



Weekly Market Commentary



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Staging a Comeback?

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Highlights

- This may feel like one long slide in the stock market since the recent peak on January 19, but it isn't. It is actually three in one. Stage 1 was driven by concerns of slowing stimulus in China, stage two was driven by Washington, and stage three by the labor market and aftershocks of the financial crisis in peripheral Europe.
- While we believe the global economy remains on a path of recovery and the global financial crisis continues to fade, the data rarely moves in a straight line and the market reaction to each data point has been dramatic and warrants some caution around key data releases.

The stock market, as measured by the S&P 500, was down about 1% last week bringing the losses since January 19 to about 7%. This may feel like one long slide in the stock market since the recent peak on January 19th, but it isn't. It is actually three. We can see this by breaking down the pullback into three distinct stages. [Chart 1]

Stage 1 - Jan 20–22: The pullback started with concerns about Chinese officials announcing steps to slow loan growth. This led to a sharp 5% drop over three days as investors feared the sudden withdrawal of stimulus to one of the world's biggest growth engines may be premature and tip the global economy back into recession. These concerns started to fade after reports in China of a huge surge in loan growth in January demonstrated that efforts to slow bank lending were not overly harsh.

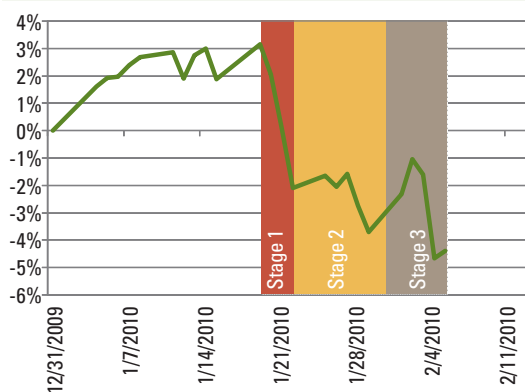
Stage 2 - Jan 23–28: The attention then turned to Washington and the President's proposals targeting the top banks, the State of the Union, FOMC meeting, Ben Bernanke's confirmation, and the administration's budget. To some degree, the uncertainty for investors created by these events lingers, but the major events are now out of the way.

Stage 3 - Jan 29–Feb 5: The more recent leg down in the stock market is being driven mainly by concerns about the labor market and aftershocks of the financial crisis in peripheral Europe. As evidenced by last week's reports on claims for unemployment benefits and the January employment report, job growth has yet to turn definitively positive (see this week's *Weekly Economic Commentary: Where Are The Jobs?* for details), renewing concerns about the sustainability of the recovery as the tailwinds begin to fade in the coming months. Without clear signs of job growth it is a concern to the markets that the stimulus programs could be coming to an end and the economy might not have enough self-sustaining momentum.

Just like the short sellers went after the banks one-by-one after Bear Stearns failed in March of 2008, we are seeing so-called "bond vigilantes" push up credit spreads around peripheral Europe, most notably in the PIIGS (Portugal, Ireland, Italy, Greece, and Spain). Greece agreed to tough budget cuts likely to prolong the pain of recession in order to remain within European Union guidelines which prompted concerns about which country was next in Europe to apply the "Grecian formula"

How much do the troubles in peripheral Europe matter for the global economy? We see these events as aftershocks of the global financial crisis. First Iceland, then Dubai, and now Greece have made the news regarding the economic challenges they face while mired in debt problems. These are

1 Year-To-Date Price Performance of S&P 500



Source: LPL Financial, Bloomberg



THE HAVES AND THE HAVE-NOTS

CREDIT DEFAULT SWAP SPREADS FOR COUNTRIES THAT SHARE THE EURO (CYPRUS, SLOVENIA, MALTA, AND LUXEMBOURG DO NOT HAVE CDS)

| Haves | | Have-Nots | |
|-------------|-----|-----------|-----|
| Country | CDS | Country | CDS |
| Finland | 9 | Italy | 129 |
| Netherlands | 15 | Ireland | 131 |
| Germany | 24 | Spain | 149 |
| France | 27 | Portugal | 204 |
| Belgium | 40 | Greece | 681 |
| Slovakia | 49 | | |
| Austria | 49 | | |

Source: LPL Financial, Bloomberg

much like some parts of the U.S. that continue to face debt-related crises like Las Vegas, and parts of Florida and California. These events are not signs of a new crisis to come, but merely aftershocks of the crisis the global economy is recovering from. We expect that there will be more aftershocks, but that they are unlikely to undermine the global economic recovery.

If all countries were in the same financial condition, the concern of a return to recession would be much greater and lead us to believe that Greece's troubles were a sign of things to come. But there is an enormous difference in financial conditions among European nations as evidenced by the credit default swap spreads (CDS) on government debt, which can be thought of a gauge of financial risk. It is easy to separate the "haves" and the "have-nots" when it comes to the confidence of investors with CDS on Greece at a very high 681 and Portugal at an elevated 204 while German CDS are at a mere 24—even below that of the U.S. at 36. We expect these concerns that the troubles in peripheral Europe could lead the rest of the global economy to another crisis will fade. [\[Table\]](#)

This week we will find out if there is going to be a stage 4 to this pullback or if stocks can stage a comeback and begin to recover their losses from a commonplace 5–10% pullback. The bulk of the monthly economic statistics on China are released on Feb 9 through Feb 11 which may reignite the fears of a slowdown in China that began stage 1 of the decline.

The very pronounced market movements this year reflect an increasingly reactionary stance by market participants that we expect to continue. While we believe the global economy and domestic labor markets remain on a path of recovery and the global financial crisis continues to fade, the data rarely moves in a straight line and the market reaction to each data point has been dramatic. We expect volatility to remain high and these outsized movements warrant some caution around key data releases. However, we believe the policy tailwinds for growth in the economy, labor market and profits remain in place in the U.S. and China and continue to recommend cyclical investments such as commodities and sectors like Information Technology. While headwinds may rise in the second half of the year, we do not believe the stock market has yet seen its highs for the year.

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