



Weekly Market Commentary

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Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

Knowing the extent of the highs and lows and when it is going to be over play a crucial role in the summertime fun of riding a metal roller coaster. Riding a market roller coaster offers no such assurances and is no fun at all.

While last week's volatility is unprecedented, we can take some comfort that the overall moves and sentiment in the market this summer are familiar; they echo those of last summer.

Last year, the roller coaster did not leave the track and the summer plunge turned into a steep climb as stock and bond yields rose to new post-recession highs. We continue to believe this summer's drop will end with similar results and ultimately produce a modest single-digit gain for the S&P 500 in 2011.

Summer Roller Coaster

Summer is a time when many Americans seek out amusement parks for the thrills of riding a roller coaster. The climbs and drops at high speed deliver an exciting mix of fear and exhilaration. But knowing the extent of the highs and lows and when it is going to be over play a crucial role in the fun of riding a metal roller coaster. Riding a market roller coaster offers no such assurances and is no fun at all.

To say last week was volatile for the markets would be a major understatement. The stock market posted one of its most volatile weeks ever with swings of greater than 4% during each of the first four days of the week, changing direction with each day. This pattern of performance has never before been seen in the 83-year history of the S&P 500 index. By Friday, stock market turbulence slowed. For the week, the S&P 500 was down 1.6% adding to the losses that now total 13% since the recent peak on July 7.

While the U.S. debt downgrade in the week before last grabbed a lot of attention and added to the lingering pessimism heading into last week, one of the primary drivers of last week's volatility was that eurozone leaders, while making some successful efforts, have not gone far enough to resolve the debt problems in the eurozone. Investors feared a downgrade to France, and another banking crisis stemming from some French banks noted by Moody's, as at risk of a downgrade due to their exposure to troubled debt. Another key driver was the better-than-expected economic data on retail sales and the labor market along with the Fed confirming they intend to keep short-term interest rates low until mid-2013. This optimism that the U.S. economic soft spot was firming vied with the concern that the pace of economic growth in the United States may soften further as stimulus begins to fade.

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- At the low point of last week, the S&P 500 was down 17%, similar to last summer's volatile 16% peak-to-trough decline.
- The 10-year Treasury note yield has fallen 1.6 percentage points from the high of the year, similar to last summer's 1.6 percentage point decline from the high of the year.
- The drivers of the decline are similar to last summer, as well. Last year, Europe's debt problems were a main cause of the market's decline, as was an economic soft spot in the United States as stimulus began to



fade when the Federal Reserve ended the QE1 bond buying program and state and local governments were cutting back on spending.

So, maybe we have been on this market roller coaster before, and, if so, we might be near the end. Last year, the roller coaster did not leave the track and the summer plunge turned into a steep climb as stock and bond yields rose to new post-recession highs. We continue to believe this summer's drop will end with similar results and ultimately produce a modest single-digit gain for the S&P 500 in 2011. We believe the fundamental underpinnings of solid corporate earnings growth (up 19% year-over-year in the second quarter), low valuations (the price-to-earnings ratio fell to levels not seen since 1989 during the lows of last week), and firming economic data (as Japan's economy rebounds from recession) will combine to support stocks, high-yield bonds, and other business cycle-sensitive investments.

However, there are factors we are watching to determine if this volatility is instead a precursor to a deeper and longer lasting bear market. In the next few weeks there are a number of potentially market-moving events that may continue some of the volatility that was so pronounced last week.

- With all the attention on Europe's sovereign debt problems, this week's meeting between German Chancellor Angela Merkel and French President Nicolas Sarkozy will garner much attention. The market wants to know how much larger the European bailout fund is going to be and under what conditions it may be used, although this is unlikely to be determined for a number of weeks.
- A lot of retailers report second quarter earnings this week. But the solid results will be tempered by an outlook clouded by the sharp decline in confidence seen in the widely-watched University of Michigan consumer sentiment index falling all the way back to the levels during the financial crisis. The question for markets is whether the stock market's violent sell off has become such a negative for consumer and business confidence that it will impact the economy and profits.
- In 2010, the Fed's annual Jackson Hole meeting at the end of August hinted that QE2 may be coming and got the markets to acknowledge improving economic and profit data and rebound. The Jackson Hole meeting at the end of the month will be closely watched for indications of how the Fed may respond to further economic weakness. In the meantime, this week Dallas Fed President Richard Fisher will speak. Fisher is one of three Fed officials who dissented to the Fed's statement that interest rates would remain low through mid-2013 and his comments may add to volatility.
- U.S. economic growth has started to show signs of improving. This can be seen in a number of economic readings including the fall in initial jobless claims to a four-month low of 395,000 in the past week, retail sales running 4–5% above a year-ago levels, and signs that industrial production has increased. In the coming week, gloomy housing-related data is on tap, but stronger readings on manufacturing in the Philadelphia Fed survey along with leading economic indicators may provide positive data points.



Although we expect volatility to continue, we foresee a more muted level than last week's market roller coaster ride and a climb over the months ahead. In general, we advise investors to do what they normally do on a roller coaster: hang on tightly, grit your teeth, scream if you need to, but do not jump off.

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The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The University of Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

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