



# Weekly Market Commentary



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## The Winds of Change

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#### Highlights

- The winds of change are blowing. Market participants clearly believe that the tailwinds for growth are beginning to fade and headwinds are rising.
- We adhere to our 2010 outlook for slowing growth over the course of the year and modest digit gains for the stock market and low to mid-single digit returns for bonds to be accompanied by heightened volatility.
- While we recommend carefully tacking across the winds, we do not currently foresee conditions that would warrant battenning down the hatches.

Events and data in recent weeks have prompted market participants to view the tailwinds that caused the markets to go sailing higher for much of 2009 as beginning to fade. They now view them as having become more balanced with the rising headwinds associated with increasing global frictions.

We continue to expect the powerful economic and profit growth to weaken in the second half of 2010. The weakening is likely to result from the fading of the extraordinary global policy efforts that created a tailwind for growth and the rise of new headwinds as some actions are reversed. The early stage of this transition is already underway leading to heightened market volatility. While there is still plenty of good news acting as tailwinds for the markets, there is increasingly more of a balance with the bad news, or headwinds. The winds of change blowing in the markets include the following:

#### Tailwinds

- The Federal Reserve (the Fed) is our friend (for now)
- U.S. Gross Domestic Product (GDP) growth is above average
- S&P 500 earnings growth is strong
- Credit and housing markets continue to heal
- China's double-digit GDP growth (but slowing loan growth)
- Steep yield curve
- Massive global fiscal stimulus in the pipeline

#### Headwinds

- No job growth (yet)
- Federal, state and local budgets are awful
- Anti-business tone in Washington
- Commercial real estate woes remain
- China and India inflation risks
- European debt problems exacerbated by weak economies
- Bank lending is weak

These are not in any particular order since the importance placed on them by the market varies from day to day. Some of them will switch from being tailwinds to headwinds this year, like the actions of the Federal Reserve, while others may switch from being headwinds to tailwinds such as job

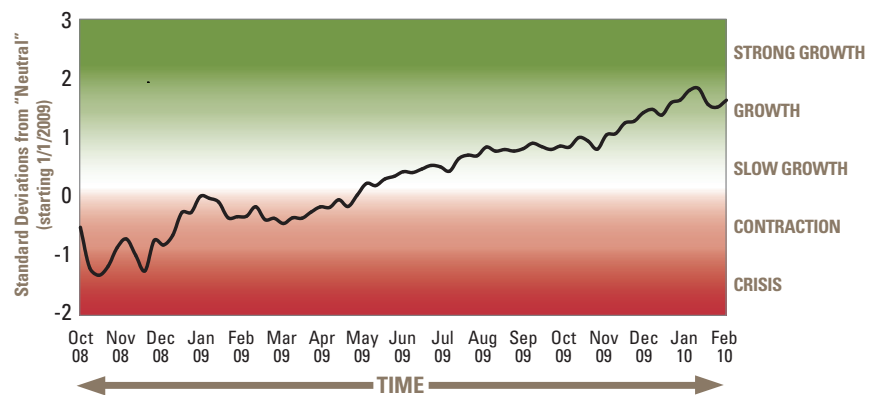


growth. Others may fade away and new ones appear. Let's explore each of the winds that are currently driving the choppy market environment.

## Tailwinds

- The Fed is our friend (for now)** – The Federal Reserve has retained the “extended period” phrase as it relates to how long they intend to keep short-term rates at record low levels to stimulate the economy and healing of the financial system. The Fed continues its purchase program to buy \$1.25 trillion in mortgage-backed bonds to help keep mortgage rates low and heal the credit markets (though likely finishing at the end of the first quarter). However, the Fed is likely to begin to raise rates in the second half of this year.
- U.S. GDP growth is above average** – The U.S. economy grew at a strong 5.7% in the fourth quarter and is on track to post above average growth again in the first quarter. Led by business spending, export growth, and the drawdown of inventories, the economy is not solely dependent upon government spending for growth and retains momentum among the key drivers. For example, the Index of Leading Economic Indicators continues to surge higher and the LPL Financial Current Conditions Index indicates an environment fostering trend-like growth in the economy and markets.

### 1 LPL Financial Research Current Conditions Index



Source: LPL Financial 02/10/10

- Earnings growth is strong** – With nearly 80% of the S&P 500 companies having reported earnings for the fourth quarter of 2009, 73% have reported earnings above analyst expectations—well above the typical 61%. The average company is beating earnings estimates by 12%. S&P 500 company earnings per share are up an incredible 208% and, even excluding financials, they are up a still impressive 16%. Expectations have been rising for coming quarters. The CEO of a big technology company said, “This is one of the most robust positive turnarounds I’ve seen in my career.” We continue to believe S&P 500 companies are likely to post robust earnings per share growth in 2010.
- Credit and housing markets continue to heal** – The two markets most central to the financial crisis were credit and housing. The credit market has improved dramatically from a year ago and has held up well despite



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the recent stock market pullback. The housing market is on the mend with home prices having risen for six straight months on a national basis and mortgage applications on the rise. In addition, lumber futures surged to a 29-month high, as measured by the CME Lumber Future Contract, as retailers and distributors restocked supplies ahead of the spring building season.

- **China's double-digit GDP growth** – China posted strong 11.7% GDP growth in the fourth quarter and is on track for another double-digit gain in the first quarter. China is acting as a huge engine of growth potential for the world driving the economies of many other nations as it imports needed raw materials, capital goods, and technologies.
- **Steep yield curve** – The yield curve has been a good predictor of economic growth in the past. When longer-term bonds are priced to yield less than shorter-maturity fixed-income securities, the yield curve is said to be “inverted” because it slopes downward. When longer-term yields are much higher than short-term yields, the curve is said to be “steep”. Over the past 40 years, an inverted yield curve has preceded every recession while a steep curve tends to precede periods of strong growth. The yield curve is now near record steepness. It is important to note that the shape of the yield curve does not cause the growth. Instead, the yield curve usually reflects financial conditions that can lead to a slowdown or pick up in business activity. Currently the steep yield curve reflects the easing in financial conditions that promote growth. We don't expect the curve to flatten until the second half of this year.
- **Massive global fiscal stimulus in the pipeline** – The American Recovery and Reinvestment Act of 2009 was an economic stimulus bill totaling \$787 billion. So far, \$273 billion has been distributed leaving much of the spending still in the pipeline to help drive growth in the coming quarters. Many of the spending programs by other countries also continue to drive global growth.

## Headwinds

- **No job growth (yet)** – The economy continues to lose jobs, although the pace has slowed sharply from over 700,000 per month in the first quarter of last year to 35,000 on average over the past three months. The lack of job growth this far into the recovery has given rise to concern over the sustainability of the recovery. Each month the economy fails to create jobs so skepticism over the durability of the economy grows. Signs that job growth may soon return include the rise in temporary employment overtime hours, and declining first time claims for unemployment benefits.
- **Federal, state, and local budgets are awful** – The budget deficit is soaring leading to potentially higher interest rates and consequently crowding out private borrowers. At the start of the last decade, total U.S. government debt equaled \$5.6 trillion. Five years ago, it totaled \$7.7 trillion. The federal debt is now \$12.3 trillion and if no changes are made the total, debt will equal \$17.43 trillion in 2015. With corporate and municipal bond, issuance is down over the past year the government has been able to finance the growing deficit without pushing up interest rates. However, with the return of demand for credit from business, consumers,



and municipalities on the horizon, the supply of bonds may force up interest rates slowing the economy as the government crowds out private borrowers looking to finance productive investments.

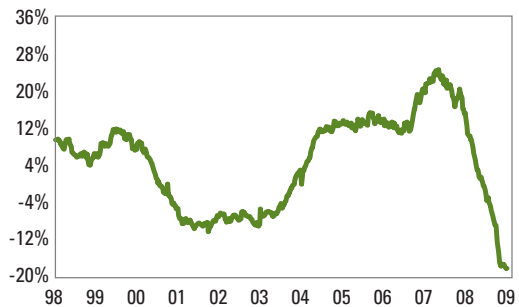
- **Anti-business tone in Washington** – Investors have been keeping both eyes on Washington for quite a while now. The uncertainty of legislative and regulatory actions has contributed to heightened volatility for stocks. While action in Congress has stalled with the Scott Brown Senate win in Massachusetts, a flurry of announcements from the White House in late January has helped to foster a very high percentage of investors viewing President Obama as anti-business according to polls. Many of these pronouncements targeted the top banks, but concerns over the broader business impact of new initiatives lingers. However, over the past couple of weeks, Obama has announced programs aimed at creating new jobs in part by expanding credit for small businesses that may begin to change the perception of the White House.
- **Commercial real estate woes** – Mounting commercial real estate losses continue to plague the banking system. Last week, a congressional oversight panel reported that a total of \$1.4 trillion in commercial real estate loans would require refinancing in the next four years with more than half of those loan values exceeding the value of the property. Credit conditions for commercial real estate remain tight. The panel warned of losses that could total \$200 to \$300 billion. The poor commercial real estate market remains a lingering element of the financial crisis that is resulting in the almost weekly failures of small and mid-sized banks.
- **China and India inflation risks/tighter policy** – India has seen inflation surge into the double-digits, while inflation in China has started to climb prompting government action. Policy makers in China are reining in credit growth after banks lent one-fifth of this year's \$1.1 trillion annual lending target in January. The accompanying money supply growth in excess of 25% has given rise to inflation pressures showing up in the price of many items ranging from food to shelter (property prices have climbed the most in 21 months as noted by Chinese Natural Development and Reform Commission). China is forcing banks to hold more cash by raising capital requirements in December and last week announced another hike in bank reserve requirements, to 16.5%, the second hike this year. We expect more announcements intended to slow economic growth, stoking fears that 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.
- **European debt problems combined with weak economies** – In contrast to the United States, financial stress is intensifying in Europe. Credit for the countries in peripheral Europe, most notably in the so-called "PIIGS" (Portugal, Ireland, Italy, Greece, and Spain) is tightening. Most of these countries are likely to agree to tough budget cuts to remain in the Eurozone. This fiscal austerity is likely to prolong the pain of recession in Europe. It was reported last week that the combined GDP in the 16 countries that use the euro rose by a weaker-than-expected 0.1% in the fourth quarter, and was down 2.1% on a year-over-year basis. The weakness, and the fact that there was no growth in any of the PIIGS, suggests that the recovery in Europe may already have run out of steam.

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## 2 Bank Lending Declining *Commercial and Industrial Loan Growth Year-Over-Year*



Source: LPL Financial, Bloomberg

- Bank lending is weak** – Lending is an important source of fuel for spending, but even more importantly it is a measure of whether businesses are committed to—and confident in—continued growth. Bank loans to businesses are down 18% year-over-year and have continued to decline each week. Businesses have been hesitant to borrow due in part to economic and legislative uncertainty and banks have been hoarding cash for similar reasons. Consumers are also borrowing less. However, a leading indicator for lending has started to improve. The recent results of the quarterly Bank Senior Loan Officer Survey from the Federal Reserve show that there is positive spread between the banks more willing to make new consumer loans and those less willing and that spread is the widest it has been over the past couple of years. This improvement typically leads consumer spending by two quarters.

The markets have stabilized over the past couple of weeks, but they have not rebounded. Stocks and bonds are basically flat so far in February as measured by the Lehman Aggregate Index as of February 12, 2010. Unlike other 5-10% pullbacks in the past, the markets have not sharply rebounded as the bulk of the earnings season and other key events like the State of the Union address and Fed chairman Ben Bernanke's reconfirmation passed.

We adhere to our 2010 outlook for slowing growth over the course of the year and modest digit gains for the stock market and low to mid-single digit returns for bonds to be accompanied by heightened volatility.

After the smooth sailing in the stock market from March 9, 2009 to January 19, 2010 when the S&P 500 rose 70%, a more choppy, volatile and lower returning environment is likely to lie on the horizon for investors. A good sailor knows how to read the conditions to make progress by carefully tacking across the winds. A good sailor also knows when the conditions are rough enough to take down the sails and ride it out. While we recommend tactical actions, we do not currently foresee conditions that would warrant battening down the hatches.



#### IMPORTANT DISCLOSURES

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Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise, are subject to availability, and change in price.

The Index of Leading Economic Indicators, calculated by The Conference Board, is used as a barometer of economic activity over a range of three to six months. This index, along with the coincident and lagging indexes, are used to determine the direction and stability of the economy. The composite index of leading indicators, which is derived from 10 leading indicators, helps to signal turning points in the economy and forecast economic cycles. The leading indicators are the following: average weekly hours, average weekly initial claims, manufacturers' new orders, both consumer and non defense capital goods, vendor performance, building permits, stock prices, money supply (M2), the interest rate spread and the index of consumer expectations. The coincident index moves with the cycles of the general economy, generally reflecting current market conditions. The lagging index reflects the former state of the economy and helps to confirm economic cycles.

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