



# Dunn Warren Investment Advisors, LLC

## The Portfolio Reporter

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## Economic Divide

Risk in the market has increased due to the rate of economic growth slowing down. Add to that high valuations, and we have a greater risk of moderate returns or even declines in the market. Our methodology incorporates multiple indicators to create an aggregate view of the economy. This is because no one indicator is 100% correct. There are times when false signals are registered. For this reason, building a composite index based on an aggregation of indexes is beneficial.

For this month's comment, I want to address one indicator that has begun to decline. The Durable Goods Orders release for April was below analysts' expectations and declined from the month before. However, neither of these comparisons provides a full picture of the economy and the business cycle. A look at the percentage change over the last 12 months is more indicative of the current state of the business cycle and how it can be applied to the stock market. Durable goods tracks the purchase of goods expected to last more than three years. This represents items such as machinery, appliances, automobiles, and airplanes. Some analysts say that orders for Boeing airplanes drive durable goods numbers more than anything. The range of products is wide, from raw steel to the most technical of machinery. However, any way you look at it, because of the size of the orders, it takes a greater commitment by consumers or companies to make the purchase.

For the purpose of monitoring the economy, we have found that looking at the 12 month percentage change is valuable in taking the pulse of the economy. The trend of new orders is a direct correlation of confidence on the part of individuals and companies. This is because individuals and companies need to feel comfortable with the future to make a purchase that will last in excess of three years. Manufacturers have to feel that they will have a return on their investment if they make the purchase. To this point, orders are a good reflection of the business cycle. Further, if we see a divergence in the percentage change in orders and the stock market, we expect to see a decline in the business cycle, which can foretell a deterioration of earnings and a subsequent decline in the stock market. The current decline in the durable goods orders is indicating that market risk has increased. Therefore, it is prompting us to be more conservative by increasing the hedge, (investing in inverse funds that increase (decrease) if the market decreases (increases)).

Geoffrey Moore, a leading economist in the study of the business cycle, first included durable goods orders as part of a list of leading indicators in 1958.<sup>1</sup> Since that time the calculation of new orders has changed and it is difficult to link the changes that the Commerce Department has undertaken to calculate the indicator. Please see the link below which shows a chart on the comparison of durable goods and the S&P 500. <http://dshort.com/articles/guest/2011/0530-durable-goods-analysis.html>

The chart tracks the most recent iteration of 12-month percentage change for three months durable goods orders, as well as the stock market as measured by the S&P 500. The gray columns represent periods of recession as marked by the National Bureau of Economic Research. Note that the decline in durable goods leads the decline in the S&P 500 as well as recessions. Consequently, monitoring durable goods orders, and specifically the 12 month percentage change, provides a useful tool in avoiding significant market declines and positioning for stock market improvements.

Based on our observation, the economy is slowing down and poses more risk to investors. As a result,

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we have begun to invest in health care service providers which tend to perform better during an economic slowdown. We also increased our weighting for VXX, (iPath S&P 500 VIX Short-Term Futures ETN). VXX tracks the VIX, Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of the S&P 500. VIX is based upon the prices traders are willing to pay for options contracts that change in value as the stock market indexes move up and down over time. Current pricing indicates that traders seem to be complacent, thinking that the uptrend will continue. Since VXX tends to rise in market declines, this investment also offers some downside protection against a decline in our other investments. It is a leveraged investment, meaning it tends to move more in percentage terms than the overall market does on a daily basis. VXX itself is a volatile investment, but we believe it is a good position to include as risk in the economy and the stock market increase.

We would like to mention the recent departure of Michael Carr from Dunn Warren and our investment committee. Mike has left to pursue opportunities in research and writing about the stock market. We thank him for his contributions the last two years. This change does not affect our management style or our course of action regarding the investments. We have used relative strength and our existing strategy since the start of the firm and will continue to use this research based approach going forward.

<sup>1</sup>. Moore, Geoffrey Forecasting Industrial Production- A comment Journal of Political Economy, February, 1958

*Please feel free to pass "The Portfolio Reporter" to interested friends and family members. For more information about your investments, please contact your financial professional.*

*The opinions expressed here are based on the author's views and should not be construed as financial advice. Model results do not represent actual trading and may not reflect the impact that material economic and market factors might have on the advisor's decision-making if the advisor were actually managing a client's money. Past performance is no guarantee of future performance. There can be no assurance that a client's investment objective will be achieved or that a client will not lose a portion or all of his or her investment. Please contact Dunn Warren directly for a list of the recommendations provided over the last year. Investing outside the United States involves additional risks, such as currency fluctuations, periods of illiquidity and price volatility. These risks may be heightened in connection with investments in developing countries.*

### **MONTHLY CONFERENCE CALL**

**Our next monthly conference call will occur Thursday, June 16th at 11 a.m. Mountain Time (1 p.m. EST).**

***Phone Number: 866-740-1260***

***Access Code: 4682824***

**To view slides on the internet during the call, go to [www.readytalk.com](http://www.readytalk.com) and enter 4682824 under "Join a Meeting".**