



POTOMAC
STRATEGIC INVESTMENT SYSTEMS

CAPITOL MARKET REVIEW

In This Issue: BOO! Global Central Banks Playing Tricks on the Market...MF Global Liquidation...Stocks Looking for Yet Another New Normal

At Mid-Day: SPY 1264 US10Y 2.21% Gold \$1727 Oil \$92.37 Oct. 31, 2011

Blame it on All Hallows Eve, but as investors poured through details of the Eurozone bailout package capital again sought safety in the JPY and USD, prompting central bank intervention and a sell-off in all global equity markets. Asia was off nearly 1%. Europe is currently down 1.5%. US markets are 1.25% lower.

The “*devil*” is again in the details, or more simply in the lack of capital required to solve the European debt crisis. Now that Eurozone policymakers have finally acted, investors are concerned the rescue plan establishes criteria for bank and sovereign debt support that cannot be sustained throughout Europe’s 17 Member-States. As is always the case in a financial crisis, the first solution is often times the best. It’s not clear as to whether Greece can uphold the terms of its bailout, yet calculations have been made as to how the Greek assumptions/template would be applied to Italy or Spain.

In spite of the announced package, Italian sovereign debt remains above 6%. If this trend continues, a global crisis will be back on the table. Italy cannot fund its sovereign debt at 6.5%. And the EU does not have the capacity to fund an Italian re-structuring.

Oddly, the first casualty of the Eurozone crisis is an American institution. Today MF Global, (a US Treasury Primary Dealer,) is filing for bankruptcy. According to the financial press, \$6B worth of Eurozone bonds has forced this venerable firm to shut-down. Washingtonians may be aware that MF Global is run by former Senator/Governor Jon Corzine; also a Goldman Sachs alumni. Financial markets do not see this spreading. Remarkably, Corzine’s risk management team was sloppy and allowed MF’s exposure to eclipse its capital base. Considering MF Global’s standing in the financial community its closure today is unremarkable.

Now that the Eurozone crisis has at least been addressed, market participants will turn their attention to more parochial issues, namely performance. Between 30% - 40% of institutional money managers are lagging their index benchmarks. These managers have eight weeks to make-up the difference. There are a limited number of outcomes to this situation. Stock indexes can drop. Or stock managers will force certain stocks, and therefore the broader market, higher.

The remainder of 2011 will now be a function of a “tug-of-war” between market forces moving stocks to post gains against a backdrop of ongoing economic issues that seek to properly define macro trends and asset valuations. CMR expects the gyrations of these two powerful forces will confound market observers till year-end. Some will argue shares will move higher, without positive news. Others will see a market vulnerable to a sell-off taking stocks to negative returns.