

Weekly Commentary

February 23, 2009

The Markets

Despite the broad market averages approaching their recent bear market lows, there's some surprising strength below the surface.

Last Tuesday, the S&P 500 index closed within about 5% of its November 20, 2008, bear market low, according to data from Yahoo! Finance. Yet, according to data from Bespoke Investment Group, as of last Tuesday, the *average* stock in the S&P 500 was up about 14% from November 20, 2008. That seems a bit confusing, doesn't it?

Here's what's going on. The S&P 500 index is a capitalization-weighted index, which means the largest companies in the index have a greater weight in the performance of the index compared to the smaller-size companies. For example, as of December 31, 2008, the top 10 stocks in the index – which accounted for just 2% of the total stocks in the index – actually accounted for a whopping 22.4% of the weighting in the index.

So, when you see a gap between the performance of the overall index and the performance of the average stock in the index, then you know something is happening with the largest companies in the index. In this case, it shows the largest companies in the index are performing worse compared to the smaller companies in the index.

As an investor, this is important because it offers clues about the health of the overall market. Since the average stock in the index is performing much better than the largest stocks in the index, it may suggest that investors are focusing their selling on a relatively small number of large companies. In other words, the weak performance of some of the largest stocks in the S&P 500 index may mask a glimmer of strength in the overall market.

Returns through 2/20/09	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrial Average	-6.2	-16.1	-40.5	-12.7	-7.1	-2.6
NASDAQ Composite	-6.1	-8.6	-37.4	-14.0	-6.7	-4.7
Standard & Poor's 500	-6.9	-14.8	-43.1	-15.7	-7.6	-4.9

Sources: Yahoo! Finance, Barron's. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. Three-, Five-, and 10-year returns are annualized. Assumes dividends are not reinvested.

BAD ECONOMIC NEWS CAN ACTUALLY BE GOOD NEWS in disguise. For example, last week, the Commerce Department reported that January 2009 housing starts dropped to a seasonally adjusted annual rate of just 466,000 units. That's an incredible decline of 79% from the peak three years ago, according to MarketWatch. It's also by far the lowest number of starts in the post-World War II era. Short-term, that's bad news, but long-term, it's very good for our economy. Here's why:

One of the outcomes of our economic crisis is a substantial oversupply of homes. *The Wall Street Journal* reported on February 9 that at the current sales rate, there's about a nine-month supply of homes nationwide, while a six-month supply is considered normal. This abundance of homes for

sale is partially why nationwide housing prices have declined 25.1% since their mid-2006 peak, according to the S&P/Case-Shiller Home Price Index. Basic economics tells us that when there's more supply than demand, prices fall. And, that's exactly what's happening. To eliminate this predicament, you can either increase demand or reduce supply or do both. The government is doing what it can to drum up demand through its various bailout programs and now the building industry is doing what it can to cut supply.

When it comes to pumping up demand, demographics is also in our favor. According to the Congressional Budget Office, population growth from 2000 to 2007 added an average of about 1.3 million new households in the United States. If that trend continues, many of these new households may buy houses, which, in turn, may stoke demand.

Now, here's why the decline in housing starts is actually good news. By cutting the construction of new homes, we help reduce the inventory of homes for sale. As the inventory declines, we move closer to a balance between supply and demand. When we reach that balance, prices may level off, or, actually start to rise. As that happens, bank balance sheets will improve and that may help end the financial crisis.

This cycle of housing supply and demand is a great example of the free market in action. When things get out of whack, the market adjusts. Unfortunately, this adjustment period, as we are witnessing, takes time and can be very painful. The big question is, are we better off with massive government intervention to try to reduce the pain of this process or are we better off letting the free market do its job? Currently, the government is trying to do both. How effective they are at managing this process will go a long way toward determining the future of our economy.

Weekly Focus – How to Become a Genius

Is there a simple formula for becoming a genius? Two leading theories contradict each other. One theory, promoted by scientist Sir Francis Galton in the 1800s, is that genius is inherited (nature). Another theory, prominent in the 1920s and 1930s, is that genius is shaped by our environment and social class (nurture). Today, many scientists promote a third theory, which is simply a combination of both nature and nurture. And, if that's not satisfying enough, we have author Malcom Gladwell promoting a theory first proposed back in 1899. That theory says if you want to become world-class at something, you have to practice for 10 years or 10,000 hours.

Bottom line, if you want to be a genius, you'll probably need good parents, a good environment, and you'll have to work at it.

Best regards,

Jim

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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.

* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.

* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

* Consult your financial professional before making any investment decision.

* You cannot invest directly in an index.

* Past performance does not guarantee future results. Due to ongoing market volatility, current performance may be more or less than the results shown in this white paper.

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