

THE MARKET OBSERVER

OCTOBER 2011

The equity markets have been experiencing significant volatility since early August with the intensifying of European debt concerns. The S&P 500 has declined a net of just under 13% from its April 2011 high, and just under 6% since the beginning of the year. Since experiencing a correction in late July/early August, the S&P 500 has traded

within the 1,100-1,220 range (roughly the same levels experienced prior to the September, 2008 Lehman bankruptcy). The 1,100 technical support level was broken briefly on October 4th before prices recovered strongly (over 4%) at the end of the day to close at 1,124. By October 10th, the S&P had climbed another 6% to close at

1194.89, fueled by pledges from German and French leaders to introduce a comprehensive plan to deal with the Eurozone debt crisis by the end of the month.

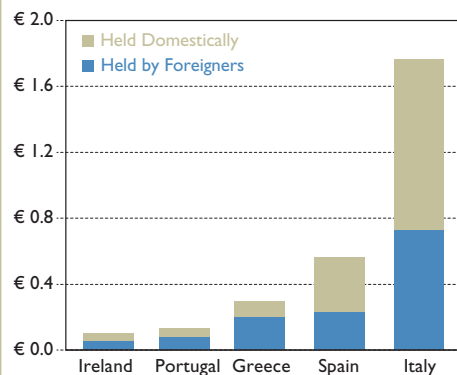
The market appears to be reflecting that Greece will default on its debt and that the associated liabilities will have to be written down. Just as we experienced

in this country in 2008, global markets are trying to determine the hit European banks will take from exposure to Greece and steps that may need to be taken to shore up bank capital levels while assessing the financial system's ability to withstand the possible additional write-downs related to Italy, Portugal and Spain.

Going forward, the U.S. must continue to deal with its own accumulated debt problem, slow and possibly faltering growth, and assess the risk of further equity declines from here. So far, recovery has been limited despite the Fed's quantitative easing programs, including "Operation Twist", to keep U.S. Treasury yields low. The backdrop of healthier corporate

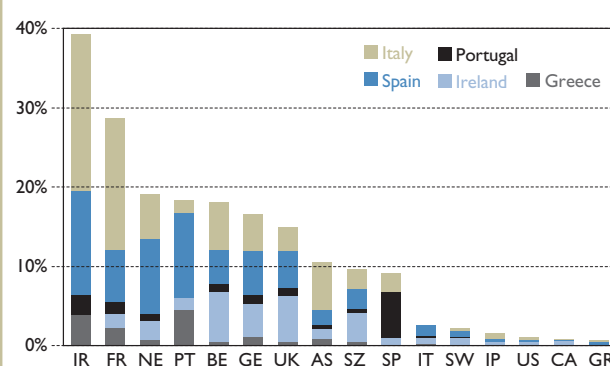
Government Debt Outstanding

End of 2009, Trillions of Euros



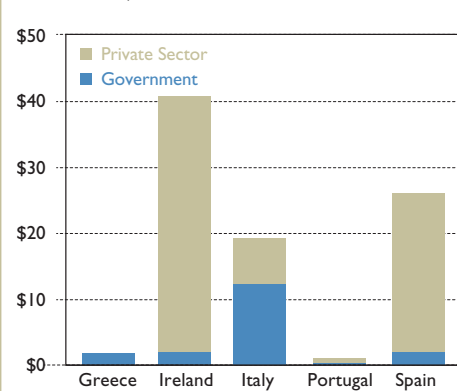
Bank Exposure to Peripheral European Countries

Percent of GDP



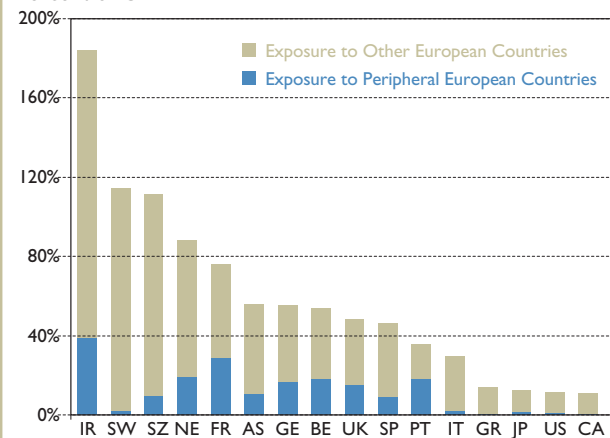
U.S. Ownership of European Debt Securities

End of 2009, Billions of U.S. Dollars



Bank Exposure to all European Countries

Percent of GDP



Source: Eurostat, International Monetary Fund, U.S. Department of the Treasury and Wells Fargo Securities, LLC

Source: Bank for International Settlements and Wells Fargo Securities, LLC

balance sheets and greater recognition of the situation we find ourselves in (as opposed to 2008) offers the possibility that at least some expected bad news that may follow is already built into market expectations. This includes the prospect of renewed global recession. A confirmation of economic contraction (which often occurs after the fact) may spur additional equity declines, but could also set the foundation for a year-end rally. More bad news may well be the catalyst to spur concrete steps (in both the private and public sector) toward a sustainable recovery.

JP Morgan in their 9/14/11 Eye on the Market commentary

offered a sample of concrete steps that could be taken in Europe:

- Greece defaults and receives 60%-70% debt forgiveness.
- The European Financial Stability Facility (EFSF) is approved and used by Sovereigns to recapitalize their banks and spur a write-down of banks' Sovereign and corporate positions.
- The ECB commits to provide secured financing to banks to offset depositor withdrawals.
- Germany accepts a weaker euro and the risk of higher inflation.
- As suggested by Ray Dalio of Bridgewater, the EU "creates a provision for allowing countries to exit from the euro zone in an orderly manner, rather than making believe that this is an impossibility."

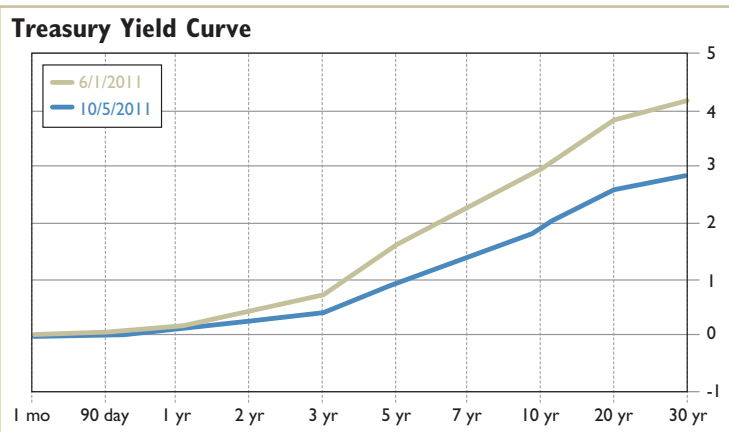
equilibrium where consumers are reluctant to spend because corporations are reluctant to hire; while corporations are reluctant to hire because consumers are reluctant to spend. Unfortunately, simply offering consumers some tax relief, or trying to create hiring incentives in a vacuum, will not change this equilibrium because it does not address the underlying problem...we cannot simply shift to a high level equilibrium (consumers spend because employers hire, employers hire because consumers spend) until the balance sheet problem is addressed. This requires debt restructuring."

Continued volatility in stock prices should be expected as the equity market continues to look for the forest through the trees. Concrete steps and real reforms (as opposed to simply higher taxes) would hopefully provide the clarity for the market to embrace the prospect of future corporate profit potential. Negative news has certainly carried the day since April. Less bad news and faint signs of good news in a slow but positive growth economy (as envisioned

by many forecasters) may provide support going forward. In the meantime, the S&P 500 yield of almost 2.5% compared to the 10 year treasury yield of 1.9% continues to provide some assurance to investors to maintain a long term perspective with the risk portions of their portfolios.

John Hussman (Hussman Funds) has been writing extensively about these realities in his weekly market comments and has been suggesting a need for debt and mortgage restructuring in the US:

"Presently, the global economy is in a low-level Nash



Source: Bondsonline.com



Source: moneycentral.msn.com



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