

Market Outlook Letter

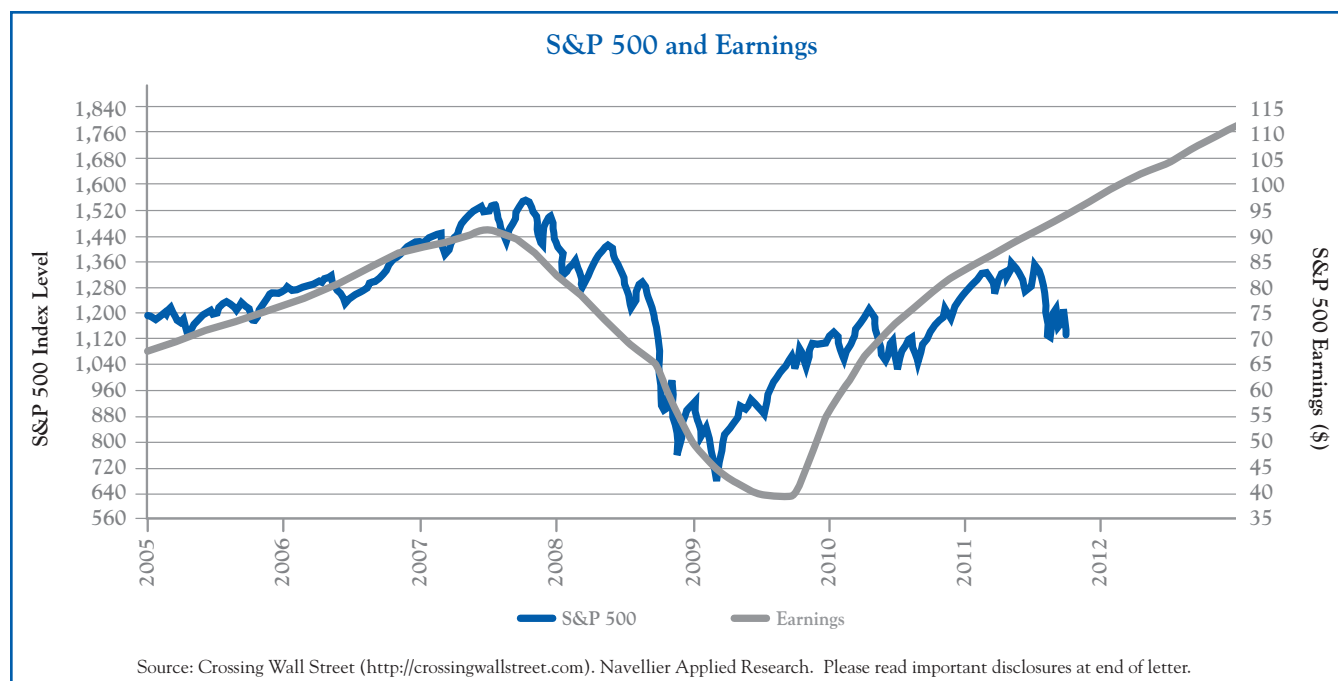
October 7, 2011

INVESTMENT COMMENTARY & OUTLOOK

At Navellier, we know that markets can be illiquid, which is why when we started designing bond portfolios to be packaged in Unit Investment Trusts (UITs), we did so intending they should be held to maturity to eliminate the “transaction risk” and mitigate the wide bid/ask spreads often associated with selling bonds.

The stock market is entirely different than the bond market, since it has been decimalized, and computers now do the vast majority of trading, with the High Frequency Trading (HFT) systems doing the bulk of the volume. The algorithms that control HFT have frequently been described as just “flipping a coin,” which may explain why during the third quarter, a big down-day was followed by a big up-day. This saw-tooth pattern seemed to persist and unnerve investors. The current lack of an “uptick” rule also seems to promote more short-selling, and seems to have escalated the recent volatility. Frankly, we think the uptick rule should be reinstated and tighter circuit breakers should be imposed, since HFT systems are promoting more volatility and undermining investor confidence.

The stock market is seasonal and typically has a tough time in the summer months and early fall, but the meltdowns in mid-August (triggered by the European banking crisis) and late-September (triggered by the Fed’s *Operation Twist*) remain troubling. In the past several weeks, Wall Street has largely been ignoring fundamentals, and predominately high dividend stocks have found favor, although they can also go down during extreme down days. Dividends are now influencing stocks more than earnings, which is evidence of the cumulative fear that has embraced the stock market. Interestingly, the following chart illustrates how the S&P 500 has diverged from the positive earnings environment that continues to characterize the underlying stock market:



Investment in equity securities involves substantial risk and has the potential for partial or complete loss of funds invested.

The \$64,000 question on many investor's minds is will Wall Street continue to ignore positive earnings forever? The answer is of course not. At Navellier, we continue to think our best defense is a strong offense, which is why we focus on companies exhibiting superior sales growth, margin expansion, earnings growth, earnings surprises, return on equity (ROE), and low forecasted price/earnings ratios (see www.navellier.com/individual_investor/pa_portfolio_fundamentals.aspx). We realize that we are now facing more difficult year-over-year comparisons, but many of our growth stocks continue to sustain strong earnings momentum in a decelerating earnings environment. Many investors may question whether or not earnings announcements actually work to propel stocks higher, and the answer is "most of the time."

You may have noticed that even though the third quarter was horrible for the overall stock market, our flagship Large Cap Growth Portfolio is largely made up of stocks that are able to "bend and not break." Typically, the stocks that are able to bend and not break are fundamentally superior stocks that remain attractive to long-term investors. Special mention should also go to our Large Core Covered Call Portfolio, which is also designed to provide relative strength during tough markets and provides the added benefit of holding many high dividend-yielding stocks as well as collecting income from covered call options.

At Navellier, our Large Cap Growth Portfolio will soon be 14 years old and continues to be a valuable strategy for long-term investors. From our point of view, there is overwhelming evidence that fundamentally superior stocks perform better, even in adverse market environments. Interestingly, as we go down the capitalization ladder to the small-and-mid-capitalization arena, the fundamentals get even stronger. To see this in Navellier's growth portfolios, go to www.navellier.com/individual_investor/pa_portfolio_fundamentals.aspx.

THE STRONG EARNINGS ENVIRONMENT

Clearly there is a "crisis of confidence" on Wall Street, similar to when Jimmy Carter was President and price-to-earnings (PE) ratios were relentlessly compressed. The S&P 500's PE ratio is at its lowest level since 1989, despite the forecast that earnings are expected to go higher for the next six straight quarters. Interest rates were a lot higher two decades ago, so the current stock market valuations seem irrational.

The stock market likes to look ahead, and the future has never been more uncertain due to the banking crisis in Europe, escalating problems with U.S. banks due to a resurgence in new foreclosure notices, and political gridlock about how to "fix" the economy. However, even some of the most nervous investors realize this could be an incredible buying opportunity – especially now that many stocks have higher yields than Treasury securities. As a result, we believe the stock market could wake up fast, particularly since the S&P 500 is expected to post over 13% annual earnings growth in the third quarter.

October marks the start of another positive earnings announcement season and should further sort the winners from the losers. Then November heats up just before Thanksgiving as year-end pension funding perks up and the national mood improves as the holiday season starts. Finally, in December, the momentum from Thanksgiving continues and an early "January effect" is typically the net result. So the outlook is pretty good between now and the end of the year.

We also expect falling crude oil prices to help the economic outlook. Gasoline demand in the U.S. is at a 9-year low. The summer driving season is over, and falling gasoline prices should effectively act like a tax cut and put money in consumers' pockets to stimulate overall economic growth.

Despite the expectation that falling energy prices will put more money in consumers' pockets, the news media is propagating a lot of "double-dip" fears even though there is little evidence of a dreaded double-dip in GDP growth. In fact, the Commerce Department recently revised up its final estimate for second-quarter GDP to an annual rate of 1.3%, from its previous estimate of 1%. This upward revision was higher than economist expectations of a 1.2% rise and was a pleasant surprise. Stronger consumer and construction spending than previously estimated was largely responsible for the upward GDP revision. We should add that many GDP forecasts are tied to consumer spending (falling crude oil tends to boost consumer spending) and export growth.

WEAKNESS CONTINUES IN EUROPEAN AND U.S. BANKING SECTORS

The stock market's recent weakness did not materialize until the second-quarter earnings season wound down in mid-August and when the European banking crisis escalated over the European Central Bank's refusal to buy Italian and Spanish debt until those countries implemented austerity reforms. Additionally, the Greece saga is never-ending. Since the 21% write-down on Greek sovereign debt restructuring is not sufficient, the Greeks are seeking a much larger 40% to 50% write-down.

The good news is that the European banking crisis seems to be temporarily resolved with the German Parliament agreeing to boost aid to the Eurozone. However, the European crisis is really no longer about Greece, since everybody knows there will be a default via debt restructuring. Instead, the Eurozone crisis is now more about Italy. It is the third largest bond market in the world, and European banks are loaded with Italian debt. As a result, the stock market remains sensitive to the unfolding events in Europe, especially Germany's willingness to continuously step up again and again to bail out indebted nations in the Eurozone.

The real problems are with financial stocks due to the European banking crisis and escalating problems for U.S. banks related to resurging foreclosure sales. At Navellier, we have steered clear of these problem financial stocks in our growth portfolios. In the U.S., the banking industry is under new stress from another wave of foreclosures in the pipeline. For example, RealtyTrac recently announced that initial default notices, the first step in the foreclosure process, surged 33% in August compared to July. RealtyTrac also noted that foreclosure activity in August slowed; however, this might be because banks are increasingly offering 2% workout mortgages to try to turn non-performing loans into performing loans. Despite these workouts, California led the way in August with a 55% surge in initial default notices, so it appears a tidal wave of foreclosures may be forming.

The wildcard that continues to spook financial markets is how much the problems associated with European and U.S. banks will constrict lending, which in turn tends to hurt business and consumer confidence. The bottom line is that both European and U.S. banks have capital problems, and there are "double-dip" fears everywhere, even though economic indicators continue to signal slow growth rather than a recession.

The International Monetary Fund (IMF) sounded a lot like the Fed recently when it said the world economy had entered a "dangerous new phase" and downgraded the economic outlook for both Europe and the U.S. The IMF now expects the U.S. economy to grow 1.5% in 2011 and 1.8% in 2012, down from its June forecast of 2.5% in 2011 and 2.7% in 2012. Regarding the Eurozone, the IMF lowered its outlook to 1.6% GDP growth in 2011 and 1.1% in 2012, down from its June estimates of 2% and 1.7%, respectively. IMF's Chief Economist Olivier Blanchard said, "Markets have clearly become more skeptical about the ability of many countries to stabilize their public debt." Interestingly, due to robust growth in emerging markets, the IMF still expects 4% global GDP growth in both 2011 and 2012, which may explain why we can still find companies characterized by strong sales and earnings growth.

THE FED INTRODUCES "OPERATION TWIST"

Wall Street's adverse reaction to the Fed's \$400 billion *Operation Twist*, where it purposely flattens the yield curve via bond swaps, was surprising since lower interest rates normally cause money to flee low-yielding investments into stocks. Traders reacted negatively on the day the Fed introduced Operation Twist. Furthermore, the Fed saying after its Federal Open Market Committee (FOMC) meeting that there are "significant downside risks to the economic outlook, including strains in global financial markets," effectively caused Asian and European investors to sell everything, including gold and other commodities. This sober tone from the FOMC was a bit out of character and spooked many traders around the globe.

One of our favorite economists, Ed Yardeni, said, "Pretzels should be twisted, not monetary policy." Clearly, the Fed's actions appear increasingly desperate. The 7 to 3 split FOMC vote does not help instill confidence either. Yardeni recently pointed out that relative to bond yields, the S&P 500 should be trading at a PE ratio of 51.2 versus 11.3. So that essentially means the S&P 500 has to climb 400% to be fairly valued relative to bonds. Only

a “crisis of confidence” similar to when Jimmy Carter was President can explain why stock valuations are so out-of-whack relative to miniscule Treasury bond yields.

Fed Chairman Bernanke recently tried to divert attention from Operation Twist by talking about another crisis. Specifically, Bernanke said the weak labor market was “a national crisis” that required immediate attention from the White House and Congress. Bernanke elaborated saying, “We’ve had close to 10% unemployment now for a number of years, and of the people who are unemployed, about 45% have been unemployed for six months or more.” Bernanke called for policies “that could help them find work, train for work, and retain their skills.” Bernanke also urged policymakers to consider “strong housing policies to help the housing market recover.” Exactly what these housing policies might be are uncertain as Bernanke did not provide specific solutions. But perhaps raising the mortgage interest deduction to stimulate housing sales or immediately eliminating the Alternative Minimum Tax (AMT) that denies the deduction of property taxes and mortgage interest for millions of Americans come to mind as potential solutions.

With 11% of all homes unoccupied in the U.S., it makes sense that sales must somehow be stimulated by offering new tax incentives to encourage purchases of these vacant homes. Some Fed officials have endorsed the outlines of a plan allowing homeowners who owe more than their homes are worth to refinance their mortgages. However, this only helps existing homeowners and does nothing to address the massive inventory of unsold homes.

SUMMARY

It is important for investors to realize that what is bad for banks is great for corporations, since most companies do not borrow from banks. Instead companies continue to issue new bonds at ultra-low interest rates and buy back their stock, which in turn boosts their earnings per share. Even though Berkshire Hathaway recently announced a massive stock buy-back program, the quarter-end stock buy-back frenzy we saw at the end of the second quarter did not materialize at the end of the third quarter. It may be that companies, like consumers, are increasingly hoarding cash due to the uncertain economic outlook. However, eventually this cash will be put to use like the more than \$40 billion in cash at Berkshire Hathaway that sparked Warren Buffett to announce an aggressive stock buy-back program. We expect more companies to follow Buffett as soon as the stock market turns and uncertainty diminishes.

In the meantime, the only certainty is that the S&P 500 has a higher average dividend yield than long-term Treasury bonds, so we believe there will be more bargain hunting by institutional investors. Expectations that third-quarter earnings will be up approximately 13%, while analyst projections for the stocks in our portfolios are 26%, 35%, 31%, and 74% earnings growth for our Large Cap Growth, Mid Cap Growth, Small-to-Mid Growth, and Fundamental ‘A’ portfolios, respectively, should also help shore up many stocks.

The seasonally strong time of year is fast approaching, which should also help support many stocks. The overall stock market tends to heat up in November just before Thanksgiving as assets are added to pension funds and the holiday season starts. The Thanksgiving momentum continues into December and often results in an early “January effect” for small-and-mid-capitalization companies. Once the stock market rallies, we believe the rally will continue through the end of the year and will be fueled by relentless corporate stock buy-backs and institutional bargain hunting.

We realize the recent stock market environment has been stressful. In the 25 years Navellier has been in business, we can assure you that earnings work at least 70% of the time, and only tend to not work when macro forces distract investors, which is exactly what has been happening since mid-August. At Navellier, we were careful to avoid distressed European and U.S. bank stocks in our growth portfolios. Normally, when banks get hit, it causes money to flow out of value stocks into growth stocks. Although growth strategies are clearly outperforming value strategies, there is no doubt that the banking crisis has impacted all stocks. However, with another strong earnings season fast approaching, record low PE ratios relative to bonds, and underlying earnings growth, we believe many of our growth stocks will resurge and end the year strongly.

In the aftermath of the recent selling capitulation, there are many incredible buying opportunities at hand, especially before another round of positive earnings announcements. We believe aggressive investors should be prepared to deploy capital before the third-quarter earnings announcement season commences. We realize the overall stock market has been worrying over the past quarter. Fortunately, the seasonally strong time of year is fast approaching, and as the holidays arrive, we believe there will be many opportunities for savvy investors.

Sincerely,



LOUIS G. NAVELLIER



SHAWN PRICE



MICHAEL J. BORGEN



MICHAEL GARAVENTA



JAMES O'LEARY, CFA

P.S. Please visit our stock rating system on over 5,000 stocks on www.navellier.com. The enhanced version of our stock rating system allows you to save portfolios, so that you can check the stock ratings on separate portfolios every week. We update our stock database every Monday following our weekend research.

Important Disclosures:

Past performance is not indicative of future results, and there can be no guarantee as to the accuracy of market forecasts. Opinions, estimates, and forecasts may be changed without notice. This material is not an offer, or a solicitation of an offer, to purchase any securities, including shares of any investment company. The views and opinions expressed are provided for general information only.

The S&P 500 Index measures the performance of 500 stocks that are considered to be widely held by Standard & Poors, a division of The McGraw-Hill Companies, Inc., and comprises approximately three-quarters of the total capitalization of companies publicly traded in the United States. The S&P 500 Index is weighted by market value and its performance is thought to be representative of the stock market as a whole. It is reported that over 70% of all U.S. equity funds are tracked by the S&P 500. The index selects its companies based upon their market size, liquidity, and sector. Most of the companies in the index are mid cap or large corporations. This index is composed of 400 industrial, 20 transportation, 40 utility, and 40 financial companies. Many experts consider the S&P 500 one of the most important benchmarks available to judge overall U.S. market performance. Presentation of index data does not reflect a belief by the Advisor that any stock index constitutes an investment alternative to any Navellier equity strategy, or is necessarily comparable to such strategies. Among the most important differences between the indices and Navellier strategies are that the Navellier equity strategies may (1) incur material management fees, (2) concentrate investments in relatively few stocks, industries, or sectors, (3) have significantly greater trading activity and related costs, and (4) be significantly more or less volatile than the indices.

All information contained in this material is provided in good faith and is believed to be accurate and reliable at the time of compilation. The information in this material is subject to applicable statutes and regulations and is provided "as is" and on an "as available" basis without warranties of any kind. Navellier does not warrant that the information will be error free.

No Financial Advice: The views and opinions expressed do not constitute specific tax, legal, or investment or financial advice to, or recommendations for, any person, and the material is not intended to provide financial or investment advice and does not take into account the particular financial circumstances of individual investors. Before investing in any investment product, investors should consult their financial or tax advisor, accountant, or attorney with regard to their specific situation.