



Weekly Market Commentary

January 31, 2011



Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

The riots in Egypt were the catalyst for a stock market that was already vulnerable to give up some gains from overbought conditions and some disappointing corporate earnings reports.

While we expect the spillover in the region to be contained, we also expect more geopolitical event-driven volatility in 2011.

Geopolitical Risk Returns

Last Friday, January 28, the S&P 500 lost nearly 2% as it suffered its biggest down day since August 11, 2010. The decline was triggered by escalating protests in Egypt that were fueled by soaring prices, sagging employment, and social media. In addition, the potential for spreading unrest to lead to the closure of the Suez Canal, a geographic choke point where two billion barrels of oil pass each day, pushed up oil prices by 4% on Friday.

The riots in Egypt were the catalyst for a stock market that was already vulnerable to give up some gains from overbought conditions and some disappointing earnings reports.

- The market was overbought and due for a pullback. Going into Friday, the Dow Jones Industrial Average was poised to be up nine weeks in a row, a hot streak not seen since the nine-week period ending April 23, 2010 when the stock market peaked and began a 14% decline over the following 10 weeks. Also, heading into Friday, the S&P 500 was as far above its 200-day moving average as it was back on April 23, 2010.
- After a solid start to the earnings season, disappointing earnings reports from some big companies weighed on the market. Amazon.com Inc., the largest online retailer, forecasted first-quarter profit to come in lower than analysts had expected. Microsoft, the leading software maker, reported that Windows sales missed the average analysts' target for the fourth quarter of 2010. Ford Motor Co., the second-largest U.S. automaker, said fourth-quarter profits fell sharply, well below analysts' expectations.

The firestorm that erupted last week over who will succeed the ailing 82 year old Egyptian President Hosni Mubarak—and by what process that succession will take place—is likely to spread into this week, as well. The United States is the primary benefactor of the Egyptian regime. After Iraq, Afghanistan, and Israel, Egypt is the largest recipient of U.S. assistance, including \$1.3 billion in annual military aid, according to the U.S. State Department. The powerful military has provided Egypt with its four presidents since the monarchy was toppled in 1952 by a coup. The Mubarak government has sustained Egypt's status as an ally of the United States and has reliably supported American interests in the Middle East. Whatever happens, the key American concern is that when the conflict is resolved, Egypt will remain an ally.



We devoted a full chapter in our *Outlook 2011*, published in late November, to the subject of geopolitical risk in 2011. In the publication we laid out four conclusions regarding the market impact of foreign policy in 2011:

- Increased volatility in global markets
- A tactical investing approach becomes more important
- Greater regional selectivity with global investments
- Rising opportunities for profit and loss with oil-industry investments

Oil prices are often driven by geopolitical events. As we noted when we published our *Outlook 2011* back in November, all signs point to the strong possibility of more geopolitical risk-driven volatility in the price of oil in 2011.

In recent years, individual investors have favored emerging markets perceiving them to have better growth prospects leading to stronger returns and lower risks. However, as part of an increased emphasis on a more tactical investing approach in 2011, investors with global exposure could benefit from taking a more active and selective approach to the regions of the world in which the prospects of international tension remain high (such as Northeast Asia and the Middle East) versus those where the potential for conflict is fairly low (such as South America).

Investors are wondering what happens now within Egypt and what is next for the region. Within Egypt, if the conflict lingers and oil traffic is disrupted, any oil supply impact would be temporary since crude shipments could be rerouted. Even after last week's rise, oil prices remain below their high for the year. At current levels, we do not expect oil prices to threaten our outlook for 2.5–3% economic growth in 2011.

Regionally, the unrest appears to be spreading. The Egyptians were inspired by the Tunisian uprising two weeks earlier that resulted in the ousting of that country's longtime dictator. However, it is not a foregone conclusion that popular revolts will spread further and more governments may topple. For example, the protests in Algeria have largely been contained and the 2009 protests in Iran were eventually neutralized by the ruling government. Unless it inspires major uprisings in Saudi Arabia, Nigeria, or other major oil producers, we expect the market and economic impact will be modest. While we expect the spillover in the region to be contained, we also expect more geopolitical event-driven volatility in 2011.



IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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. It is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Stock investing may involve risk including loss of principal.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit