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Weekly Viewpoint



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Bull Rally Resumes

WEEK IN REVIEW

11/2/09 – 11/6/09

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Performance for Week Ending 11/6/09

The Dow Jones Industrial Average (Dow) rose 3.2%, the Standard & Poor’s 500 Index (S&P 500) added 3.2% and the Nasdaq Composite Index (Nasdaq) tacked on 3.3%. Sector breadth was positive as all 10 of the S&P sector groups finished higher. The Industrials (+6.1%) sector was the best performing while Telecoms (+1%) was the laggard. The Canadian market, as measured by the S&P/TSX Composite Index, gained 3.1%.

Index*	Closing Price 11/6/09	Percentage Change for Week Ending 11/6/09	Year-to-Date Percentage Change Through 11/6/09
Dow	10023.42	+3.20% ▲	+14.21% ▲
S&P 500	1069.30	+3.20% ▲	+18.38% ▲
Nasdaq	2112.44	+3.29% ▲	+33.95% ▲
S&P/TSX Composite	11250.42	+3.11% ▲	+25.18% ▲

*See Last Page for Index Definitions.

Market Observations: 11/2/09 – 11/6/09

After two consecutive weeks of decline, the major market indices snapped back and finished broadly higher. A round of upbeat economic data and the 5%-plus pullback over the preceding two weeks was the right recipe for drawing “fresh” money back into the market.

The bull market rally off the March lows appears to be intact as the macro environment of low interest rates, improving earnings, and the better than expected GDP report provide a favorable stage for additional gains. In addition, bull market rallies rarely end at the early stages of a recovery in corporate profits. After nine consecutive quarters of negative earnings growth, S&P 500 earnings are forecast to grow 71%, 27.7%, and 25.8% in 4Q09, 1Q10 and 2Q10, respectively.

The weakness in the markets over the past two weeks had left the S&P 500 in an oversold position on a near-term basis. While corrections within an established uptrend are common, the pullback, in my opinion, did not appear to be the start of an extended down leg. Investors appear to be struggling with the price discovery process, as they debate what is discounted in the market and what is coming to fruition. The markets generally mirror economic performance in the corporate world. While almost 90% of the S&P 500 companies that reported third quarter earnings have beat expectations, cost cutting efforts seem to be the driving force behind the upside. Despite the high "beat" rate, the quarter is on track to be the ninth consecutive quarter where earnings have contracted. More importantly, a sustainable earnings recovery requires rising revenues, a trend that has been, for the most part, missing. With that said, markets are forward-looking mechanisms that tend to discount 6-12 months into the future. According to Bloomberg data, the nine quarter losing streak is expected to end in the fourth quarter, where earnings are currently projected to grow by 71% accompanied by an uptick in revenues.

A driving force behind forward earnings will likely be the uptick in productivity and the downturn in unit labor costs. Last week the Labor Department reported that nonfarm productivity rose by 9.5% in the third quarter after expanding by 6.9% in the second quarter. This favorable data point was followed by numbers showing unit labor costs dipped by 5.2% in the third quarter. In other words, labor costs are declining while the amount of output by the remaining workers has surged. Labor costs are typically one of the largest expenses for most corporations. The lower cost of labor coupled with the aggressive cost cutting efforts over the past year should continue to enhance operating leverage.

Payroll Report. Last week the Labor Department reported that nonfarm payrolls during the month of October fell by 190K, slightly higher than the 175K expected by economists. On a positive note, the September data was revised to -219K from the prior reading of -263K. The unemployment rate rose to 10.2% (from 9.8%) and now stands at the highest level since early 1983. While the rise in the unemployment rate was larger than expected, the markets have been expecting a double-digit rate for some time. The event appeared to be well discounted within the market and seems to become more of a political "hot potato" than an economic one (i.e. last Tuesday's Republican wins in New Jersey and Virginia).

While on the surface the November 9 payroll report seemed troubling, a closer look at the details offered signs of hope. For instance, while the headline nonfarm payroll number (-190K) fell short of economists' expectations, the upward revision to both the August and September (+90K) data more than covered the shortfall. In addition, temporary employment gained for a third consecutive month. The recent turn in temporary help is very encouraging as historically it is a precursor to actual hiring and usually precedes a peak in the unemployment rate.

While the momentum in the unemployment rate will likely push it higher, it generally appears the bulk of the upside appears to be behind, in my opinion. When reviewing leading employment

indicators such as weekly initial jobless claims, temporary employment and the stabilization in average weekly hours, all hint at improving, albeit modest, conditions in the forthcoming months.

In addition, the previously mentioned high levels of productivity usually precedes an uptick in hiring—after all there is only so much productivity that can be squeezed out of workers before additional help is needed to fulfill rising demand. Make no bones about it, a skeleton staff can only take you so far.

One troubling aspect of last Friday's jobs report was the U6 rate of unemployment. The U6 rate, which is the broadest measure of unemployment, rose to 17.5%. In other words, more than one in six Americans are not working or are under-employed.

More Stimulus Funds on the Way. The rising unemployment rate was likely the impetus to the approval of additional stimulus funds offered through the extension of two current programs. Congress voted to extend jobless benefits for up to 20 weeks in some markets and the first time homebuyers program will be extended until April of next year. In addition, the program was expanded by raising the income limits for those who qualify and allowing homeowners who have been in their current residence for at least five years to take advantage of the program as well.

FOMC Meeting. As expected, interest rates were left unchanged at the conclusion of last week's two-day Federal Open Market Committee (FOMC) meeting. The accompanying statement released at the conclusion of the meeting stated that the Committee saw an uptick in activity following the last meeting in September. It was also stated although economic activity is likely to remain weak for a time, policy measures and market forces are in place to support a strengthening of economic growth. Inflation pressures remain subdued and Committee members believe the current environment warrants exceptionally low levels of the federal funds rate for an extended period.

Dollar—Trend Remains Lower. The phrase, "exceptionally low levels of the federal funds rate for an extended period" weighed on the dollar as higher interest rates appear to be off the table for the intermediate future. The statement also appears, in my opinion, to be the Federal Reserve Board's (the "Fed") way of telegraphing that dollar weakness will be tolerated for the time being. A cheaper dollar makes U.S. goods more competitive in the global market place and generally leads to asset price reflation. While a weak dollar could eventually lead to inflationary pressure, the Fed seems to be willing to take that gamble in light of the current low levels of pricing pressure.

All Aboard! Transportation stocks surged last week on news that Warren Buffet's Berkshire Hathaway will acquire railroad concern Burlington Northern (BNI) for approximately \$100/share. Buffett summed up his purchase of BNI as an "all-in wager on the economic future of the U.S." Buffet's purchase also appears to be a bet that fuel costs will remain high, making rail transportation more economical than trucking.

Are Consumers Opening Their Wallets? A report from the International Council of Shopping Centers (ICSC) showed October same-store sales rose 2.1%, the second consecutive month of expansion and the best performance since July 2008. Although results were uneven, the headline number suggests that consumer spending may be on the rise. While much of the economic recovery so far has been driven by the combination of corporate (inventory restocking) and government spending programs, at some point the consumer will need to take the reins. With consumer spending accounting for approximately 70% of economic activity, the ICSC data may be an early sign that this transition is in the works.

Economic Data. Last week's round of economic data was generally upbeat. Highlights include the Institute for Supply Management (ISM) Manufacturing Index, which rose to 55.7 in October from 52.6 in the prior month. The ISM is a diffusion index where any reading above 50 signals expansion. Importantly, the employment sub-index rose above the 50-threshold and is now at its highest level since April 2006. The Institute for Supply Management also reported that its Non-Manufacturing Index (services) came in at 50.6 during the month of October. While the report was just shy of economists' expectations, the index still signals expansion in the services sector. The reading showed the second consecutive month of expansion, an event not seen in over a year. Service-oriented businesses account for almost 90% of the U.S. economy. In addition, the new orders component rose to the highest level in two years. New orders tend to be a leading indicator and generally correlate with additional upside in the equity markets.

Meanwhile, pending home sales surged 6.1% in September and is now up 19.8% on a year-over-year basis. The annualized gain is the largest on record, and the index now stands at its highest level since Dec. 2006.

The Labor Department reported that nonfarm productivity surged to a 9.5% annual rate, the fast pace in six years, while unit labor costs fell by 5.2%. The Labor Department also reported that initial jobless claims during the week ended October 31 fell by 20K to 512K, results were better than the 522K forecast by economists. The closely watched 4-week moving average, which helps smooth the week to week volatility, fell to 523.75K, the lowest level since January 9. Continuing claims, the ongoing number of people collecting unemployment benefits, fell to 5.75M—the lowest reading since late-March. Continuing claims remain in a steady downward trend and are well off the late-June peak of 6.90M.

Third-Quarter Earnings. As of Friday, 445 members of the S&P 500 have reported with 80.6% exceeding estimates, 6.8% meeting and 12.6% falling short. With almost 90% of results reported, overall earnings are now off by 16.6% on a year-over-year basis. The better than expected trend has forced analysts to upwardly revise their estimated growth rate for the overall quarter. When all reports are in, analysts expect earnings to decline by approximately 13.4% versus a 22.3% loss forecast in early September.

Market Viewpoint

Maintain Positive Intermediate Term Outlook. While my bias is for the market to continue on an upward trajectory over the intermediate term, the markets have also discounted a lot of good news and may need to go through a period of consolidation to filter out any excesses. I view pullbacks and periods of consolidation as healthy components of bull market advances as they typically set the stage for the next leg up in the market.

With that said, I think March 9 represents the low in the current market cycle. Also, because of the high levels of cash on the sidelines and what appears to be a growing level of risk taking, a "buy-the-dip" mentality should provide a downside buffer, in my opinion. In other words, any pullback in the market will likely be short and shallow.

Potential Risks/Wildcards: My expectation that stock prices will trend higher over the next 6-12 months assumes an economic recovery continues to progress, a stable to moderately declining price environment (no extended periods of deflation and/or hyperinflation), and the eventual recovery of 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.

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.

International Council of Shopping Centers (ICSC) is the global trade association of the shopping center industry. Members represent more than 80 countries and include shopping center owners, developers, managers, marketing specialists, investors, lenders, retailers and other professionals as well as academics and public officials.

Institute for Supply Management (ISM) Manufacturing and Non-Manufacturing Indices:

The Manufacturing Index is a monthly composite index that is based on surveys of 300 purchasing managers throughout the United States in 20 industries in the manufacturing area. The index is released on the first business day of the month and covers the previous month's data, which makes it particularly timely. If the index is above 50, it indicates that the economy is expanding. Values below 50 indicate a contraction.

The Non-Manufacturing Index is based on surveys of 370 purchasing and supply executives. If the index is over 50, it typically indicates expansion among non-manufacturing components of the economy. A value under 50 indicates contraction. There are ten sub-indices. Of those, the business activity sub-index is most influential. The other nine indices are new orders, supplier deliveries, employment, inventories, prices, backlog of orders, new export orders, imports, and inventory sentiment. A limitation of the survey is that it doesn't include any questions on wages, which is an important component of overall costs.

The Pending Home Sales Index (PHSI) is released during the first week of each month from the National Association of Realtors research. The index is designed to be a leading indicator of housing activity measuring housing contract activity. It is based on signed real estate contracts for existing single-family homes, condos and co-ops.

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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