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Weekly Viewpoint

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Dow 10K: A Conspiracy of Optimism?

WEEK IN REVIEW

10/12/09 – 10/16/09

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Performance for Week Ending 10/16/09

The Dow Jones Industrial Average (Dow) added 1.3%, the Standard & Poor's 500 Index (S&P 500) rose 1.5% and the Nasdaq Composite Index (Nasdaq) tacked on 0.8%. Sector breadth was positive as nine of the 10 S&P sector groups finished higher. The Energy (+5.1%) sector was the best performing sector while Financials (-0.2%) was the worst. The Canadian market, as measured by the S&P/TSX Composite Index, added 0.6%.

Index*	Closing Price 10/16/09	Percentage Change for Week Ending 10/16/09	Year-to-Date Percentage Change Through10/16/09
Dow	9995.91	+1.33% ▲	+13.90% ▲
S&P 500	1087.68	+1.51% ▲	+20.42% ▲
Nasdaq	2156.80	+0.82% ▲	+36.76% ▲
S&P/TSX Composite	11504.76	+0.59% ▲	+28.01% ▲

*See Last Page for Index Definitions.

Market Observations: 10/12/09 – 10/16/09

The major market indices finished higher for a second consecutive week reflecting further evidence that the economic recovery continues and signs that third quarter results are trending better than initial forecasts.

Last week the Dow rose above 10,000 for the first time in over a year. While the significance is nothing more than the psychology of surpassing a significant round number, the media, made this into a major milestone. The Dow first crossed the 10K mark in early 1999 and over the next decade see-sawed above and below it at least a dozen times. The move above 10K coincided with the Chicago Board Options Exchange SPX Volatility Index (commonly called the VIX and referred to as the "fear" index) fell to its lowest level in over a year, a sign that complacency is growing amongst Wall Street investors.

The VIX finished at 21.43 last week and is approaching levels that throughout much of 2007 and early 2008 signaled a near-term peak in the market. Volatility is typically associated with fear and has generally been a good contrarian indicator (i.e. fear tends to be highest at market bottoms and lowest at market tops).

There's an old Wall Street adage that says bull markets climb a "wall of worry." The current VIX levels is suggest that investors may be wearing rose-colored glasses, and therefore, a near-term pause may be in the cards. In addition, the complacency in the equity markets (as signaled by the VIX) conflicts with the recent rise in gold prices. While gold is generally thought of as a barometer for inflation expectations, it is a better indicator, in my opinion, of fear and potential crisis. In addition, as pointed out last week, inflation expectations, as measured by the difference between the yield on the 10-year Treasury bond and 10-year Treasury Inflation Protected Securities (TIPS), have remained relatively muted at approximately 2%.

Earnings Summary. Despite the spotty nature of last week's earnings reports, overall third-quarter results are tracking at a much better than expected rate. As of Friday, 62 members of the S&P 500 have reported with 79% exceeding estimates, 9.7% meeting and 11.3% falling short. While it's still early in the quarter, overall results are up 6.6% on a year-over-year basis. To be fair, the results are being skewed by the easy year-over-year comparisons for the Financials sector (the sector's results are up 207% so far this quarter). When the Financials are extracted, earnings are off 9.2%, but are still ahead of the 20% loss forecast by analysts.

The Financials sector has posted big year-over-year gains, however, not all results are created equal. In fact, there is a real dichotomy occurring amongst bank earnings. Companies like Goldman Sachs, who have very little exposure to consumers, are "minting" money through their trading and risk taking operations. In contrast, commercial banks like Bank of America and Citigroup, who have significant exposure to consumers, are struggling. In other words, the fortunes of some are still generally masking the issues in the overall financial sector.

Interestingly, the Financials sector was the only sector last week to lose ground. The poor relative performance likely reflected the earnings conundrum and the fact that a lot of good news has already been priced into the group. Since the March lows, the S&P Financial sector has gained approximately 150%, almost 2.5 times better than the overall market, as measured by the S&P 500.

For the economic recovery and bull market to have sustainability, the restoration of overall health in the banking sector is a prerequisite, in my opinion. Not only do banks act as a transmission mechanism for the large amounts of fiscal stimulus pumped into the economy, but lending and liquidity are vital components (the grease, if you will) to keep the economic wheels of the economy turning. Despite the favorable yield curve that should be very conducive to lending, most banks are still reluctant to lend money due to fears of further financial stress.

Third-quarter earnings are being watched very closely to see if the uptick in economic activity over the past few months is beginning to filter through to the corporate space. The focus is clearly on revenue generation as opposed to cost cutting efforts as the primary source of earnings growth. Arguably, the strong rally we've had off the March lows was the market pricing out a Great Depression-like scenario and pricing in a more "normal" recession. The next leg of the market recovery will likely be investors pricing in a transition to an earnings fueled recovery. While the bottom-line numbers are exceeding analysts' projection, so far the top line results have not been as strong. According to Bloomberg, revenue growth is off 0.7% on a year-over-year basis and only 41% of companies have exceeded analysts' projections. While it's still early in the quarterly reporting season, the trend in revenue growth looks uninspiring.

Oil. Oil, as measured by the New York Mercantile Exchange (NYMEX) WTI Crude Futures, reached its highest level in over a year prompted by expectations of recovering demand due to the global economic recovery, a weak U.S. dollar and favorable inventory data. Last week, the Department of Energy reported that crude inventories during the week ended October 9 rose by 334K barrels versus consensus expectations of a 1million barrel build. In addition, gasoline inventories were reduced by 5.23 million barrels versus consensus expectations of a 1.1 million barrel build.

Economic Round-Up

Economic data continues to suggest the recovery remains intact. Last week the Labor Department reported that initial jobless claims during the week ended October 10 fell 10K to 514K, better than the 520K forecast by economists. First time claims now stand at the lowest level in nine months, hinting that the pickup in economic activity may be leading to a slowdown in the pace of firings. The closely watched 4-week moving average—which helps smooth the week-to-week volatility—fell to 531.5K and now stands at the lowest level since January 16 and well off the April peak of 658.75K. Continuing claims—the ongoing number of people collecting unemployment benefits—fell by 75K to 5992. Continuing claims remain in a steady downward trend and are well off the late-June peak of 6904K.

In addition, the Labor Department reported that inflation, as measured by the Consumer Price Index (CPI) during the month of September rose 0.2% while the "core" rate also advanced by 0.2%. On a year-over-year basis consumer prices are off 1.3% while the core rate advanced 1.5%. Inflation data generally remains muted, and therefore should allow the Federal Reserve Board (the "Fed") to keep interest rates low for the foreseeable future.

Inflation data, however, could start turning less accommodative over the course of the next several months reflecting the upturn in energy prices. Last year during the fourth quarter oil went from $98.00 in early October to just under $40 per barrel by the end of the year. The ascent in energy prices over the course of the past few months will likely begin to put upward pressure on the headline CPI. While the headline index may rise, the upward pressure will likely be blunted by the ongoing economic slack and rising unemployment rate, which will make it very difficult for manufacturer and retailers to pass along higher prices.

In a testament that inflation remains mild, it was announced last week that the annual cost of living adjustment (COLA) given to Social Security recipients would be nil this year reflecting the current negative rate of inflation. This was the first time since 1975, when COLA were adopted, that recipients did not receive a higher payout.

CEO confidence continues to increase. According to a survey of more than 100 business leaders by The Conference Board, confidence among CEO's rose for a third consecutive quarter. The growing optimism, according to The Conference Board should set the stage for an uptick in spending during 2010. This uptick in spending will likely coincide with the expected inventory restocking cycle and the massive injection of fiscal stimulus set to hit the economy early next year. Combined these forces should bode well for the sustainability and durability of the economic recovery.

Consumers, who account for over 70% of economic activity, may also be contributing to the recovery sooner than expected. Last week's initial jobless claims report showed the employment situation starting to improve, while retail sales during September fell at a much lower pace. According to the Commerce Department, retail sales during the month of September fell a less than expected 1.5% (consensus estimate was for a 2.1% decline) however, when auto sales were excluded, sales rose a better than expected 0.5%.

The report on retail sales also coincided with comments from Intel Corporation's CEO Paul Otellini, who stated that the upside in the quarter was "primarily consumer driven." While much of the economic recovery so far has been based on expectations that the early part of the recovery will be driven by a combination of corporate (inventory restocking) and government spending programs, at some point the consumer will need to take the reins.

Market Viewpoint

Maintain Positive 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

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 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.

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 of 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.

New York Mercantile Exchange (NYMEX) WTI Crude Futures - Crude oil is the world's most actively traded commodity, and the NYMEX Division light, sweet crude oil futures contract is the world's most liquid forum for crude oil trading, as well as the world's largest-volume futures contract trading on a physical commodity. The contract trades in units of 1,000 barrels, and the delivery point is Cushing, Oklahoma, which is also accessible to the international spot markets via pipelines. The contract provides for delivery of several grades of domestic and internationally traded foreign crudes, and serves the diverse needs of the physical market.

The Consumer Price Indexes (CPI) is measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

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.

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