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Weekly Viewpoint



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Market Braces for Third Quarter Earnings

WEEK IN REVIEW

10/5/09 – 10/9/09

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Performance for Week Ending 10/9/09

The Dow Jones Industrial Average (Dow) added 3.98%, the Standard & Poor's 500 Index (S&P 500) rose 4.5% and the Nasdaq Composite Index (Nasdaq) tacked on 4.45%. Sector breadth was positive as nine of the 10 S&P sector groups finished higher. The Energy (+7.5%) sector was the best performing sector while Telecom (-2.5%) was the worst. The Canadian market, as measured by the S&P/TSX Composite Index, added 4.4%.

Index*	Closing Price 10/9/09	Percentage Change for Week Ending 10/9/09	Year-to-Date Percentage Change Through 10/9/09
Dow	9864.94	+3.98% ▲	+12.40% ▲
S&P 500	1071.49	+4.51% ▲	+18.63% ▲
Nasdaq	2139.28	+4.45% ▲	+35.65% ▲
S&P/TSX Composite	11436.92	+4.37% ▲	+27.25% ▲

*See Last Page for Index Definitions.

Market Observations: 10/5/09 – 10/9/09

After two consecutive weeks of losses, the major market indices posted strong gains that left the S&P 500 just shy of its recent cycle highs. Renewed optimism that the global economic recovery is intact along with a growing wave of confidence that third-quarter earnings could surprise to the upside, seemed to be the driving force behind last week's gains.

Short and Shallow. In last week's *Viewpoint*, I raised the question of whether the 4%-plus pullback that occurred in the prior two weeks was enough to bring the "buy the dip" crowd back into the market. As mentioned, since late May, the S&P 500 has posted five corrections that have ranged from 3% to 5%. While these pullbacks have been shallow in nature, they have been enough to draw fresh money back into the market. As it turns out, the recent dip was enough to bring investors back into the market as performance anxiety amongst portfolio managers seemed to spark a "fear of missing the next up leg" rally.

Economic Data Inspires Optimism. While last week's economic calendar was relatively light, the data that was reported gave investors renewed confidence that the recovery, while still fragile, remains intact. The health of consumers and their ability to spend was given a boost after reports on retail sales and jobless claims pacified nervous investors. Last week the International Council of Shopping Centers (ICSC) monthly sales tally showed that consumer spending may finally be starting to gather steam as last month, retailers saw their first sales gains in more than a year. According to the ICSC, sales at major retailers showed an increase of 0.1% for September, compared with a 1.0% drop a year ago. While still tepid, it was the first monthly gain since July 2008. Investor sentiment was also bolstered by a better than expected reading on the labor market. The Labor Department reported that new claims for jobless benefits fell to 521K, down from 554K during the prior week and better than the 540K expected by economists. Initial claims now stand at the lowest level since early January. With approximately 70% of U.S. economic growth driven by consumer consumption, the ICSC report and jobless claims were viewed in a very favorable light.

Also of importance was the fact that the Institute for Supply Management's (ISM) Non-Manufacturing (services) Index showed expansion for the first time in over a year. The report was well received as service-oriented businesses dominate the U.S. economy. The move to expansion coincides with the ISM Manufacturing Index moving to expansion mode two months ago.

Third Quarter Earnings Off to a Solid Start. The third quarter earnings season got off to a solid start after Dow component Alcoa beat analysts' estimates on both the top and bottom lines. The upbeat report sets a favorable tone for the quarter, however, it's noteworthy to point out that the bulk of quarterly reports won't be released for another two weeks. Analysts have been reluctant to notch up Q3 earnings estimates for the S&P 500 due to the wobbly nature of recent economic data and this will likely leave room for upside surprises, in my opinion. 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.

Housing Affordability Continues to Improve. Housing affordability is measured by the combination of housing prices and financing costs. The stability in the housing markets over the past several months has been prompted by the near-record high in affordability coupled with the \$8K first time home buyers credit. Last week, financing costs continued their downward trend. As reported by Freddie Mac, the average rate for a 30-year fixed mortgage fell to 4.87% from 4.94% in the prior week. This decline resulted in a surge in mortgage applications. The Mortgage Bankers Association reported that mortgage applications in the week ended October 2 rose by 16.4%, led by an 18.2% jump in refinancing activity. Purchase activity also rose by a solid 13.2%. Also, last week there was continued talk of additional stimulus being added to the economy, including an extension of the \$8K tax credit, currently set to expire at the end of November.

Gold Shines. Last week the price of gold hit an all time closing high of \$1055.40 per ounce before finishing the week at \$1047.80 per ounce. While weakness in the dollar and growing fears over a potential uptick in inflation were the primary explanation, I believe

the gains were partially caused by portfolio managers chasing the strong momentum, i.e. "buying begets buying." In addition, 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 stable at approximately 1.90%. Another potential explanation that may have had a favorable impact on gold prices was a news report that stated a consortium of countries was looking for an alternative currency in which to price oil. Currently oil is priced in U.S. dollars and the weakness and instability of the dollar has oil-producing countries searching for an alternative. Floated last week was the creation of a new benchmark which would include a blend of currencies and may even include a benchmarking to the price of gold. Also attracting investors to the yellow metal is the perception that gold is cheap on an inflation-adjusted basis, while stocks look "rich" in terms of valuation. While gold is trading at a new high in nominal terms, when adjusted for inflation it is still well below levels reached in 1980.

Dollar Remains Volatile. Trading in the U.S. dollar has been volatile with the overall trend skewed lower. The dollar did manage to bounce higher mid week after comments favorable to a strengthening dollar were made by Federal Reserve Chairman Bernanke. Mr. Bernanke addressed the Federal Reserve Board (the "Fed") conference in Washington and said the central bank will be prepared to tighten when the economic outlook "has improved sufficiently." Higher rates would likely curb the exodus from the dollar and make returns on dollar denominated investment more attractive. Bernanke's remarks follow similar comments over the past couple weeks by other Fed members including Kansas City Fed President Thomas Hoenig. Mr. Hoenig made generally hawkish comments about removing stimulus from the system "sooner, rather than later." While higher rates don't appear to be in the cards any time soon, I believe the verbal "jawboning" by Fed officials is a veiled attempt to curtail weakness in the dollar and support the government's "strong dollar" stance.

With that said, the fact that there has been little intervention to support the dollar may be more telling. The Fed has cut rates to zero, pumped trillions of dollars of stimulus into the economy, and has little to show for it (e.g. the unemployment continues to trend higher, etc). One of the last tricks left in their bag is to intentionally let the dollar devalue as dollar devaluation generally leads to asset price inflation. Since the beginning of the year, the U.S. Dollar Index and the S&P 500 have developed a strong inverse correlation. In other words, what's good for the dollar has generally been bad for stocks. and a weaker dollar would jump start exports and stem the negative impact of deflation. While not a win-win scenario in the near term, I believe dollar weakness may be their preferred route although I wouldn't expect any government officials to formally announce this strategy.

Market Viewpoint

Maintain Positive Outlook. While my bias is for the market to continue on an upward trajectory over the intermediate term, the most likely path for the markets in the near term will be a choppy, sideways range. With that said, I think March 9 represents the market's low. 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 will provide a downside buffer, in my opinion. In other words, any pullback in the market will likely be short and shallow.

Stocks will likely resume an upward tendency with the emergence of further signs of economic stability, in my opinion. This includes signs that banks are making progress in ridding their balance sheets of "toxic assets," further stabilization in the job market, and a continuation of economic progress.

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.

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 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 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 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.

U.S. Dollar Index (USDX) is a measure of the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

Currently, this index is calculated by factoring in the exchange rates of six major world currencies: the euro, Japanese yen, Canadian dollar, British pound, Swedish krona and Swiss franc. This index started in 1973 with a base of 100 and is relative to this base. This means that a value of 120 would suggest that the U.S. dollar experience a 20% increase in value over the time period.

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.

The individual companies mentioned in this piece were for informational purposes only and should not be viewed as recommendations.

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