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Weekly Viewpoint



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Focus Shifting to Earnings

WEEK IN REVIEW

1/11/2010 – 1/15/2010

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Performance for Week Ending 1/15/2010

The Dow Jones Industrial Average (Dow) lost 0.1%, the Standard & Poor's 500 Index (S&P 500) fell 0.8% and the Nasdaq Composite Index (Nasdaq) shed 1.3%. Sector breadth was negative as seven of the 10 S&P sector groups finished lower. The Health Care sector (+1.5%) was the best performing while Telecom (-4%) was the worst. The Canadian market, as measured by the S&P/TSX Composite Index, lost 2.3%.

Index*	Closing Price 1/15/2010	Percentage Change for Week Ending 1/15/2010	Year-to-Date Percentage Change Through 1/15/2010
Dow	10609.65	-0.08% ▼	+1.74% ▲
S&P 500	1136.03	-0.78% ▼	+1.88% ▲
Nasdaq	2287.99	-1.26% ▼	+0.83% ▲
S&P/TSX Composite	11685.37	-2.25% ▼	-0.52% ▼

*See Last Page for Index Definitions.

Market Observations: 1/11/2010 – 1/15/2010

Spotty economic data and jitters over fourth quarter earnings reports left the major market indices with modest losses for the week. Concerns over the strength of the global economic recovery also weighed on commodities and commodity-related sectors.

Last week kicked off the unofficial start to earnings season with the quarterly earnings update from Dow-component Alcoa. While the company managed to report its first year-over-year profit in nine quarters, results fell short of analysts' expectations. This week approximately 65 members of the S&P 500 are scheduled to report.

Despite last week's modest sell-off, the January barometer remains skewed towards positive full-year performance. January performance tends to be watched closely as it has often been a precursor to full-year performance. According to the *Stock Trader's Almanac*, since 1950, January performance has predicted full-year performance 90% of the time. Last year was one of only six exceptions where the indicator proved wrong, i.e. the S&P fell 8.6% in January but finished the year up over 23%.

Focus Shifting to Earnings. The market has, in my opinion, priced in a sustainable (albeit still fragile) economic recovery and will begin to shift focus to whether the recovery has started to carry through to corporate profitability. Expectations for the quarter are relatively high reflecting the rebounding economy and the large amounts of operating leverage built into companies. According to Bloomberg data, Wall Street analysts are expecting fourth-quarter earnings for the S&P 500 to grow by 67% on a year-over-year basis. This would be the first positive year-over-year growth in nine quarters. Investors are likely to keep a close eye on the makeup of quarterly results looking for signs that the economic recovery is starting to have a positive impact on revenue/sales growth. While it's still very early in the reporting season (only 6% of the S&P 500 has reported), revenues are up 7.0%.

Fourth Quarter Earnings Summary. While it is still early in the reporting season, results are looking very encouraging. As of Friday, 30 members of the S&P 500 have reported with 86.7% exceeding estimates, 3.3% meeting and 10% falling short. With 6% of results reported, overall earnings on a share-weighted basis are up 127% on a year-over-year basis significantly outpacing the combined 67% gain forecast by the Bloomberg consensus estimate. The better than expected results; however, were skewed by strong results in the Financials sector. When the Financials sector is excluded, overall earnings are up 59%.

Economic Fits and Starts. Last week saw a compilation of economic reports that showed the economy remains in recovery; however, the recovery will likely be uneven. The employment situation continues to slowly improve. The Labor Department reported that initial jobless claims during the week ended January 9 rose 11K to 444K. Results were slightly higher than the 437K forecast by economists. However, the closely watched 4-week moving average—which helps smooth the week-to-week volatility—fell to 440.8K, the lowest level since August 2008. Continuing claims—the ongoing number of people collecting unemployment benefits—fell 211K to 4596K. Continuing claims are now at their lowest level in over a year. Meanwhile, the Commerce Department reported Retail Sales, during the month of December, unexpectedly fell 0.3% versus the 0.5% gain expected by economists. “Core” retail sales (excludes autos and gasoline) fell 0.3%, which was also below expectations. The report breaks a two-month string of gains and highlights that the recovery in consumer spending will likely come in fits and starts.

Energy Costs on the Rise? The price of oil fell 5.7% after four consecutive weeks of gains. The pullback appeared to be a reflection of global economic jitters coupled with weaker than expected demand trends. This was evident in last week's Department of Energy weekly inventory report. The inventory data showed a much larger than expected build in crude and gasoline inventories. Crude inventories rose by 3.7M barrels versus consensus expectations of a 1M-barrel build. Gasoline inventories showed a 3.8M build versus the consensus estimate of a 1M-barrel rise. The report likely signaled that demand trends may not be in synch with the almost 20% rise in crude prices during the prior four weeks. The recent rise in crude prices has pushed gasoline prices to levels last seen in late-October 2008. According to the American Automobile Association the national average price of regular unleaded gasoline averaged \$2.75 per gallon last week.

Market Viewpoint – 2010 Outlook

While the 2008/2009 period will be a time that many investors will never forget, I believe 2010 will be a forgetful year, relatively speaking. This year will likely be characterized by the ongoing march to “normal” as both the economy and markets continue to stabilize.

While the healing of the economy is well underway, the rehabilitation process is not as advanced. The markets and economy will continue to face headwinds over the next 12 months including an elevated rate of unemployment and the still feeble housing recovery—the epicenter of the problems over the past two years. Despite the solid gains posted since last March, I continue to believe that additional upside is likely over the next 12 months. While the “easy money” in the markets has been made and the pace of gains will likely slow, the combination of low interest rates, an expected turn in the corporate earnings cycle and the building economic recovery, likely means the bull market rally has further room to run.

In addition, bull market rallies rarely end at the early stages of a recovery in corporate profits. The markets generally mirror what is happening in the corporate world. After nine consecutive quarters of negative year over year earnings growth, consensus expectations are for S&P 500 earnings growth to turn positive in the still to be reported fourth quarter.

While I continue to believe the economy is currently in the process of transitioning from recession to recovery, the process rarely happens in a straight line and potholes are almost always present on the road to recovery. With that said, the economy should continue to move forward reflecting the large injection of stimulus spending due to hit the economy early in the new year. Additionally, the expectations of corporate inventory restocking to replenish bare bone inventory levels.

As Sir John Templeton said, “Bull markets are born in despair, grow amid skepticism, mature in optimism and die on euphoria.” The rally off the March lows has generally been met with high levels of skepticism and doubts about its sustainability. In addition, the mood among investors generally remains noncommittal (as witnessed by the elevated levels of cash on the sidelines and anecdotal evidence that large investors have been generally underweight their equity benchmarks). Paradoxically, with market risks skewed to the upside, the large cash weightings and below benchmark exposure to equities should buffer the downside risk and could provide significant “fire power” with improving macro considerations. In addition, “performance anxiety” amongst portfolio managers, in light of a trending market, could prompt skeptics and fence sitters to reenter the markets.

1250 Target. 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 revert back to its long-term mean of 16.6x (uses the 10-year rolling earnings since 1920) and 2010 earnings will expand to the \$75.50 (as being forecast by S&P). From the current price of around 1100, the move to 1250 would equate to approximately a 10% return.

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. The combination 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. outcome of mid-term elections, geopolitical events, etc.), potential speed bumps may crop up along the way. While at this point in time, 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 the ability to peak 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 that are 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 6 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.

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.

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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