



Weekly Market Commentary

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Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

- We believe this pullback is merely part of the higher volatility in the markets we have been expecting this year to accompany the transition from recovery to sustainable growth.
- We offer ten reasons why we expect the markets to rebound during the second quarter.
- We still believe that while the next week or two could be up or down a little, four or six weeks from now stocks will be up and headed back near the highs of April.
- What would change our minds? Not a level on stocks, but a level on spreads and other indicators of contagion like borrowing rates in Europe and signs of bank stress.

Ten Reasons for a Rebound

Our outlook for 2010 remains for modest gains in the stock and bond markets, accompanied by a lot of volatility. Over the last couple of months, we presented our reasons for why we believed the stock market, as measured by the S&P 500, was due for another 5-10% pullback. While the current pullback that began on April 24 came as no surprise, the month long decline has exceeded our expectations with a peak-to-trough decline of 12%. Nevertheless, we continue to believe it is a pullback and not the start of a new bear market. This pullback is merely part of the higher volatility in the markets we have been expecting this year to accompany the transition from recovery to sustainable growth.

The market pullback has a number of drivers:

- Financial reform legislation has weighed on the Financials sector.
- China's measures to slow growth have been raising 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.
- Last week's decline in the Index of Leading Indicators, the first decline in a year, is a sign that economic growth may be slowing.
- However, the big issue affecting the market has been the debt problems in Europe and fear of another global credit crisis.

We expect the markets to rebound during the second quarter for the following ten reasons:

1. Although unlikely to improve much in the near-term, the European debt and deficit problems are unlikely to get much worse. The trillion dollar rescue package has been passed ensuring adequate capital to meet the financing needs over the next few years for Europe's most troubled economies. Europe has some silver lining to the problems they are facing since the lower euro is a boost to the competitiveness of European exports helping to balance out weaker domestic growth.
2. The derivatives and leverage tied to the sovereign debt is very different than the financial crisis of 2008 (for example, debt-to-GDP (gross domestic product) for Greece is 1-to-1, while at Bear Stearns and Lehman Brothers it was 40-to-1). The smaller magnitude of the debt problem is unlikely to lead to another global financial crisis.
3. The concerns over the debt problems in Dubai and Iceland faded quickly after a month or two of intense concern last year. The budget and debt problems now weighing on Greece are an aftershock of the global



financial crisis and not a sign of a new crisis developing. The problems are akin to what many people and businesses that overindulged during the credit boom are now experiencing, as the negative consequences of the global recession have forced belt tightening to try to make ends meet while restructuring debt. That is what happens at the end of a credit crisis and recession, rather than at the beginning.

4. Fortunately for investors, expectations for the Eurozone are low and do not need to be cut drastically leading to further declines in markets. For example, U.S. exports to Europe, European oil consumption, and Europe's GDP are all already expected to be very low or negative.
5. The problems in Europe are good for the U.S. consumer by putting more cash in consumers' pockets. The falling price of oil is pulling down gasoline prices as we head in to the peak demand summer driving season and the money flowing into Treasuries is leading to lower mortgage rates and a new wave of refinancing.
6. As indicated by the *LPL Financial Current Conditions Index*, conditions remain favorable for growth.
7. Stock market valuations are now low at a forward price-to-earnings ratio of about 13 times. Also, the stock market is technically oversold by even more than it was overbought in mid-April when we were concerned about a pullback, suggesting selling may soon stall and buyers attracted by value will re-emerge.
8. China's growth remains on track and the weakness in Europe may keep Chinese officials from invoking further measures to slow their economy in the second quarter.
9. Financial reform legislation may see a lot of changes to moderate it in conference before it is signed by the President, given some objections by the Fed and Treasury. This may help stabilize the Financials sector which has been one of the sectors that has led the stock market lower.
10. The outlook for The Federal Reserve (Fed) rate hikes may now be pushed out with the futures markets now pricing in the first hike not taking place until 2011

We still believe that while the next week or two could be up or down a little, four or six weeks from now stocks will be up and headed back near the highs of April.

What would change our minds? Not a level in the stock market, but a level on spreads and other indicators of contagion like borrowing rates in Europe and signs of bank stress. Material deterioration in indicators of contagion such as:

- The TED spread, a measure of stress in the banking system based on the willingness of banks to lend to each other, has risen this year to a slightly above average 35 basis points (bps), but remains well off of the crisis peak of 463 bps in 2008 and below the levels of 2008 that led up to the peak of the crisis in October 2008.
- The level of European interest rates and credit default swaps, which have



both declined from the peak levels prior to the announcement of the rescue plan, but some southern European countries are elevated from levels at the start of the year.

- The value of the euro, which has fallen sharply this year but has stabilized in the past two weeks around \$1.24.
- Corporate bond issuance, which has contracted sharply reflecting tighter financing conditions.
- The volume of central bank liquidity swaps, which has picked up reflecting the need for dollar-based financing overseas.

These factors would prompt us to re-evaluate our outlook and may warrant a more defensive investment stance.

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Stock investing involves risk including loss of principal.

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.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

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

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