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Special points of interest:

- Our best guess is that the economy will continue to recover
- We see limited downside for stocks and a potential 10% gain by year end.
- VIX short-term futures offer a type of market insurance
- Gold prices should continue to move higher
- Short duration fixed income positions are favored

The Outlook for the Economy

High volatility in U.S. stock prices amidst Europe's worsening economic outlook has many asking, what is the current state of the economy? Our best guess is that the economic recovery will continue albeit at a slow and agonizing pace. The open question is will consumer and business spending kick in to continue last years growth that was fueled by government stimulus and inventory rebuilding? There are some signs that the private sector is taking up the slack. Europe uncertainty does give one pause

as Europeans struggle to rein in large government budget deficits. It appears that the economy is growing at a moderate pace of about 3.0% to 3.5%. At this rate, the U.S. unemployment rate will remain high (and could rise) for an extended period of time. The Federal Reserve appears committed to maintaining short term interest rates at near zero and circumstances suggest no immediate change. Weak employment, low inflation and inflation expectations allow for the Fed to remain accommodative. In addition,

no apparent bubbles are developing in the financial markets. Despite the cautiously optimistic view, it's not yet clear that the economy will dodge a double-dip recession. A number of concerns persist. Banks continue to be a problem. Despite extremely low interest rates, banks remain cautious lenders. Perhaps because of the uncertainty that new government regulation poses. In addition, political risk is high. Excessive government spending and large deficits could derail growth.

U.S. Equity Strategy

Equities are now negative year-to-date. The S&P 500 is down about 6% after being up 7% by late April. While still down, the sectors showing the strongest relative strength have been, consumer discretionary, financials, and industrials. The worst performing sector has been energy. The decline in prices since April has been driven by catalysts that have the potential to slow growth. These include a decline in the Euro which puts companies that compete with manufacturers based in the Euro zone at a disadvan-

tage. Also, political leaders in European countries have announced plans to tighten fiscal policy. In the U.S. a number of states have announced increases in tax rates and/or cuts in planned spending beginning July 1. There has also been a suspension of deep water drilling in the Gulf of Mexico and Congress is likely to pass financial reform legislation that is expected to lower the expected return on equity in the financial sector. As a result of these factors, earnings expectations for U.S. companies,

in general, have been revised down. These revisions reinforce our conviction to lower beta and less economically sensitive stocks. The positive side is that valuations have improved. The S&P 500 currently trades about 13.3 times estimated 2010 operating earnings per share. Fair value is considered to be in the range of 16 to 18 times earnings which would put the S&P fair value band at 1,250- 1,400. At its current level near 1,040 stocks appear inexpensive and downside appears limited.

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Understanding S&P 500 VIX Futures

Within many accounts we have allocated funds to the iPath S&P 500 VIX Mid-term Futures (VXX). Bear with me through this explanation of the security. The return on the VXX is linked to the performance of the S&P 500 VIX short-term futures, which provides exposure to the CBOE Volatility Index (the VIX Index). The VXX provides exposure to one month maturity future contracts on the VIX Index, which reflects implied volatility of the S&P 500 Index at a point along the volatility forward curve. The calculation of the spot level of the VIX Index is based on prices of put and call options on the S&P 500 Index. The VIX has a tendency to move inversely with the stock market and is considered the market's "fear index." It is a signal of how fearful investors are about the future. As a

result, the VIX has a tendency to move inversely with the market. That's to say that when the S&P 500 is moving down, fear is often higher which in turn sends the VIX higher. As the name implies, this security doesn't follow the spot price of the VIX but instead tracks the futures price with a fairly high correlation of 0.87. The VXX can be considered an insurance policy of sorts for a falling market which is why we have included the security in most portfolios. In quieter markets holding the VXX is likely to result in deterioration of its price or little movement at all. Generally, going long the VXX is a good strategy when valuations approach short-term extremes. In many accounts we added the VXX during late March at prices in the low \$20 at a point where the S&P was priced around

1,175. During April, volatility increased as the S&P declined. On May 21, we reduced the VXX position by one-half in most of the accounts at a price over \$33. The increase in the price of the VXX was related to increased fear that developed as the S&P declined. The rise in value helped to offset the decline in value experienced by most stock positions during April. We will continue to hold the balance of the position until short-term volatility subsides and/or the S&P begins to move upwards and surpasses its 200-day moving average. In summary, the VXX security when properly allocated offers one opportunity to manage market risk. The VXX joins other assets such as gold, Treasury bonds, and options that can also be useful in risk management during uncertain times.

The VIX is considered the stock market's "fear index"

2nd Half 2010 Predictions

We are muddling through a period of world economic and political turmoil. A half dozen or so major countries are on life support and the U.S. is suffering under failed economic policies, crushing debt and the uncertainty of which party will have control of Congress. With the mid-term elections just around the corner (November 2), what are some of the implications. Between now and the elections expect the current Congress to do whatever they think is necessary to help their re-election prospects. It is likely these actions will further add to the deficit and polarize the electorate. The Gulf oil crisis is likely to postpone any coherent energy policy. As is generally the case the government will respond with new regulations and drilling restrictions that will serve to reduce production and drive up the price of oil.

In addition, using what appears to be strained logic the Administration sees the disaster as another reason to pass cap and trade legislation which will substantially increase the cost of energy and be yet another drag on economic growth. Look for the Bush tax cuts to at least in part be extended. Most likely taxpayers earning less than \$250,000 will see their tax burden remain unchanged. The top marginal rate for those earning \$250,000 or more is likely to rise. In addition people below the \$250,000 income threshold are likely to continue to pay a top 15% tax rate on long-term capital gains and dividends. Above the threshold look for the rate to increase to 20%. Higher capital gains tax rates are likely to encourage affected investors to take profits during the fourth quarter. It is uncertain if these

funds will immediately find their way back into the market. Proposed financial regulation has been adding to market volatility and depressing prices. Look for legislation to be passed soon and its impact understood later. The witch hunt against Wall Street is likely to fade away if for no other reason than campaign contributions from financial firms to both parties are generally very generous. Gold prices have been driven higher by fears of inflation and political uncertainty. As we approach the election both parties will posture and likely pray on public fear. Gold should continue to do well. Expect markets to benefit from any perception that the Democrats will lose control of at least the House. Markets like divided governments which means fewer surprises.

Interest rates remain at historically low rates and fixed income securities provide paltry returns for investors. The objectives of fixed income investing are to protect principal to a future date, possibly reduce overall volatility in a predominantly equity based portfolio, to generate income and to preserve purchasing power. Fixed income investing is subject to a number of risks including but not limited to; inflation (decreased purchasing power), credit risk, and maturity risk. Inflation risk is generally understood. Credit risk is that the guarantor of the debt fails to pay either the promised income or principal. Maturity risk is greater with longer-term bonds that during periods of rising interest rates will fall in value. To develop a fixed income strategy, one must have an opinion about the direction of rates. On the short-end of the curve, the U.S. Federal Reserve Bank

has significant influence. Fed policy is influenced by three primary factors; employment, longer-term inflation expectations, and inflation. Presently none of these factors suggest a near-term hike. Longer-term rates are more influenced by demand. During 2010 the Treasury will offer an estimated \$2.48 trillion of debt. Thus far, the offerings have been well received and have not pressured rates higher. Two scenarios going forward are possible. One, long-rates underperform as would be the case if the yield curve moved higher. This is the scenario that the majority of forecasters embrace. A less likely scenario is that the long-end rallies. As counter-intuitive as this may seem it is not out of the realm of possibility and has already played out in Japan. For this scenario to play out, the economy would need to experience deflation. Of the two we predict a 70%

chance that scenario one will unfold. To protect against inflation and maturity risk, three primary strategies are useful; structuring a portfolio with a short average duration, purchasing variable rate securities, and including at least a small percentage of assets with historically low or inverse correlation to fixed income. Presently our target duration for fixed income portfolios is 4.3 years with an average maturity of 8.11 years. We view a mix of securities including U.S. Treasury bonds, Treasury inflation protected bonds, and high-yield corporate bonds to be most efficient. With this mix we are able to create an asset with a 4.65% yield to maturity and an average credit rating is, 'A'. Finally, to reduce risk all income portfolios contain not only fixed income securities but, a small allocation to non-correlated assets such as commodities and equities.

***The Treasury
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The Outlook for Commodities

Commodity prices on the whole had reflected through the quarter what appears to be rising concerns of a double-dip recession. Copper and crude oil are relatively good indicators of economic activity. During the quarter both traded lower. The oil markets are now factoring in the impact of the BP Macondo oil blow out. Assuming there will be a six-month moratorium on drilling in U.S. Gulf of Mexico, the US Department of Energy forecasts, 2011 oil production will be lower than last year. If demand growth remains healthy fundamental factors should keep crude prices firm. Natural gas prices appear to have found support and have been rising in response to dwindling storage surpluses and an

expectation for further declines given the forecast of widespread heat across core air-conditioning regions in the U.S. during July and August. On the other hand distillate (diesel fuel) demand has been rising as have prices. Distillate price direction is also an indicator of economic activity. Positive growth appears to be supported by a rise The American Trucking Association's Trucking Tonnage Index that is up 9.5% year-over-year. We expect base metals such as Copper to find support near current levels and to begin trending higher as the quarter's risk aversion subsides and foreign, especially Asian economic strength continues to be supportive. Precious metals have been an exception to the generally

downward price movement of commodities during the quarter. The strength driven by political fears and weakness in the euro. Gold reached a new nominal dollar high during June. Price pullbacks have met decent sized bids resting below the market. However, there has been a slowing in the rate of buying by retail investors in Europe. The largest physically backed ETF, 'GLD', continues to experience further strong inflows. Silver, has not yet made a new high but, in the short-term, has outperformed gold. We expect the overall level of nervousness in the financial markets to remain elevated, which could easily drive precious metals prices higher.

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*"Helping Clients
Balance Risk and
Return"*

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We also understand the relationship between risk and return and seek to reduce risk through targeted asset allocation among numerous asset classes. Each asset class has separate and distinct characteristics, including returns and risk that can be measured over time. While all classes are cyclical, they often trend in different directions. Two portfolios, each having similar return prospects, may have substantially different short-term risk characteristics. Clearly, the lower risk portfolio would be the choice of most investors.

Of course, all investments contain risk and there is no guaranty of positive returns; losses can occur. For additional information and a complete performance history, please visit www.starkadvisers.com.

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