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Weekly Viewpoint



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Earnings on Q2 Tap

A CATALYST OR A CATASTROPHE?

WEEK IN REVIEW

7/5/2010 – 7/9/2010

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Performance for Week Ending 7/9/2010

The Dow Jones Industrial Average (Dow) added 5.28%, the Wilshire 5000 Total Market IndexSM (Wilshire 5000SM) rose 5.37%, the Standard & Poor's 500 Index (S&P 500) gained 5.41% and the Nasdaq Composite Index (Nasdaq) tacked on 5.00%. Sector breadth was positive as all 10 of the S&P sector groups finished higher. The Materials sector (+8.03%) was the best performing while Telecom (+1.82%) was the laggard. The Canadian market, as measured by the S&P/TSX Composite Index, added 3.34%.

Index*	Closing Price 7/9/2010	Percentage Change for Week Ending 7/9/2010	Year-to-Date Percentage Change Through 7/9/2010
Dow	10197.72	+5.28% ▲	-2.21% ▼
Wilshire 5000	11118.67	+5.37% ▲	-2.66% ▼
S&P 500	1077.93	+5.41% ▲	-3.33% ▼
Nasdaq	2196.45	+5.00% ▲	-3.20% ▼
S&P/TSX Composite	11570.45	+3.34% ▲	-1.50% ▼

*See Last Page for Index Definitions.

Market Observations: 7/5/2010 – 7/9/2010

The major market indices finished the week solidly higher on optimism that the recent market weakness may have over discounted the likelihood of a double-dip recession. Admittedly the recent economic data has been disappointing, although it appears, in my opinion, to be more of a "soft patch" than a screeching halt in economic growth. In addition, double-dip recessions are very rare. According to Strategas Research, once an expansion begins it is usually long-lasting, with the average expansionary phase (post World War II) lasting approximately 58 months. I believe the recent data is a reminder that the road to recovery is never a straight line and speed bumps and potholes will be present along the way.

While it may be too early to call this a renewal of the bull market, the recent rebound has pushed the markets back above important resistance levels. With that said, I will continue to consider myself a “nervous” bull until the market moves back above the 200 day trend line (approximately 1111 for the S&P 500).

Adding to the positive sentiment were reduced concerns over the financial health of Europe. If we are to look at a country’s currency as a proxy for its economic health and fiscal policies, then the fact that the euro has rebounded to a six-week high is likely an indication that investors are becoming more comfortable with the sovereign debt issues in the eurozone. While the problems have far from disappeared, the developments, at worst, seem to be stabilizing.

Double-dip fears were also allayed somewhat after the International Monetary Fund (IMF) raised its global growth prospects for 2010, although to be fair, it also warned that the financial market turmoil has increased the risks to the recovery. The IMF now sees the global economy growing at a 4.6% rate up from its prior estimate of 4.2%. The IMF also raised its expected growth rate for the United States to 3.3% from 3.1%.

Earnings Season on Tap. Second quarter earnings season kicks off in earnest this week. With the recent decline in the markets, investor sentiment has generally soured and expectations have been reeled in. This, coupled with attractive valuation levels, could potentially set the stage for an earnings-induced rally, in my opinion. According to Bloomberg data, second-quarter earnings are expected to be up a robust 34%, although traders will likely focus on forward guidance and look for clues as to whether the problems in Europe are filtering through to corporate bottom lines.

In addition to the forward-looking guidance from company management, investors also appear to be waiting for the outcome of the “stress tests” being performed on 91 European banking institutions. The test results are due out later this month and are expected to shed light on the health of the European banking system.

Corrections are Normal and Healthy. After gaining almost 80% from the March 2009 low to the recent peak in late-April, the S&P 500 had pulled back by as much as 15%. The weakness has been prompted by softness in economic data, coupled with external uncertainties such as the oil spill in the Gulf, geopolitical tension, and European debt issues, among others. While corrective phases are nerve wracking, they also tend to serve a purpose, in that they act as a mechanism to filter out the “weak holders” and allow for shares to be repositioned to longer-term investors at more attractive price points.

It is also comforting that the correction is occurring at a time when inflation is subdued, interest rates are very low, valuation levels are attractive and sentiment levels have turned very bearish. On the last point, the American Association of Individual Investors (AAII) recently reported that the percent of investors who are bullish on the market’s outlook over the next six months had fallen to 20.9%, this is the lowest reading since March 5, 2009 when bullish sentiment fell to 18.9%. Remember in its simplest form investment decisions are made with emotions—fear and greed. Investors tend to be overly greedy at market tops and the very fearful at market bottoms. Emotional investing also tends to be contrarian in nature. To quote Warren Buffet, “We simply attempt to be fearful when others are greedy and

to be greedy only when others are fearful.” In other words, the best time to buy is when negative sentiment is near extremes.

Jobless Claims – Less Bad. Last week’s economic calendar was very light and the data that was released was generally mixed. On the jobs front, the Labor Department reported that initial jobless claims during the week ended July 3 fell 21K to 454K. The report was slightly better than the 460K expected by economists. The 4-week moving average—which helps smooth the week-to-week volatility—fell to 466K but remains just off the highest level since early March. Continuing claims—the ongoing number of people collecting unemployment benefits—fell by 224K to 4413K and now stands at the lowest level since November 2008. Meanwhile, The Conference Board reported that its Employment Trends Index (ETI) rose 0.6 to 96.7, the highest level since November 2008. Additionally, the prior month’s reading was upwardly revised to 96.1 from 95.7. The June increase was the 11th in a row, suggesting a gradual improvement in labor market conditions.

Technicals. Technicals were also likely at work as the S&P 500 broke through the 1040/44 resistance area and the Dow moved back above the psychologically important 10K level. While I think it is still too early to pass the baton back to the bulls, the near-term momentum has definitely taken on a more positive tone.

Looking Ahead. The beginning of the second quarter earnings season features Dow-component Alcoa scheduled to report results after-the-close on Monday. This week a total of 23 members of the S&P 500 are scheduled to report results followed by 131 members the following week. The economic calendar also heats up with reports on retail sales, regional manufacturing and consumer and producer inflation. Also of interest will be the vote on financial regulatory reform. The passage of reform would help remove the regulatory uncertainty and allow Wall Street to figure out how to work within the new rule structure.

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 the durability of the 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, average growth (+3.5%) over the past three quarters is 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 \$2.8 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 12.4 times earnings.
- E.** Interest rates are low and the Federal Reserve 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.

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 16% 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 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 AAIL (American Association of Individual Investors) is a non-profit organization headquartered in Chicago, and was founded in 1978. The AAIL’s stated mission: “assisting individuals in becoming effective managers of their own assets through programs of education, information, and research.”

The AAIL sentiment survey is a weekly poll conducted by the organization which intends to gauge the overall sentiment of their membership. Individual members are asked where they think the market will be in six months and the responses are grouped into three categories: bullish, bearish or neutral.

The Conference Board Employment Trend IndexTM (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.

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