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Weekly Viewpoint



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An Ugly Win, But a Win Nonetheless

WEEK IN REVIEW

5/10/2010 – 5/14/2010

The major market indices, featured in table on the right, finished the week with moderate gains. Despite the upside, trading was very choppy reflecting the uncertainty surrounding fiscal issues in Europe.

Performance for Week Ending 5/14/2010

The Dow Jones Industrial Average (Dow) gained 2.31%, the Wilshire 5000 Total Market IndexSM (Wilshire 5000SM) added 2.69%, the Standard & Poor's 500 Index (S&P 500) rose by 2.23% and the Nasdaq Composite Index (Nasdaq) tacked on 3.58%. Sector breadth was positive as all 10 of the S&P sector groups finished higher. The Industrials sector (+3.77%) was the best performing while Health Care (+0.68%) was the laggard. The Canadian market, as measured by the S&P/TSX Composite Index, rose 2.76%.

Index*	Closing Price 5/14/2010	Percentage Change for Week Ending 5/14/2010	Year-to-Date Percentage Change Through 5/14/2010
Dow	10620.16	+2.31% ▲	+1.84% ▲
Wilshire 5000	11770.17	+2.69% ▲	+3.05% ▲
S&P 500	1135.68	+2.23% ▲	+1.85% ▲
Nasdaq	2346.85	+3.58% ▲	+3.42% ▲
S&P/TSX Composite	12014.97	+2.76% ▲	+2.29% ▲

*See Last Page for Index Definitions.

Market Observations: 5/10/2010 – 5/14/2010

The major market indices finished the week with moderate gains. Trading was volatile as a “snapback” rally early in the week was pared by sharp declines on Thursday and Friday. The pullback late in the week reflected “buyer’s fatigue” and concerns about potential headwinds to the global economic recovery, in my opinion.

The market is likely to enter into a period of “price discovery” over the next few weeks as investors digest recent events and try to gauge what is currently priced in the markets and what is likely to come to fruition. While a choppy, sideways trading pattern may play out in the near-term, I also believe that the favorable U.S. macro fundamentals (improving economy, attractive valuation, robust earnings growth), as well as bullish intermediate technicals, should continue to set the stage for additional market gains over the medium term.

Fighting Debt with Debt? Global stock markets rallied strongly in the early part of the week in reaction to an almost \$1 trillion emergency aid package geared towards the sovereign debt crisis in Europe. The rescue package was much larger than most expected and structured to prevent the crisis from becoming a full-fledged credit market contagion. While the package was applauded by the global markets, the question remains whether Greece and the other heavily indebted European countries will have the fortitude to follow through with the tough austerity measures (i.e. tax increases, wage cuts, etc.) that are being imposed. In addition, the aid package is basically being structured as a lending facility. Therefore, one has to wonder whether lending money to already over borrowed countries will fix the problems or will it be akin to giving a junkie the keys to a pharmacy.

While the lending facilities and the loan guarantees will likely provide a near-term backstop, they do little in the way of addressing the fiscal and economic issues in the region. In addition, there is a possibility that the rescue fund will create an environment of "moral hazard," leaving indebted countries with little incentive to implement tough fiscal programs.

Uncertainty = Volatility. The uncertainty surrounding the situation in Europe has led to an uptick in volatility. While the CBOE Volatility Index (aka the "fear index") has doubled since mid-April, the swing in intraday prices is also notable. On this front, I like to monitor the daily price swings in the Dow Jones Industrial Average. Over the past two weeks, the difference between the daily high and low of the Dow has surged to an average 302 points. This compares to an average of 135 points since the beginning of this year.

Gold Hits New High. Gold has a tendency to benefit during times of financial stress as well as when inflation expectations are on the rise. Both factors have come into play recently as uncertainty surrounding the state of the monetary union has led to a plunge in the value of the euro. This, in turn, has resulted in an increased appetite to own tangible assets like gold. One of the unintended consequences of the debt issues in Europe is that most global central banks will likely have to keep interest rates "lower, longer." This is fueling fears that the influx of fiscal programs being implemented in Europe could result in an uptick in inflationary pressure. From a political point of view, it may be hard to raise rates to combat inflation when the wheels are falling off wagon.

As an aside and a potential prelude to a near-term top in gold prices, it was reported last week that a hotel in Dubai has recently installed an ATM like machine that allows for the exchange of paper money for gold coins and bars. While gold, in my opinion, will likely trend higher for the foreseeable future, news stories like this tend to be a caution flag and indication of building frothiness.

Oil Declines. The building concern over the strength of the global recovery has weighed on oil prices recently. After peaking at almost \$87 per barrel in early April, oil finished the week at \$71.85 per barrel. According to weekly statistics from the Department of Energy, oil inventories have risen in 14 out of the last 15 weeks, a sign of waning demand. This was also the reason the International Energy Agency lowered its global oil demand forecast for 2010. The agency now estimates daily demand at 86.4 million barrels, a reduction of 220,000 barrels per day. In addition, because oil is priced in dollars, the recent strength in the greenback is making crude more expensive for foreign buyers.

China Enters Bear Market. Also weighing on sentiment last week was the fact that the Chinese market, as measured by Shanghai Composite Index, has corrected by over 20% from the highs reached in November and has officially moved back into bear market status (a bear market is defined by a 20% reversal from a prior peak). The weakness in China, in my opinion, reflects the ongoing efforts by policy makers to slow growth through stricter lending policies. The Chinese markets are considered a leading indicator as they were able to bottom well ahead of the rest of the global benchmarks. The Shanghai's underperformance and the threat of slower growth seems to be another factor in the recent bout of global market weakness. The concerns seem to reflect the potential "ripple-effect" of slowing growth in China and how it could impact the fragile recoveries that many other economies are still navigating.

Q1 Earnings Summary. As of Friday, 460 members of the S&P 500 have reported first-quarter results with 77.1% beating analysts' expectations. This is well ahead of the "normal" 61% beat rate. Overall earnings are up 55% and well ahead of the estimate for 35% growth coming into the quarter. In addition, revenue growth is coming in well ahead of analysts' expectations, suggesting that the better than expected trend in earnings is not just a product of cost-cutting initiatives. On the sector level, nine of the 10 S&P sector groups have posted positive year-over-year gains, with only Telecom (-2.3%) showing a loss.

Market Outlook

While there is still a lot of "noise" in the marketplace and the market could move lower before it stabilizes, I remain of the opinion that macro fundamentals 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, the 5.6% growth in the fourth quarter and the 3.2% (preliminary estimate) in the first quarter are still ahead of the 2.8% average growth rate that has occurred since 1980.
- B.** Earnings growth is 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 \$2.87 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 12.9 times earnings.
- E.** Interest rates are low and the Federal Reserve Board (the "Fed") is likely to remain on hold through the end of this year. 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 14 months old and has produced gains of roughly 70%. 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.

I. Unused fiscal stimulus. Just over 30% of last year's \$787 billion fiscal stimulus has been spent. Another 40% (approximately \$315 billion) will be allocated this year.

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 10% return. While the S&P 500 is getting close to my target, I believe the number 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-adverse 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.

The Chicago Board Options Exchange Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

The Shanghai Composite Index (SSEC) comprises of all the A shares and B shares listed on the Shanghai Stock Exchange.

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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