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Mike Schwager, Chief Market Strategist

Weekly Viewpoint



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Market Inches Higher as Fears of a Double Dip Fade

WEEK IN REVIEW

8/2/2010 – 8/6/2010

The major market indices finished the week moderately higher on growing confidence a double-dip recession has been averted.

Performance for Week Ending 8/6/2010

The Dow Jones Industrial Average (Dow) added 1.79%, the Wilshire 5000 Total Market IndexSM (Wilshire 5000SM) rose 1.67%, the Standard & Poor's 500 Index (S&P 500) gained 1.82% and the Nasdaq Composite Index (Nasdaq) tacked on 1.5%. Sector breadth was positive as all 10 of the S&P sector groups finished higher. The Health Care sector (+3.97%) was the best performing while Financials (+0.48%) was the laggard. The Canadian market, as measured by the S&P/TSX Composite Index, added 0.61%.

Index*	Closing Price 8/6/2010	Percentage Change for Week Ending 8/6/2010	Year-to-Date Percentage Change Through 8/6/2010
Dow	10653.56	+1.79%▲	+2.16%▲
Wilshire 5000	11568.38	+1.67%▲	+1.28%▲
S&P 500	1121.64	+1.82%▲	+0.59%▲
Nasdaq	2288.47	+1.50%▲	+0.85%▲
S&P/TSX Composite	11799.97	+0.61%▲	+0.46%▲

*See Last Page for Index Definitions.

Market Observations: 8/2/2010 – 8/6/2010

The major market indices finished the week moderately higher. The markets have been in an upward trend since early July on fading fears of a double-dip recession. In addition, concerns over the fate of the euro zone continue to diminish following a series of favorable economic data points and better performance amongst the major European markets. The German DAX Index, for example, hit a new 52-week high on Thursday.

Also likely confirming that the global recovery is starting to regain traction, is commodity prices have begun to move higher. Since July 1, Oil has gained almost 11% while Copper has tacked on more than 16%.

Although headwinds and uncertainties remain—i.e. the debate over inflation vs. deflation, the political landscape, the impact of regulation, outlook for monetary/fiscal policy—they are, in my opinion, currently being countered with renewed global growth, strong corporate balance sheets, and a turn in the corporate profitability cycle. With that said, the bond market, as witnessed by the sub-3% yield on the 10-year Treasury, is telling us that the recovery remains fragile and deflation is likely a bigger threat than inflation.

Employment Situation

On Friday the Labor Department reported that non-farm payrolls during July fell 131K, well below the 65K decline forecast by economists. The headline number included the loss of 143K Census-related jobs. Private payrolls (which filter out government hiring/firing) rose by 71K, but fell short of the 90K expected by economists. The unemployment rate held steady at an elevated 9.5% rate. On a positive note, both average hourly earnings and the average work week ticked up slightly.

Heading into the payroll report, uncertainty over the outcome was very high as a result of a mixed bag of jobs-related data earlier in the week. On the positive side, a report from the Institute for Supply Management (ISM) showed employment in the services sector (which represents the bulk of jobs in the U.S.) expanding for the second time since late-2007. In addition, the ADP payroll data estimated that corporations added 42K jobs during the month of July following the upwardly revised 19K gain in June. On the flipside and challenging the favorable data was the weekly initial jobless claims report that showed claims rising to the highest level (479K) since early April.

Employment, in my opinion, will continue to be a major headwind for the U.S. economic recovery. The jobs report seems to be a confirmation of slower economic growth in the months ahead as indicated by the recently released gross domestic product (GDP) report. Despite the fact that corporate balance sheets are flush with cash, hiring has been generally muted reflecting political, economic and regulatory uncertainty. Unfortunately, clarity on all fronts still appears elusive.

FOMC Meeting on Tap

The focal point of the upcoming week will be Tuesday's meeting of the Federal Open Market Committee (FOMC). While no change in interest rate policy is expected, the focus will be on how the Fed plans to combat the threat of deflation and jumpstart the flagging economy. The debate will likely center on whether the Federal Reserve (the "Fed") should be preemptive (act now) or reactive (wait a few more months to see how the numbers pan out). Friday's weaker than expected payroll report could be the 'game changer' as it will likely put pressure on the Fed to act sooner rather than later or at a minimum telegraph a plan of attack. In addition, the weak jobs report will also likely result in a more guarded assessment of the economy in the after meeting communiqué.

Slowing Economy Likely Discounted...

Since troughing in early July, the S&P has tacked on over 9%, as the fiscal troubles in Europe have faded and the likelihood of a second half slowdown in the U.S. economic recovery (but no double-dip) has morphed in to the consensus view. With that in mind, I continue to believe the economic recovery should be viewed in the context of a slow expansion versus a pending contraction.

Last week, the Institute for Supply Management reported that its non-manufacturing (services) index rose for a seventh consecutive month. This is key as service-oriented businesses account for the bulk of the U.S. economy. Importantly, the new orders component showed impressive growth and the employment component moved to expansionary levels for only the second time since late-2007. While the early stages of the recovery were fueled by a rebound in the manufacturing sector, the handoff to the services component of the economy appears to be underway.

Also of note, last week the Association of American Railroads reported that total carloads at the end of July hit 300,292—a 9.4% year-over-year gain and the highest level since November 2008. This is generally a measure of raw materials and other "stuff" being shipped to factories for the production of goods. The indicator, which happens to be closely followed by investment guru Warren Buffet, is viewed as a good barometer of demand for future production.

..But Caution Remains.

Treasury bond yields remain at or near-record lows as a cautious tone continue to overhang the investment environment. During times of uncertainty, investors tend to flock to the U.S. Treasury bonds due to their backing by the U.S. government. The low level of yields are at least partially explained by the expectations that the Fed will hold rates steady for the foreseeable future and that inflationary pressures are very subdued. However, the ongoing appetite for these low-yielding investments also likely signals that investors remain concerned about capital preservation versus capital appreciation. As Mark Twain once said "I'm more concerned about the return 'of' my money than the return 'on' my money."

The cautious tone is also evident in the money market arena. Despite the recent rebound in the equity markets, cash sitting in money market mutual funds has expanded by \$26 billion over the past two weeks, the first back-to-back gains this year.

Investor Sentiment

Bears remain overwhelmingly at the forefront of investor sentiment measures. According to the American Association of Individual Investors (AAII) only 30.4% of members polled are positive on the markets outlook over the next three to six months. This is also evident in the Ned Davis Crowd Sentiment Poll that shows investors remain extremely pessimistic. Sentiment measures tend to be contrarian in nature, meaning investors are typically the most pessimistic at or near market bottoms and the most optimistic at/near market tops. This reminds me of an old Wall Street adage, "The market exists to frustrate the majority, and reward the minority."

Q2 Earnings Summary

As of Friday, 443 members of the S&P 500 have reported quarterly results, with overall earnings up 52.5% on a year-over-year basis. More than 76% of the companies have beaten analyst expectations while only 15% have fallen short. The “beat” rate is significantly better than the historical 61% average. Revenues are up 9.5% in the quarter. Overall quarterly results are being fueled by the Materials, Financials and Consumer Discretionary sectors. When all is said and done, second quarter earnings for the S&P 500, according to Bloomberg data, are expected to rise 48.6%.

Looking Ahead

Earnings season continues to wind down with only 17 members of the S&P 500 scheduled to report this week. The calendar will contain a heavy concentration of retailers including results from Macy’s, Kohl’s, Nordstrom and JC Penney. This week’s economic calendar will be back-end loaded with reports on consumer inflation, retail sales and consumer confidence all due out on Friday.

Market Outlook

After gaining almost 80% from the March 2009 low to the recent peak in late-April, the market appears to be caught in a “price discovery” process as investors digest the gains and try to gauge what is discounted in stock prices and what is coming to the fruition.

While these “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.

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 four 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 economic growth is likely to remain positive and fears of a double dip seem overdone.
- 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 third 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 \$92/share, the S&P 500 is selling at only 12 times earnings.

E. Interest rates are low and the Fed is likely to remain on hold through at least mid-2011. Maintaining a low rate policy is a two pronged strategy. On one hand it makes the COST of money low and therefore encourages borrowing/spending. On the other hand, it make the RETURN on money very low and therefore discourages holding low yielding (cash) vehicles in lieu of risk assets (stocks, corporate bonds, commodities, etc).

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 17 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 rebound in earnings growth and the belief that the economic growth will have a positive skew, I believe the S&P 500 has upside potential to at least 1250. With that in mind, I believe targets should be looked at as more of a directional bias than an absolute call on valuation.

The bullish outlook becomes a little trickier as I look out over the next couple of years. 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-averse 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 Deutscher Aktien Index or DAX Index is a stock index that represents 30 of the largest and most liquid German companies that trade on the Frankfurt Exchange. The prices are taken from Xetra, an electronic trading system. A free-float methodology is used to calculate the index weightings along with a measure of average trading volume. DAX member companies represent approximately 75% of the aggregate market cap that trades on the Frankfurt Exchange.

Institute for Supply Management (ISM) Non-Manufacturing Index (or Services 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.

Automatic Data Processing (ADP) is one of the world's largest providers of business outsourcing solutions including HR, payroll, tax and benefits administration.

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.

Ned Davis Research Crowd Sentiment Poll is an indicator that aggregates several different sentiment indicators. It can help in anticipating reversals in investor psychology, and thus stock prices, going forward. Ned Davis Research is an independent research provider and investment advisor.

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CLAYMORE®

A GUGGENHEIM PARTNERS COMPANY

Claymore Investments, Inc.
200 University Avenue, 13th Floor
Toronto, Ontario M5H 3C6

866-417-4640
www.claymoreinvestments.ca