

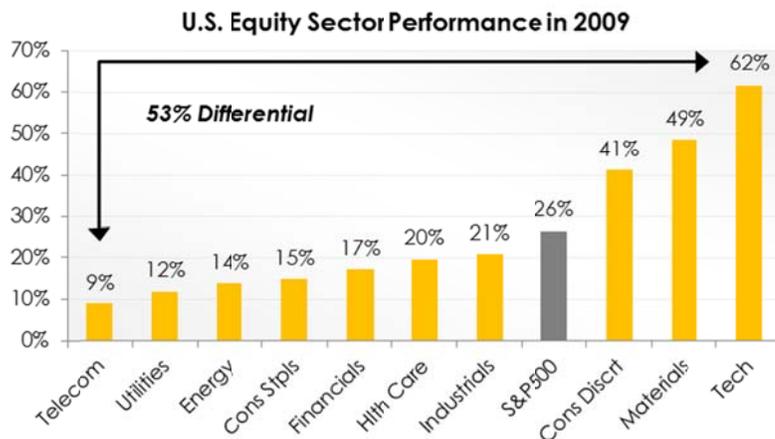
Choppiness in the equity market in 2011 has caused a lot of uncertainty for investors, particularly during the second half of the year. Large daily swings, and even larger weekly spikes and troughs, have left investors with the dilemma of whether to sit idle – either in or out of the market – or try to time the gyrations. Many conservative and moderate investors chose to reduce risk and sit out the possibility of a downward catalyst like an unorganized default in Europe. This proved to be a very good sleep-well decision for those concerned more with protection of principal than maximizing profits until European leaders showed last week that 17 nations can, in fact, work together more effectively than the United States Congress.

The market's euphoria over progress on Greece's fiscal problems may seem an overreaction to many investors given that there are still significant hurdles ahead. Europe is not out of the woods yet as Italy's cost of borrowing continues to rise, and the United States still faces very difficult fiscal decisions in the weeks and months ahead. Largely overshadowed by these headline problems, the economic data in the U.S. has been firming up. The U.S. equity market confirmed this trend and broke through the upside of its multi-month trading range in October, albeit much sooner than we had anticipated. After a very strong month of equity performance, balancing the risks against potential reward becomes even more difficult, but we believe that identifying the cyclical patterns of sector rotation may be the key for even wary investors to benefit from equities in the months ahead.

### ***Sometimes It's the Trees, Not the Forest***

The S&P 500 is the arguable standard for performance of U.S. equities, but the headline data do not tell the entire story. Digging deeper down to the sector level we learn quite a bit about what is driving headline performance. The year 2009 was a perfect example of how sector positioning can impact a portfolio. The broad S&P index posted a healthy gain of 26.5%, but the three top-performing sectors put that return to shame: the Technology, Materials and Consumer Discretionary sectors soared 41%, 49% and 62%, respectively.

The spread between the best and worst performing sectors was nearly 53 percentage points – roughly double the return of the S&P 500 itself. An over- or under-weight in a particular area would have resulted in a considerable difference in performance relative to the index.



This sector behavior was very typical for that stage of the business cycle – as the economy bottomed and then began to recover defensive sectors like Utilities and Consumer Staples underperformed while sectors that correlate positively with the business cycle (pro-cyclical) like Technology and Consumer Discretionary reaped the benefits of improving prospects. This was the opposite of what occurred the year prior when the market collapsed in the post-bubble melt down, and the defensive Consumer Staples sector fell less than half the amount of the S&P 500 (“only” -15% versus -37%). The cyclical pattern of sector behavior provides a significant spread between the highest and lowest areas of the markets, and therefore an opportunity. In fact, over the past decade the best performing sector generally has outperformed the worst by a minimum of 25 percentage points every year, as show in the table below.

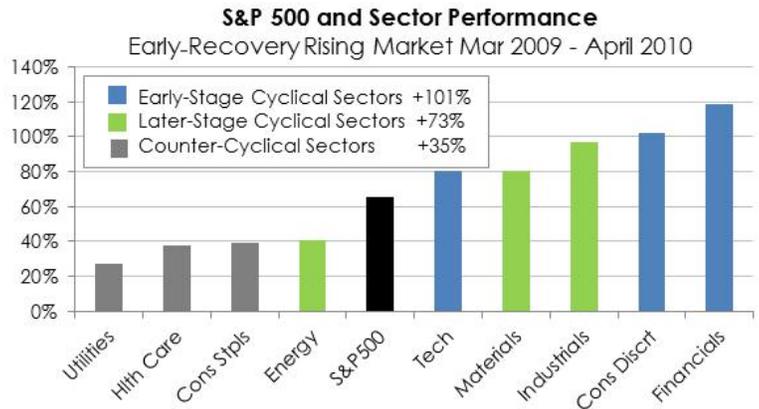
| Performance of Best and Worst Sectors in the S&P 500, % |         |                        |       |                        |       |            |
|---|---------|------------------------|-------|------------------------|-------|------------|
| Year  | S&P 500 | Worst Sector           |       | Best Sector            |       | Difference |
| 2001  | -11.9   | Utilities              | -30.5 | Materials              | 3.2   | 33.8       |
| 2002  | -22.1   | Technology             | -37.4 | Consumer Staples       | -4.3  | 33.2       |
| 2003  | 28.7    | Telecomm               | 7.1   | Technology             | 47.2  | 40.1       |
| 2004  | 10.9    | Health Care            | 1.7   | Energy                 | 31.5  | 29.9       |
| 2005  | 4.9     | Consumer Discretionary | -6.4  | Energy                 | 31.4  | 37.7       |
| 2006  | 15.8    | Health Care            | 7.5   | Telecomm               | 36.8  | 29.3       |
| 2007  | 5.5     | Financials             | -18.6 | Energy                 | 34.4  | 53.0       |
| 2008  | -37.0   | Financials             | -55.3 | Consumer Staples       | -15.4 | 39.9       |
| 2009  | 26.5    | Telecomm               | 8.9   | Technology             | 61.7  | 52.8       |
| 2010  | 15.1    | Health Care            | 2.9   | Consumer Discretionary | 27.7  | 24.8       |

Sector rotation has played an important role in the Opportunistic portion of our portfolios at Miracle Mile Advisors. A cautious top-down economic view prompted our holdings in defensive sectors like Utilities and Consumer Staples when the market weakened throughout the middle of 2010. We then sold these positions later that year in favor of commodity-related ETFs as quantitative easing drove up the prices of raw materials. We moved back into a defensive Opportunistic stance in the spring of 2011 when the economic recovery showed signs of faltering, but added some cyclicity in the form of Technology during the summer to increase exposure to the market. These Opportunistic changes at the margin provide a chance to enhance returns, and they also provide some relief from a market stuck in a trading range. No two cycles produce exactly the same results, but for the most part sectors follow a fairly predictable pattern of behavior over time.

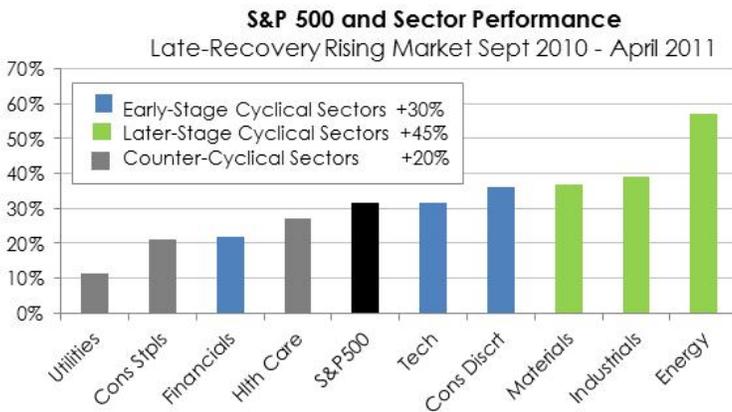
## Each Cycle's Story May Be Unique, but Sector Patterns Rhyme

During most of the post-recession period, the relative performance of sectors has shown a fairly typical pattern. Sectors which led the market from the time that the S&P 500 bottomed in March 2009 through its temporary peak in April 2010 were those that usually perform best in the early stages of expansion – as the economy transitions into growth mode and then accelerates.

The average return of pro-expansion sectors was over 100% during the market bounce, while the more defensive, counter-cyclical sector group gained just 35%.

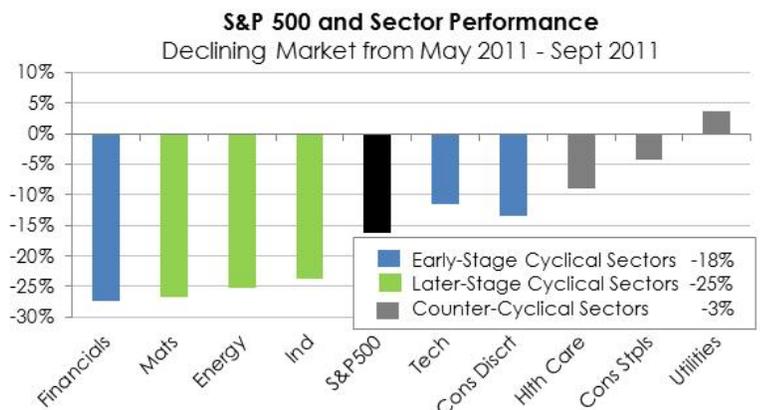


The post-recession rally in the S&P 500 index took a breather through the summer of 2010, but the index once again began to accelerate in the fall. This time, however, there was a very different economic backdrop than the year before. In the fall of 2010, inflationary pressures were building from higher commodity prices and a weak dollar, and sector behavior reflected these forces.

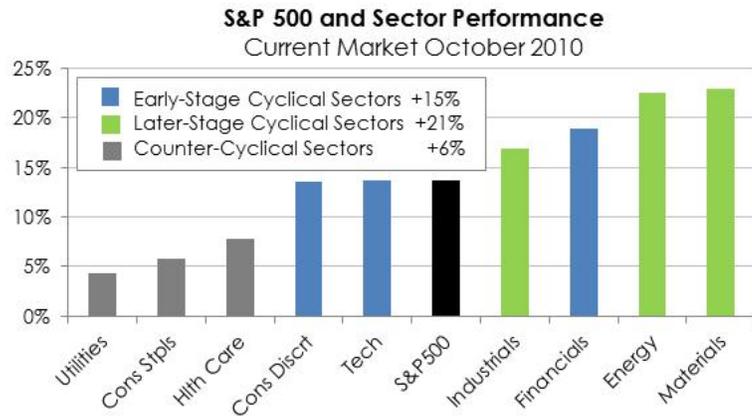


Sectors that perform best in the face of inflationary pressures tend to lead the market during the *later* days of an economic recovery, as the expansion hits a wall due to overheating growth. This was the global backdrop from September 2010 through April 2011. Price-resilient Energy, Industrials and Materials sectors combined for an average return of 45%, while the early-stage cyclical sectors had a more subdued 30% gain. Defensive sectors still lagged with a 20% return.

The market once again stumbled from May through September of this year, and this provided the opportunity for defensive sectors to shine. The top performing – and only positive – sector during this period was Utilities, followed by Consumer Staples and Health Care. The group had an average loss of -3%, but held up much better than the pro-cyclical sectors.



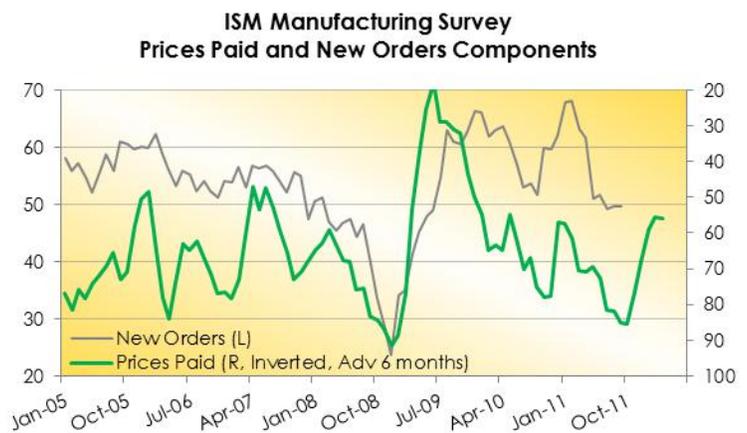
It appears that October has ushered in a new market environment. After five straight months of negative returns, the S&P 500 is poised to close out October with its best monthly return in more than 35 years. As would be expected, defensive sectors have taken a backseat to the pro-cyclical sectors during the rally. The question now is whether this is a temporary reprieve, or the beginning of a period of pro-cyclical leadership.



Many investors have chalked up the equity market's strength to positive developments in Europe, but we do not believe that is the entire story. As we discussed in last month's research piece, [\*"Light at the End of the Tunnel,"\*](#) signs have been emerging that better days are ahead for equities. We did not foresee a significant turn until early 2012, but progress on resolving the fiscal issues in Greece may have provided a necessary catalyst. Many economic data points - including the ISM Manufacturing and Services leading indicators - have surprised on the upside of expectations in October, but it is still unclear whether the market will hold up in the near term. We do believe, however, that the rotation in favor of more pro-cyclical sectors should remain intact, and we are making changes in the Opportunistic portion of our portfolios to reflect this shift.

***Sector Leadership Reflects the Underlying Economics***

We have written many times about the challenges facing the American consumer in an era of deleveraging. Without multiple sources of money to spend, consumers are much more dependent on their (stagnant) employment incomes than ever before. It follows, then, that they are more sensitive to changes in the prices of the day to day necessities for their families. If the costs of food and gas go down, there is more income left to spend on clothes, vacations, and entertainment. The commodity price inflation that was fueled by the Fed's quantitative easing program has eased, and lower input prices are gradually feeding through the supply chain toward the consumer. One of the first signs that leading economic indicators may be poised for improvement usually comes from a lower reading on the Prices Paid component (shown at right, inverted and advanced six months forward).



As manufacturers pay less (more) for their inputs, these lower (higher) prices eventually make their way to the consumer. The chart shows that a lower reading in Prices Paid (shown as a rising green line in the graph) typically leads to a pick-up in the New Orders component (rising grey line) within a few months – a sign of improving economic activity. We experienced the downside of that relationship throughout the first half of 2011, but the trend in orders appears poised to reverse. It is unclear how long this tailwind will last since improving economic growth likely will spark more upward pricing pressure on inputs, but for now the pipeline is supportive.

Some investors are concerned that oil prices are again on the rise, but in conjunction with improving leading indicators this is a good sign for equities in the short run. Looking back at the past two run-ups in oil prices, equities followed suit until oil reached a suffocating point – usually over \$100 per barrel. Until oil again rises to the point that it chokes off growth, gains in commodities could be a sign of economic strength ahead.

Another sign that cyclical pressures have eased is that several central banks are now lowering interest rates. Many global policy makers, particularly in high-growth emerging markets, were forced to raise rates to combat the inflationary commodity boom fueled by quantitative easing in the U.S., which in turn put the brakes on economic growth. A handful of central banks have moved from a neutral to easing stance in the last few months, which could help spark renewed economic activity. Lower rates abroad should also benefit the U.S. dollar as the gap between our low interest rates and other countries' rates closes.

The market slowdown has also brought sentiment (from a contrarian point of view) onto the tally of positives. Late in the summer when the markets began to slide, investors were overly optimistic. Most economic data were disappointing investors as they fell below consensus estimates. Today, the sentiment tide has shifted. The market volatility of August and September, as well as the tail-risk issues of Europe and a hard landing in China, have led market participants to rush toward pessimism. This month we have seen data points surprise on the upside, including real GDP growth which recorded a 2.5% annual rate in Q3 2011.

### ***The Economy and Market May Go Their Separate Ways, but Their Bond Remains***

Last month we wrote that investors are frequently confused by the seemingly-contradictory signals sent by the markets and economic data, but now these two sources are sending largely the same message. The components in leading indicators which tend to have the most lead time, such as Prices Paid series, have been improving for several months. In October, several of the headline leading indicators have improved as well. Since stocks themselves tend to show improvement several months prior to real economic expansion, it is likely that pro-cyclical sectors will continue to shine. At Miracle Mile Advisors we expect to move our Opportunistic holdings away from defensive areas to take advantage of the signals in front of us. If

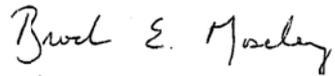
the data continues to hold up, we will gradually reduce cash exposure and reinvest in more risky assets.

October 31, 2011



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