FINANCIAL SERVICES ADVISORY

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Rockville, MD 20850 800.235.4567 www.fsainvest.com

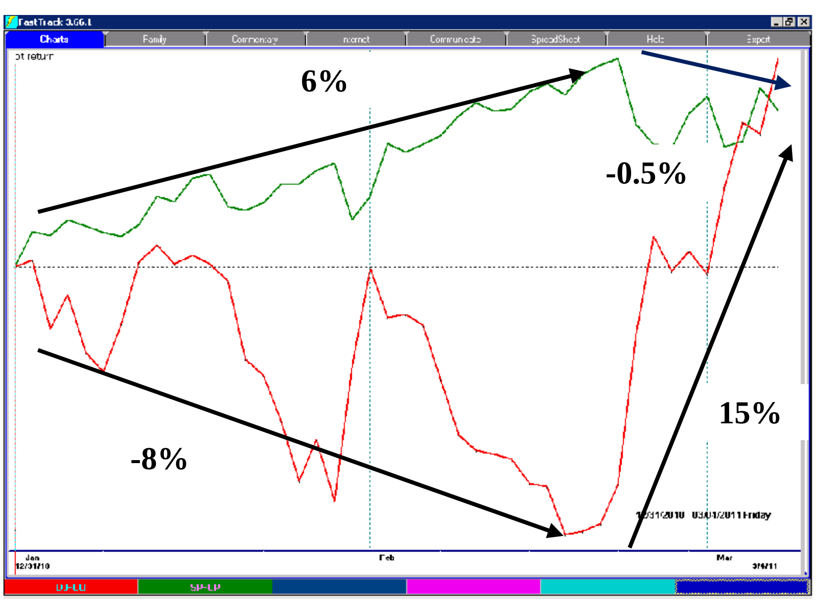
Oil Up = Stocks Down

February Market Review From Your Portfolio Management Team—March 11, 2011

Stocks continued their winning ways in February (rising almost 3%), which marked the six month in a row that stocks finished in positive territory. The economic numbers continue to improve, with the unemployment rate falling below 9% for the first time since April 2009. In addition, the Institute for Supply Management recently released its Purchasing Managers Index reading for February, which showed a very strong reading, suggesting better economic growth ahead. Also, the government released another estimate for fourth quarter 2010 GDP growth (how much the overall U.S economy is growing) and that reading was just below 3%, a decent number, although not as high as some economists feel we need in order to get more people back to work.

In spite of the recent good news, stocks appear to have stalled out recently, with the S&P 500 index hitting a high for the year of 1343 back on February 18. What appears to have investors on edge is the ongoing turmoil in the Middle East—in particular, Libya. Libya is a major oil exporter and the ongoing civil conflict has investors worried about two things: 1) that oil exports from Libya could contract if the fighting drags on or intensifies; 2) the bigger worry is that the civil unrest spreads to an even bigger exporter like Kuwait or even Saudi Arabia. As a result, oil prices have spiked higher over the past several weeks, which has caused stock prices to stall. Actually, it is a bit surprising that stocks have held up as well as they have, given that oil prices have moved back above the psychologically important barrier of $100 for the first time since August 2008. From its recent low on February 15, oil prices have surged over 15%, while from January 1 through February 15, oil prices had declined over 8%, (with stock prices climbing almost 6%).

The chart below (from FastTrack) gives you a visual sense of this recent relationship (oil price in red and the S&P 500 index in green for calendar year 2011 through March 4).



This recent behavior between oil prices and stock returns is a distinct change from the past several years in that oil prices have tended to move in tandem with stock prices—which makes intuitive sense. Oil prices fell in 2008 as economic activity shrank, which, of course, would typically mean that stock prices in general were shrinking. Then in early 2009, oil prices recovered alongside stock prices, as economic activity rebounded along with investors' appetite for risk. This relationship can hold until the price of oil climbs to a level that begins to choke off economic growth. As oil prices climb higher and higher, that translates into more consumer money being used for gasoline, and heating our homes, as well as higher prices for any goods that use petroleum-based materials—and there are many. So, at lower prices, oil prices tend to move in the same direction as stock prices, but above a certain level, the relationship flips. At that point, rising oil prices are seen as a negative for economic growth, and thus they tend to move opposite the direction of stock prices.

It appears from the graph above that we have made the crossover. Prices above $100 a barrel seem to get investors on edge, and as prices begin to close in on $150, they will react negatively. Will oil prices climb towards that $150 level, or will they retreat back below $90? That answer seems tied to the political events in North Africa and the Middle East—and anyone's guess is as good as the next.

From a technical standpoint, stocks have appeared over-extended to us for several months, anyway, so we are not surprised that the environment has turned more challenging. Stocks around the world have performed strongly over the past six months, so it should not be surprising that they have stalled recently. Frankly, if the S&P index pulled back to 1250 or so, that could be healthy for the stock market by reducing some of the investor optimism. Stocks perform best when the general mood is a bit skeptical towards stocks.

Even though we have been selectively adding to our stock positions, in general, we have tended to add money to more dividend oriented (that is, less aggressive) funds. These funds have tended to hold up pretty well on the days when the market has been hit the hardest. While we do not expect this correction to develop into anything too serious, we are also skeptical that stocks will mount a large rally from these levels. We continue to maintain that stocks are in a long-term secular bear market for another five years or more, and will remain so until we have solved the ongoing financial crisis, which includes state and federal budget deficits, excessive leverage in the financial system, sluggish employment growth, exploding health care costs, not to mention political gridlock. We have no doubt that these issues can be resolved, but there remains a great deal of hard choices in order to improve the situation.

Please let us know if there is anything we can add to these reports that will help you understand what is going on in your portfolios.