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# Weekly Viewpoint



JUNE 14, 2010

## Buyers Return as Fear May Have Outpaced Fundamentals

### WEEK IN REVIEW

6/7/2010 – 6/11/2010

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### Performance for Week Ending 6/11/2010

The Dow Jones Industrial Average (Dow) added 2.81%, the Wilshire 5000 Total Market Index<sup>SM</sup> (Wilshire 5000<sup>SM</sup>) rose 2.51%, the Standard & Poor’s 500 Index (S&P 500) gained 2.51% and the Nasdaq Composite Index (Nasdaq) tacked on 1.10%. Sector breadth was positive as all 10 of the S&P sector groups finished higher. The Materials sector (+5.25%) was the best performing while Technology (+0.89%) was the laggard. The Canadian market, as measured by the S&P/TSX Composite Index, rose 0.84%.

Index*	Closing Price 6/11/2010	Percentage Change for Week Ending 6/11/2010	Year-to-Date Percentage Change Through 6/11/2010
Dow	10211.07	+2.81% ▲	-2.08% ▼
Wilshire 5000	11294.49	+2.51% ▲	-1.11% ▼
S&P 500	1091.60	+2.51% ▲	-2.11% ▼
Nasdaq	2243.60	+1.10% ▲	-1.13% ▼
S&P/TSX Composite	11666.92	+0.84% ▲	-0.67% ▼

\*See Last Page for Index Definitions.

### Market Observations: 6/7/2010 – 6/11/2010

The major market indices finished the week moderately higher as investors took advantage of the recent pullback to do some “bargain hunting.” The catalysts for the strength seemed to be fading concerns over the European debt crisis and a growing realization that fear may have outpaced fundamentals, in my opinion.

Last week’s strength pushed the Dow back above the psychologically important 10K mark, although all of the major U.S. benchmarks still remain below their technically important 200 day moving averages. Despite the gains, I continue to believe the markets are locked in a period of a “price discovery” as investors try to gauge what is reflected in stock prices and what is coming to the forefront. This process will likely remain in play until further clarity

emerges on how the European financial crisis has impacted the global economy. This could take several weeks, in my opinion, and will likely be centered on second quarter earnings season (which unofficially kicks off on 7/12), when it will become clearer if the problems in Europe have filtered through to corporate earnings.

**Bernanke Testimony.** At a testimony before the House Budget Committee, Federal Reserve (the “Fed”) Chairman Ben Bernanke reiterated that the economic recovery remained intact (albeit at a moderate pace) and that the Fed will act as needed to aid financial stability and economic growth. Bernanke also noted that the unemployment rate will likely remain stubbornly high, although he still believes the economy remains on track for 3.5% growth in 2010. Bernanke’s testimony was generally shrugged off by the marketplace as most of the rhetoric was deemed old news.

**Beige Book Report.** On Wednesday, the Fed released the Beige Book. The report, published eight times annually, is a summary of anecdotal economic conditions in the 12 regional Fed districts. The Beige Book showed that all 12 districts expanded during the period. While the majority of districts categorized growth as “modest,” this was the first time since 2007 that all regions reported growth, a sign that the economic recovery is starting broaden out. The report noted that consumer spending and tourism activity generally increased, while business spending also rose, on net. Labor market conditions generally improved, while pricing pressure were subdued.

**Contagion Fears Fading.** Fears that the European debt crisis could lead to a global slowdown appear to have faded slightly last week. There were also subtle signs that confidence may be returning to the European markets. Last Thursday, China reported that exports in May climbed by a very robust 48.5% on a year-over-year basis, well ahead of the low-30% rate expected by economists. With China being looked at as a major engine of global economic growth, the report seemed to ease concerns over a global slowdown. Meanwhile, the head of China’s national pension fund, said the euro would weather Europe’s debt crisis. This was also echoed by comments from Banco Santander Chairman Emilio Botin, who stated that the crisis in Spain has been blown out of proportion. In addition, last week several European counties were able to successfully raise funds in the bond market. Spain, Portugal, Italy and Ireland were able to sell debt, although borrowing costs were elevated relative to several weeks ago, the overall demand for the paper was solid. The bond auctions may be an early sign of building confidence and that the austerity measures adopted by many of these nations are the right “medicine” to help cure their ills.

**Mortgage Apps Plunge.** Despite mortgage rates falling to near-record lows, mortgage applications continue to plunge, raising concerns of a double dip in the housing market. Last week the Mortgage Bankers Association reported that mortgage applications during the week ended June 4 fell by 12.2%. Both the Purchase Index (-5.7%) and the Refinancing component (-14.3%) contributed to the weakness. Purchase applications have declined for five straight weeks and now are sitting at their lowest level since early 1997. The plunge in purchase applications is likely partially explained by the ending of the homebuyer tax credit, which seems to have cannibalized future sales. However, with the seasonally strong spring selling season coming to an end the probability of further downside risk in the housing market cans to grow, in my opinion.

The dip in refinance applications was the first in a month. Refinancing activity may weaken further as many borrowers may not qualify from a credit perspective or due to the fact that the value of their home may be “underwater” relative to the amount they owe. According to an update from real estate consulting firm CoreLogic, 11.2 million, or 24% of all residential properties with mortgages, were in a negative equity position at the end of the first quarter. CoreLogic also stated that it could take between five to seven years for homeowners to regain the lost equity.

**Economic Data.** While the recent batch of economic data indicated that the economic recovery is intact, there were fleeting signs that we may be hitting a near term soft patch. For example, the Commerce Department reported that Retail Sales during the month of May fell 1.2%, well short of the 0.2% gain expected by the Bloomberg consensus. While much of the decline can be explained by a sharp reversal in building material sales (-9.3), auto sales and gas station receipts also contributed to the weakness. With that said, overall retail sales were up 6.9% on a year-over-year basis, well ahead of the 10-year monthly average of 3.0%. This was the first dip in retail sales in eight months and highlights that the road to recovery is never a straight line and often contains speed bumps along the way.

Other reports of note from last week included The Conference Board’s Employment Trend Index (ETI). The ETI—a basket of eight labor market indicators—rose for a ninth consecutive month suggesting, according to The Conference Board, that the disappointing nonfarm payroll growth in May could just be a one-month blip, and that jobs will likely expand further in the next several months. Meanwhile, the Manpower Employment Outlook Survey indicated continued momentum in the U.S. hiring outlook. The survey found U.S. employers anticipate favorable hiring plans for third quarter, marking three straight quarters of positive intentions.

In another sign that the underlying tone of the Labor market is improving, the Labor Department reported that the number of people quitting their jobs is on the rise. Historically this has been a signal that people are gaining confidence in the labor market recovery. In April, the latest month for which data is available, “quits” rose 3.4%—the fourth consecutive monthly increase. The level of quits as a share of total employment remained at 1.5%—a clear improvement from the 1.3% back in the fall of 2009.

**Mutual Fund Flows.** The Investment Company Institute (ICI) reported that domestic equity mutual funds experienced a fifth consecutive week of outflows and have now seen net redemption of almost \$25 billion during that period. Unfortunately, these redemptions are coming at a time when mutual fund cash holdings are at record lows. The situation appears to be causing a negative feedback loop as mutual fund managers need to liquidate holdings (and therefore contributing to the selling pressure) to raise cash. On a positive note, this week’s outflows of \$1.1 billion were well off the \$13.4-billion pace during the prior week, and may be hinting at sellers’ exhaustion, in my opinion.

## 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% 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 \$2.84 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 12.3 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. 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 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.

**The Mortgage Bankers Association (MBA)** is the national association representing the real estate finance industry, an industry that employs more than 370,000 people in virtually every community in the country. The mission of the Washington, D.C.- based association includes, but is not limited to, investing in communities across the nation by ensuring the continued strength of the nation's residential and commercial real estate markets; expanding homeownership and extending access to affordable housing to all Americans and supporting financial literacy efforts. Among the resources offered by the MBA are: The Purchase Index includes all mortgages applications for the purchase of a single-family home and covers the entire market, both conventional and government loans, and all products. The Refinance Index covers all mortgage applications to refinance an existing mortgage. It is an overall gauge of mortgage refinancing activity. It covers conventional and government refinances, regardless of product or coup rate refinanced into or out of.

**The Conference Board Employment Trend Index<sup>TM</sup> (ETI)** aggregates eight labor-market indicators as follows: percentage of respondents who say they find jobs hard to get; initial claims for unemployment insurance; percentage of firms with positions not able to fill right now; number of employees hired by the temporary-help industry; part-time workers for economic reasons; job openings; and industrial production.

The Conference Board is a not-for-profit organization that creates and communicates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. The Conference Board operates as a global independent membership organization working in the public interest. It publishes information and analysis, makes economics-based forecasts and assesses trends, and facilitates learning by creating dynamic communities of interest that bring together senior executives from around the world.

**The Manpower Employment Outlook Survey** is released quarterly by Manpower, Inc., which provides job opportunities around the world. The survey measures employers' intentions to increase or decrease the number of employees in their workforce during the upcoming quarter.

**Investment Company Institute (ICI)** is the national association of U.S. investment companies including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of the ICI manage total assets of \$9.86 trillion and serve nearly 93 million shareholders.

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