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Mike Schwager, Chief Market Strategist

Weekly Viewpoint



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A Mixed Message from Earnings and the Economy

WEEK IN REVIEW

7/12/2010 – 7/16/2010

The major market indices finished the week lower as a solid kick-off to second quarter earnings season was offset by concerns over the weakening economic recovery.

Performance for Week Ending 7/16/2010

The Dow Jones Industrial Average (Dow) lost 0.98%, the Wilshire 5000 Total Market IndexSM (Wilshire 5000SM) fell 1.38%, the Standard & Poor's 500 Index (S&P 500) declined by 1.21% and the Nasdaq Composite Index (Nasdaq) shed 0.79%. Sector breadth was negative as eight of the 10 of the S&P sector groups finished lower. The Financials sector (-2.86%) was the worst performing while Consumer Staples (+0.1%) was the best. The Canadian market, as measured by the S&P/TSX Composite Index, was little changed.

Index*	Closing Price 7/16/2010	Percentage Change for Week Ending 7/16/2010	Year-to-Date Percentage Change Through 7/16/2010
Dow	10097.90	-0.98% ▼	-3.17% ▼
Wilshire 5000	10965.29	-1.38% ▼	-4.00% ▼
S&P 500	1064.88	-1.21% ▼	-4.50% ▼
Nasdaq	2179.05	-0.79% ▼	-3.97% ▼
S&P/TSX Composite	11569.65	-0.01% ▼	-2.45% ▼

*See Last Page for Index Definitions.

Market Observations: 7/12/2010 – 7/16/2010

The major market indices finished the week modestly lower as concerns over the state of the economic recovery outweighed the strong start to second quarter earnings season.

Last week several bellwether companies beat earnings expectations and issued upbeat forward guidance. Such positive news would usually be a catalyst for market outperformance, however, the data seems to conflict with recent economic reports that suggest the economic recovery may have hit a wall.

While I continue to believe that earnings season could be a segue to a period of near-term market stabilization, the growing confusion between what corporations are telling us and what the economy is saying, could lead to some "choppy" trading in the near term.

Q2 Earnings – So Far, So Good.

As of Friday, 49 members of the S&P 500 have reported quarterly results, with overall earnings up 131% on a year-over-year basis. Approximately 80% of the companies have beaten analyst expectations while 18% have fallen short. While still early in the reporting season, the “beat” rate is significantly better than the historical 61% average. The strong results have been fueled by the Technology, Materials and Consumer Discretionary sectors. When all is said and done, second quarter earnings for the S&P 500, according to Bloomberg data, are expected to rise 36%.

Fed Pares Back Growth Expectations

The minutes from the June 22/23 Federal Open Market Committee (FOMC) meeting were released last week. While the Committee acknowledged that the risk to the economic outlook had “shifted to the downside”, it was far from convinced that further stimulus was needed. The Committee did reiterate its concerns over the high level of unemployment and expressed concerns over the rising risk of deflation.

As part of the FOMC minutes, the Committee also released its updated assessment on the economy. The FOMC said it now expect softer than originally forecast economic growth and a decline in pricing pressure. It also warned the unemployment rate would fall at a slower than expected rate in the coming years. For 2010 it sees GDP growth within a range of 3.0% - 3.5% versus its prior estimated range of 3.2% - 3.7%. Inflation is expected to remain subdued and fall within a range of 1.0% - 1.1%. Looking ahead, policymakers are forecasting 2011 GDP growth of 3.5% - 4.2% and between 3.5% - 4.5% in 2012.

While the reductions were not surprising in light of the recent softness in economic data, what is surprising is that, unlike almost all private forecasters, the Federal Reserve (the “Fed”) is forecasting a continuation of positive sequential growth. Using the average of the Fed’s range, they are forecasting GDP growth of 3.25%, 3.85% & 4.0% in 2010 - 2012, respectively. Private forecasters on the other hand are forecasting growth of 3.1% this year and then a decline in the growth rate to 2.9% in 2011.

Financial Reform

The Senate, by a 60 to 39 vote, passed the Financial Reform Bill last Thursday. While the regulatory bill (all 2,300 pages of it) sets the stage for a major overhaul of the financial services industry, the full impact will likely take years to be felt. The bill is structured to put more power in the hands of regulators, who in turn will be responsible for writing the underlying rules and regulations. The bill moves to the President’s desk and is expected to be signed into law by the end of this week.

More Stimulus on the Way?

The recent softness in the data is once again raising the chorus for another round of stimulus to try and help revive the sagging economy. If this weren’t an election year (mid-term) I would say that the likelihood of additional stimulus would be very low, however, with the current administration floundering in the polls, the full court press could be coming. Stay tuned.

China’s Economic Soft Patch?

Not only is U.S. data shifting into low gear but a report last week showed China’s GDP falling to 10.3% in the second quarter from 11.9% in Q1. While a 10%-plus rate of growth is nothing to sneeze at, the rate did fall short of the 10.5% rate forecast by economists. The Chinese government has been intentionally trying to slow growth for several quarters in an attempt to prevent “bubbles” from developing in certain segments of its economy. So, while the pace of slowing growth in China was surprising, the fact that growth is actually slowing should not be.

Eurozone

In a sign that the eurozone continues to be on the mend Spain, Greece and Portugal all held very successful debt auctions last week. While the interest rates that these countries were forced to pay was elevated, the strong demand is likely a signal that investors are becoming more confident that a fiscal crisis has been averted. As mentioned last week, if a country’s currency represents a proxy for its economic health and fiscal policies, then the fact that the euro continues to strengthen underscores the progress being made in Europe.

Looking Ahead - Stress Tests.

The results from the “stress tests” on European financial institutions are due out this Friday (7/23). While there has been strategic “telegraphing” that most banks will breeze through the test, I believe many investors are still waiting to see if any “skeletons emerge from out of the closet.” This week’s economic calendar will be heavy on housing data with housing starts, building permits, mortgage applications and existing home sales on the docket. The earnings calendar will get top billing over the next two weeks as approximately 290 members of the S&P 500 are scheduled to report results.

Market Outlook

After gaining almost 80% from the March 2009 low to the recent peak in late-April, the market has entered a corrective phase as investors digest the gains and try to gauge what is discounted in stock prices and what is coming to the fruition.

While these “corrective phases” are nerve wracking, they also tend to serve a purpose, in that they act as a mechanism to filter out the “weak holders” and allow for shares to be repositioned to longer term investors at more attractive price points.

With that said, I still believe the macro fundamentals in the U.S. should continue to provide a solid foundation for further upside over the course of the year, to wit:

- A.** The U.S. economy has expanded for three consecutive quarters and appears to be shifting from recovery mode to expansion mode, in my opinion. While economic growth, relative to past recoveries, is somewhat muted, average growth (+3.5%) over the past three quarters is ahead of the 2.8% average growth rate that has occurred since 1980.
- B.** Earnings growth has been robust and should remain so through the course of the year. After nine consecutive quarters of negative year-over-year growth, S&P 500 earnings appear to be on their way to a second consecutive quarter of positive growth. Historically, a turn in corporate profits prolongs a bull market and has rarely ever halted a bull cycle.
- C.** High levels of cash on the sidelines. Cash in money market mutual funds remains elevated at just over \$2.8 trillion. This cash hoard could provide fuel for additional upside in the equity markets as investors rotate out low yielding cash instruments.
- D.** Valuation remains attractive. Based on the forward 12-month consensus estimate for the S&P 500 earnings of approximately \$87.00/share, the S&P 500 is selling at only 12.4 times earnings.
- E.** Interest rates are low and the Federal Reserve is likely to remain on hold through mid-2011. Low rates encourage flow into “risk assets” and discourage holding low yielding (cash) vehicles.
- F.** The bull market is still young. Since 1928 the average bull market cycle has lasted 57 months and has produced average gains of +164%. The current bull market is approximately 16 months old and has produced gains of roughly 60%. The shortest bull market cycle currently on record occurred during 1966 – 1968 and lasted approximately 25 months.
- G.** Corporate balance sheets (ex-financials) are flush with cash. This has led to an uptick in corporate stock buybacks and stock buyback announcements. Intuitively, this likely signals that company managements think their stocks offer good value at current levels.
- H.** Employment data has started to turn positive and should result in improved consumer confidence. Consumer spending accounts for over 70% of economic growth.

1250 Target Unchanged. Based on the favorable macro environment and the expected rebound in earnings growth, I believe the S&P 500 has upside potential to at least 1250. This assumes the P/E (price to earnings) multiple will expand to 16x and 2010 earnings will expand to the \$78.00. From recent prices, a move to 1250 would equate to approximately a 16% return. With that in mind, I believe targets should be looked at as more of a directional bias than an absolute call on valuation. While market momentum may carry the S&P 500 above my target, I believe the eventual threat of higher interest rates and rising taxes will buffer the upside.

The bullish outlook becomes a little trickier as I look out beyond 2010. There will be a point in the future when the bill comes due for the large amounts of stimulus afforded to the economy and that will likely result in a combination of higher taxes and higher interest rates. This blend of elements will likely result in a period of diminished returns for the equity markets and a shift in investor focus to capital preservation from capital appreciation. While it would be foolish to try and forecast beyond the next 12 months due to the many twists and turns that could potentially take place (e.g. the outcome of mid-term elections, geopolitical events, etc.), potential speed bumps may crop up along the way. While I believe the economy should be “over the hump” and be self sustainable by then, the market will long provide clues as to the ultimate outcome.

An important trait of seasoned investors is their ability to peek around the corner and adapt to potential obstacles. The stock market represents the collective wisdom of all investors at any single point in time. There are always subtle clues presented in the form of elements such as valuation, reaction to positive/negative news, sector rotation, deteriorating internals, technical patterns, and outperformance of risk-averse instruments, among other metrics. Those clues will be monitored closely and will be presented in the ongoing *Weekly Viewpoint* series, if and when I see them transpire.

Potential Risks/Wildcards. My expectation that stock prices will trend higher over the next six to 12 months assumes an economic recovery continues to progress, a stable to moderately declining price environment (no extended periods of deflation and/or hyperinflation), and a recovery in earnings growth. A delay of any of these events could ultimately prolong the market’s recovery period.

Definitions

The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally defined as the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Wilshire 5000 Total Market IndexSM represents the broadest index for the U.S. equity market, measuring the performance of all U.S. equity securities with readily available price data. The index is comprised of virtually every stock that: the firm's headquarters are based in the U.S.; the stock is actively traded on a U.S. exchange; the stock has widely available pricing information (this disqualifies bulletin board, or over-the-counter stocks). The index is market cap weighted, meaning that the firms with the highest market value account for a larger portion of the index.

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

The Nasdaq Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The index was developed with a base level of 100 as of February 5, 1971.

The S&P/TSX Composite Index is a capitalization-weighted index designed to measure market activity of stocks listed on the Toronto Stock Exchange (TSX). The index was developed with a base level of 1000 as of 1975.

Indices do not include any expenses, fees, or sales charges, which would lower performance. Indices are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

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CLAYMORE[®]
A GUGGENHEIM PARTNERS COMPANY

Claymore Investments, Inc.
200 University Avenue, 13th Floor
Toronto, Ontario M5H 3C6

866-417-4640
www.claymoreinvestments.ca