



AL FRANK MARKET MONITOR

February 2010

As Goes...So Goes...

With stocks closing out the initial month of 2010 in the red, the 'January Barometer' has been garnering plenty of attention. As the theory goes, January's market direction sets the tone for the balance of the year, with The Wall Street Journal reporting that when the Dow Jones Industrial Average has fallen in the first month, the median gain for the next eleven months has been only 0.3%, compared to a 10.4% increase when the Dow has risen. We've crunched our own numbers using data going back to 1926 from Morningstar for Small and Large Company stocks. Though there have been only 18 (small stocks) and 32 (large stocks) instances in which January failed to show an advance, the median gains over the balance of those years (February through December) have actually worked out to 2.3% and 6.9%, respectively. Better than the Dow's breakeven figure, but not exactly cause for cheer.

After the big rally of 2009, we think that stock selection becomes even more critical.

Of course, if we are to find value in the January Barometer, we must also consider the First Five Days of January indicator, as this year stocks staged a healthy beginning-of-the-year rally. Mark Hulbert, of Hulbert Financial Digest fame, studied the Dow all

the way back to 1896 and found that if the first five days were up, the stock market finished out the year higher 68% of the time, compared to a winning percentage of 'only' 56% when the new year started poorly. Hooray!

And we wouldn't want to overlook the Super Bowl Indicator which has predicted the direction of the stock market in 34 of the last 43 years, a 79% accuracy rate. If a team from the 'original' National Football League wins the big game, the market is supposed to rise for the year, while it falls if the champ is from the 'old' American Football League. Well, this year the bulls are smiling as both the New Orleans Saints and the Indianapolis Colts (Peyton Manning & Co. represent the American Football Conference, but the team began in Baltimore, an original NFL member) reside on the 'right' side of the ledger. Yippee!

Certainly, most would challenge the statistical significance of any conclusions drawn from so few data points, but we understand that market players are always searching for signals that will get them into and out of stocks at the right

time. While we share famed fund manager Peter Lynch's view that the only problem with market timing is getting the timing right, maybe a certain groundhog has some prognosticating power. After all, Punxsutawney Phil predicted six more weeks of winter last year and stocks didn't bottom until March 9, which happened to be the start of the sixth week after Groundhog Day! What did Pennsylvania's finest predict this year? Alas, his shadow was again seen, so there won't be an early spring. Uh Oh!

The 'indicators' cited above notwithstanding, we think it safe to say that the near-term outlook for equities is about as uncertain as it's ever been, with some forecasting that the January swoon is the start of the next bear market and others suggesting that it is another necessary pause in the 11-month old bull run. Obviously, none of us has a crystal ball, but we remain convinced that maintaining a broadly diversified portfolio of undervalued stocks is the best way to navigate the volatile waters for those with long-term time horizons.

In our view, low interest and inflation rates are supportive of higher-than-normal valuations, sentiment is far from rosy and Q4 sales and earnings reports have been beating expectations at a stronger-than-usual rate, with management teams generally expressing measured optimism in 2010 outlooks. That said, we respect that plenty of questions remain in regard to the vitality of the economic recovery and we are not counting on much in the way of near-term top-line improvement for Corporate America in the face of a double-digit U.S. unemployment rate and uninspiring global economic growth. As such, we are more critical of our holdings, not hesitating to swap out of a less-favored stock when we find a better risk/reward candidate. We may not be market timers, but we are always using our valuation metrics to 'time' our individual stock entry and exit points.

Getting back to normal

Ten years from now, once we—hopefully—have endured this latest assault on the global economy, we'll better understand the effects of directional change on market psychology, its emphasis generally on 'what will be'. We're as likely to better comprehend the drag on popular psychology endured while the economy struggles to retake prior peaks, as the average consumer focuses on 'what was'. Clearly exhibited in the third week of January, however, market ma-

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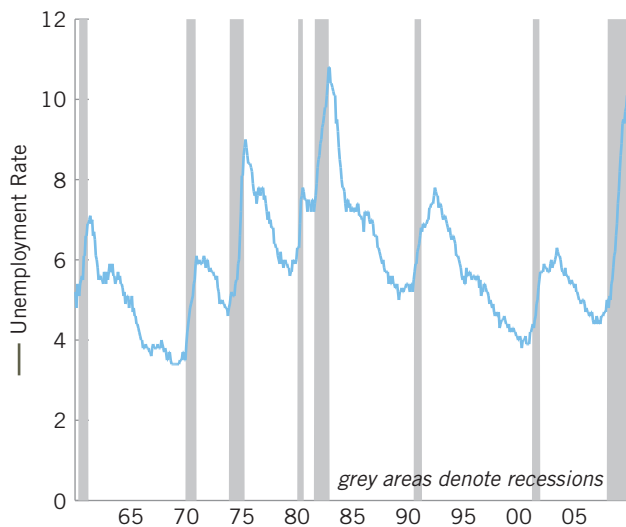
nia—and we mean that in the true clinical sense—is likely to constrain perspectives. Investors won't so easily overlook interim setbacks. That is, the tension between what was and what will be likely will continue to lift volatility as the economy strains to retake former ground. That the obstacles to surmount in that effort are many—and that many of those may prove epic—still leave us wondering if not when, then certainly 'how?' and 'how long?'

The challenges in getting back to a sustainable normal—whether 'new' or not—are the crux of this dilemma we face as equity investors, and is the surely reasonable basis for our continued focus on relative safety in our portfolio work. See, many of those folks who had been employed maintaining that level of activity in the housing market likely have been forced to seek alternative pursuits. And that scenario of incongruence—lots of capacity for work, little demand for the production; too much supply, too little demand—and those consequential searches for substitute endeavors are being effected across much of the sector spectrum.

This unemployment gap, above all others, remains top of mind in our research work. And until the level of employment regains a material portion of positions lost, the velocity and direction of its change will only matter in so much as they bring us closer to the job market's former verve. The average unemployment of 2006-07 of 4.6%, tallied by the Bureau of Labor Statistics was, arguably, ideal. January's rate of 9.7%, only marginally lower than the 10.1% peak seen in October, remains vastly worse than ideal. It is of this gap that presidential advisor Lawrence Summers, Director of the National Economic Council, was speaking when at the World Economic Forum in Davos, Switzerland he noted, "What we are seeing in the United States, and perhaps in some other places, is a statistical recovery and a human recession." ■

EMPLOYMENT DISAPPOINTMENT

The current rate of unemployment—about as high as it's been in the past 50 years—remains a worrisome weight on the economy.



As of 11.30.09. SOURCE: FactSet Research Systems

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