coincided with a decline in energy prices. The decline in energy prices caused a sell-off in energy stocks which, as we all know, have been the equity markets' saving grace this year. In fact, was it not for the rise in energy prices, the S&P 500 would be down over ten percent year-to-date. If the markets are simply adjusting for a change in leadership, this sell-off could be a wonderful buying opportunity. On the other hand, if the markets are predicting a sharp decline in economic growth (and profits) over the coming months, we may well see continued weakness. As such, we will be monitoring things very closely as the week progresses.

From a technical standpoint, the sell-off did a lot of damage. The S&P broke the 1200 level, suggesting that 1175 and lower may be on the horizon. Bulls need to see it move back above 1200. The DJIA fell through the 10,400 level which has been pretty important support over the past year. If 10,400 is not re-taken in the near future, a test of 10,100 or lower may be expected. For the NASDAQ, the break of 2100 brings 2025 back into play. Given all the damage last week, it is hard to believe we were "tickling" multi-year highs just two weeks ago. In any event, 90% days have marked solid turning points in the past and we hope the trend continues.

The Treasury markets did not respond well to the combination of Fed "speak" and inflationary signals from last week's ISM report. The 10-year approached the key 4.42 resistance level and then quickly retreated. This is a "line in the sand" for many bond bulls, as a breach of that level will signal higher yields are in the offing. If that level goes, it could be bearish for stocks in the short-term, as the equity markets will begin discounting the effects of higher interest rates (such as the potential for a swifter decline in consumer spending). The bond markets are closed today in observation of Columbus Day.

Economic Reports: It appears to be a slow week for economic reports. On Friday, September retail sales should show a 0.2% overall rise, with a 0.6% gain in the core rate. This compares to a 2.1% overall decline in August with a 1% rise in the core rate. The September CPI, also out Friday, should show a gain of 0.9% with a 0.2% rise in the core rate.