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# Weekly Viewpoint



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## An Uphill Coast or the Next Leg Up?

### WEEK IN REVIEW

6/14/2010 – 6/18/2010

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### Performance for Week Ending 6/18/2010

The Dow Jones Industrial Average (Dow) added 2.35%, the Wilshire 5000 Total Market Index<sup>SM</sup> (Wilshire 5000<sup>SM</sup>) rose 2.37%, the Standard & Poor’s 500 Index (S&P 500) gained 2.37% and the Nasdaq Composite Index (Nasdaq) tacked on 2.95%. Sector breadth was positive as all 10 of the S&P sector groups finished higher. The Utilities sector (+3.94%) was the best performing while Telecom (+0.87%) was the laggard. The Canadian market, as measured by the S&P/TSX Composite Index, rose 2.23%.

Index*	Closing Price 6/18/2010	Percentage Change for Week Ending 6/18/2010	Year-to-Date Percentage Change Through 6/18/2010
Dow	10450.64	+2.35% ▲	+0.22% ▲
Wilshire 5000	11561.90	+2.37% ▲	+1.23% ▲
S&P 500	1117.51	+2.37% ▲	+0.22% ▲
Nasdaq	2309.80	+2.95% ▲	+1.79% ▲
S&P/TSX Composite	11927.59	+2.23% ▲	+1.55% ▲

\*See Last Page for Index Definitions.

### Market Observations: 6/14/2010 – 6/18/2010

The major market indices finished higher for a second consecutive week. The recent rebound in stock prices appears to reflect fading concerns over the fiscal issues in Europe, portfolio “jockeying” as we near the end of the second quarter, and the break above the technically significant 200 day moving average.

**Technicals Show Improvement.** As mentioned several weeks ago, the S&P 500 index fell below its 200 day moving average (dma), a barometer used to determine the market’s overall trend. Last week’s strength managed to push the index back above the “200” and appears to have given the “fence sitters” a catalyst to reenter the market. While the push above the 200 is not necessarily an “all clear” signal, the action seemed to ease fears of a larger, near-term meltdown. In the world of technical analysis former resistance should now be viewed as a new level of support. Over the coming weeks investors will monitor

closely the S&P 500's ability to hold above the 1108/1110 area and, if successful, will likely become a catalyst for additional upside, in my opinion. The next major upside level on traders' radar screens is the 1140 area which represents the 50 day moving average.

**European Banks will be Stress Tested.** In an effort to pacify investor concerns over the state of the European banking sector the European Union (EU) announced it will initiate a series of "stress tests" on the 25 largest banking institutions within the eurozone. The EU also agreed to publish the results of the tests by late-July in hopes of renewing confidence in the beaten-down sector. A similar exercise was completed in the United States last year and ultimately helped shore up confidence in the U.S. banking system.

**Euro Gains on Fading Contagion Fears.** The euro has tacked on almost 4% since the closing lows reached June 7. Moves in a country's currency (either up or down) tend to be a very good barometer of investors' viewpoint on a country's viability and/or its economic outlook and policies. The recent uptick in the euro may be an early indication that investors are becoming more comfortable with the developments in the eurozone and policy makers steps to remedy the situation.

Last week, Spain was able to sell a total of \$4.3 billion in 10- and 30- year notes and bonds. Demand for the paper was solid helping ease contagion fears. In addition, despite a series of poor economic reports, all the major European stock market indices posted solid gains, a sign that stocks may have over discounted the near-term risks.

**Financial Reform Still Pending.** While the need to impose stricter standards on some parts of the capital markets is inevitable, the government's inability to clarify the regulatory process appears to be hampering investors' ability to evaluate the impact and determine the eventual winners and losers. This indecision is likely, in my opinion, partially responsible for the recent bout of volatility in the market place. It is well known that Wall Street dislikes uncertainty. While the regulatory bill may ultimately prove to be a negative for some financial institutions, Wall Street will likely figure out how to work within the new rule structure, however, they must know what the rules are before that can happen. With the Financials sector accounting for a 16% weighting in the S&P 500, let's hope clarity emerges soon.

On a positive note, an effort to "politicize" the Federal Reserve (the "Fed") by installing a provision within the regulatory bill allowing the White House to appoint the president of the New York Federal Reserve was recently killed. The independence of the Fed remains vital as a decision towards monetary policy should not be politically motivated. The end result of such a scheme would have likely resulted in a bias around election time that would likely favor politicians and not necessarily be in the best interest of the overall economy.

**More Cracks in the Housing Foundation.** As expected, cracks in the housing market continue to appear. Last week, the Commerce Department reported that Housing starts plunged by 10% in May while Building Permits fell for a second consecutive month. The fall in permits is especially worrisome as building permits are considered a leading indicator for the housing market. While the plunge in housing appears to be a direct response to the expiration of the first-time homebuyer tax credit, the question remains: What will it take to get buyers off the sidelines? With financing costs near record lows

and housing prices coming down substantially, affordability doesn't appear to be the issue. In addition, with the seasonally strong spring selling period rapidly coming to an end, the probability of further downside risk in the housing market stands to grow, in my opinion.

**Looking Ahead.** The focal point of the week ahead will be the two-day Federal Open Market Committee (FOMC) meeting on Tuesday and Wednesday. While the FOMC is not expected to make any changes in their interest rate policy, all eyes will be focused on the after-meeting communiqué for hints into the Fed's thinking. Of interest on the economic calendar will be existing home sales (Tuesday), mortgage applications and new home sales (Wednesday), durable goods and jobless claims (Thursday), and the final revision to first quarter GDP (Friday).

## Market Outlook

The markets appear to be caught in a period of a "price discovery" as investors try to gauge what is discounted in stock prices and what is coming to the fruition. This process will likely result in a choppy, sideways trading pattern in the near-term as investors await further clarity on regulatory reform and how the European financial crisis has impacted the global economic recovery.

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, the 5.6% growth in the fourth quarter and the 3% in the first quarter are still 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 \$2.81 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 Fed 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.
- 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 15% 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. 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.) and 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 Index<sup>SM</sup>** 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.

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