THE MUSTICO
FINANCIAL GROUP, INC.

MARKET UPDATE

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FLASH CRASH 2010

I am sure many of you have noticed the "flash crash" that we are experiencing this month. Although this has been referred to as a flash crash due to the flash trading problem on one of the earliest days of the stock market plunge, I believe it is more aptly named due to the precipitous drop over such a short period of time. As I write this newsletter, the market has dropped about 12% in approximately four weeks, as measured by the S&P 500 index. Thus, an investor with $1 million dollars in the stock market would have lost approximately $120,000 in a very short time.

I believe this market is following historical patterns, and as I noted in my January newsletter we had yet to witness a correction, which is generally defined as a loss of more than 10% in the markets. I fully planned to see such a correction, as it is a natural, expected and recurring occurrence in bull markets. This is why in that same newsletter I explained the overriding defensive nature of our portfolios and that I planned on being cautious in increasing equity positions. While the correction itself was expected, what surprised me was the rapid pace of the decline. It always seems much easier to mentally absorb a plunge of more than 10% when the decline occurs slowly over several months rather than weeks.

To make matters worse, the pundits are back again predicting the end of the world as we know it. I am not sure if any of you can recall those same pundits back in March 2009 making similar claims. It seemed almost everyone in the media was claiming that there would be an "L" shaped recovery in the stock market or at best a very slow recovery. I responded with a newsletter in March 2009 which indicated my belief that we were near the end of the stock market slide. I also explained that even though the markets historically bounce back in a sharp "V" shaped pattern, I believed this recovery would have the potential to be "quicker or more pronounced than history would suggest." At the time, my position seemed so outlandish and against everything that was being portrayed in the media that I felt compelled to include some of my research in those newsletters to back up my positions.

Lately, every time I turn on my television, I see the same pictures of protests in Greece being portrayed as if anarchy is going to take over the European continent. I personally believe there is more civil unrest in their soccer games. I also seldom hear mention of the tiny size of the Greece economy in the European Union, not to mention the global economy.

The infamous Warren Buffett, in his recent 2010 shareholder newsletter, notes that fear is your friend when you are a value investor. He states, "When it's raining gold reach for a bucket, not a thimble." However, this does not mean that we should ignore the potential effects of the situation. There is a significant possibility that there could be a ripple effect on the European or global economy. This is especially true considering Spain and Portugal seem to be right behind Greece in terms of solvency issues. In addition, there is a remote possibility that the European Union could dissolve.

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So the question becomes, could these or similar concerns transform this correction into a global bear market, which could be a similar situation to the Great Depression over 70 years ago. This is difficult to analyze considering the massive structural problems prevalent in the economy in the 1930s. Rather, this situation seems more similar to the recent U.S. debt crisis, although I believe to a lesser global effect. When the market is being driven by fear and panic, rather than tangible, deteriorated economic fundamentals, the markets tend to have wild swings in both directions. For example, despite the market crash that ended about a year ago, once economic Armageddon seemed unlikely, we witnessed a quick and dramatic increase in the stock markets.

There are many different factors that one can consider to help determine whether we are dealing with more fear and panic than a structural economic problem. However, I strongly believe that stock prices, sooner or later, are a direct function of the earnings that the corporations are making. The U.S. corporate earnings that were reported during this earnings season have been very strong. They have been very strong for quite some time. In China, which I believe is one of the most important drivers of global growth, the government is purposefully attempting to slow down their economy for fear that they are growing too fast.

Thus, I anticipate that the global economy is on firm enough footing to withstand a ripple effect. If that is true, then I believe any stock market decline will be short term, even if it is more pronounced than a typical correction due to the fear and panic of such global events occurring. This is why investors should always remember the long-term nature of their investment goals and objectives. I imagine any people out there who listened to the pundits early last year when markets were at historic lows and panicked by selling their equities are kicking themselves today.

For many of you who are building significantly larger equity positions, I have started slowly easing into the markets during this downturn. Due to the massive volatility that we have seen over the last couple of years, I believe this downward correction will be slightly more pronounced than history would normally indicate which is why I have generally been treading more cautiously. In addition, we are also heading into the calendar months that are typically not the strongest for equity returns. Thus, I plan on performing the building of significant equity positions more cautiously and slowly than what may otherwise be anticipated. I appreciate your patience in this regard. In the meantime, should you have any questions or concerns, please do not hesitate to contact our office at your convenience.

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