

# Markets

Eastwind  
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## *Change Brings Opportunity*

**AS THE BATON OF PERFORMANCE PASSES**, new possibilities appear. Investors continued to

weather shifting winds and extreme tides in August markets. In the U.S., large stocks as measured by the S&P 500 Index gained 1.4% and small companies as measured by the Russell 2000 gained 3.5%. Meanwhile, offshore stocks as measured by EAFE lost 3.5% for the month.

So far this year, but particularly during the rally from the last low in mid-July, small-cap U.S. stocks have clearly led. From the end-of-October high through July 15th, both the S&P 500 and the Russell 2000 were down 20%, while EAFE was down 25%. The big divergence came in the last six weeks when the Russell 2000 index surged 12% and the S&P 500 gained 6% through the end of August. Meanwhile, the EAFE Index barely budged and is ahead only 0.05% from what may be a bottom for U.S. stocks.

Looking back, small-cap funds pranced ahead of their larger counterparts from late '99 through mid-2006, during which time the Russell 2000 averaged gains of over 9% annually while the large-cap S&P 500 averaged little more than 1% per year. Then after the first quarter of '06, large caps resumed the lead and more than doubled the returns of small company stocks through early '08.

Just as in a relay race, transition periods can be tricky. We often observe that market leadership changes occur in fits and starts. Fortunately, Upgrading takes the guesswork out and provides the discipline so trades are not left to chance or emotion. Simply follow the rules; buy winners, sell laggards, monitor and repeat.

## **Rotating Out of Internationals**

After a long run of under-performance, domestic funds have recovered the leadership baton from international funds. A year ago, international funds dominated ranks and represented the majority of our growth portfolios. European stock funds had returned roughly twice as much as their American counterparts in the previous three years.

Some internationals remained highly ranked through the first half of 2008 because their 12-month performance was higher than that of their peers, but diversified domestic funds steadily climbed our performance-based ranks and finally this month, all of the top ranked equity funds are domestic.

The stronger dollar had a negative impact on offshore investments which are priced in dollars. Funds that were least exposed to the dollar's recent strength held up best. Emerging market regions that focus on commodities were hurt most.

Commodity markets were also weakened by the dollar's strength, but oil stocks which took a heavy hit last month, held up better than most commodity groups. Natural resource funds and funds with heavy exposure to energy lagged. Defensive sector funds including health care and consumer staples did well.

## **Sector Reversals**

Financials bounced from the recent bottom but remain low ranked after falling precipitously over the past year since the credit crisis began-- they began the year as one of the worst performing areas and remain down 22% year-to-date. Between the start of the year and July 15th, financials dropped 36%. But since mid-July, the S&P 500 financial sector soared 30%. No one knows for sure if the tide has turned or this is an oversold bounce.

The sharp retreat in oil prices caused a reversal in energy funds. The clear leaders for most of the first half, energy funds have tumbled and are among the very worst performers since the mid-July market low.

Both may be positive portends, however. Generally when financials are doing well, the rest of the economy benefits when banks provide the liquidity needed to keep business growing. On the other hand, when natural resources and commodities are soaring, it usually means high energy prices are a drag on the economy and the most affected sectors suffer.

Interestingly, the financial sector, once the biggest contributor to the market value of the S&P 500, has fallen into second place behind technology, which makes up nearly 17% of the index. Meanwhile, energy companies which have mostly thrived thanks to booming oil prices, now make up 14% of the S&P 500, up from just 7% seven years ago.

## **Ranks Lead Us Through Market Changes**

The only constant is change. We can't know whether small caps or financials will continue to outperform, or which of the funds we're buying this month will outperform the funds we're selling this month.

What we do know is that market leadership will change and Upgraders will take advantage of leadership trends by simply following the quantitative ranks. It is the cumulative result of our actions that bring about long-term success.

**Thanks again for your trust and continued support,**

P. Michael Valley II