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# Weekly Viewpoint



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## Rally Exhaustion or Pause to Refresh?

### WEEK IN REVIEW

10/19/09 – 10/30/09

The major market indices finished lower for a second straight week on fears the strength of the economic recovery may be over discounted in stock prices.

### Performance for Week Ending 10/30/09

The Dow Jones Industrial Average (Dow) lost 2.6%, the Standard & Poor's 500 Index (S&P 500) fell 4% and the Nasdaq Composite Index (Nasdaq) 5.1%. Sector breadth was negative as all 10 of the S&P sector groups finished lower. The Materials (-7.1%) sector was the worst performing while Telecoms (-0.08%) was the best. The Canadian market, as measured by the S&P/TSX Composite Index, lost 4.1%.

Index*	Closing Price 10/30/09	Percentage Change for Week Ending 10/30/09	Year-to-Date Percentage Change Through 10/30/09
Dow	9712.73	-2.60% ▼	+10.67% ▲
S&P 500	1036.19	-4.02% ▼	+14.72% ▲
Nasdaq	2045.11	-5.08% ▼	+29.68% ▲
S&P/TSX Composite	10910.75	-4.14% ▼	+21.40% ▲

\*See Last Page for Index Definitions.

### Market Observations: 10/26/09 – 10/30/09

The major market indices finished lower for a second straight week despite better than expected third quarter earnings trends and signs the economy has exited from the recession. The failure to post gains in light of upbeat data signals, in my opinion, that the good news has already been discounted in stock prices, and the ongoing rebound in the markets may be suffering from "rally exhaustion."

The markets seem to be locked in a period of "price discovery" as traders try to gauge what is discounted in the market and what is coming to fore. Last week's sell-off was global in nature as witnessed by the 4.1% loss in the MSCI World Index.

While demand for equities wilted, demand for "safe-haven" assets like U.S. Treasuries and the dollar bloomed. Since Monday October 19, the S&P 500 has lost over 5.6%. Looking at periods of weakness in the S&P 500 since late May shows five other pullbacks that ranged from 3% to just over 5%. While generally shallow in nature, these pullbacks have been enough to draw

fresh money back into the market. The current uncertainty is whether the sell-off over the past two weeks will be enough to bring the “buy the dip” crowd back into the markets.

**Pullbacks Are Healthy.** Bull market rallies—such as the one we have been in since early March—often experience short-term setbacks. These pullbacks, in my opinion, are healthy as they help filter out the excesses that get built into stock prices (i.e. they provide a reality check) and often help set the stage higher for the next move. As mentioned in the *Viewpoint* during the past few weeks, the markets had been overbought and were in desperate need of a consolidation phase. These periods tend to act as a “pause to refresh” resulting from profit taking and reshuffling of assets within portfolios and not necessarily the start of a sharper correction.

**Recession “Unofficially” Ends...** After contracting for four consecutive quarters, the Commerce Department reported that the U.S. economy expanded by 3.5% in the third quarter. The pace of growth was the best seen since the third quarter of 2007 and exceeded the 50-year average of 3.2%. While the return to expansion likely marks the “unofficial” end of the recession, the official announcement from the National Bureau of Economic Research (NBER) dating committee could still be several months off. Economic data is generally subject to revisions, and the committee has historically waited for the revised data to be presented before making any official declarations.

Despite the rebound in the economy, the ongoing pace of the recovery is expected to be muted. Consumers, who drive almost 70% of economic activity, still face many headwinds and generally appear reluctant to spend. The negative sentiment amongst consumers likely reflects the high levels of unemployment and net worth compression over the past two years. While a pickup in consumer expenditures was a driving force behind the solid third quarter Gross Domestic Product (GDP) report, the recovery, at this juncture, remains heavily influenced by government stimulus. In particular, the surge in spending reflected strong auto sales from the Cash for Clunkers program and Home Sales enticed by the \$8k first time home buyers tax credit.

**...But Continued Gloom Likely.** While statistically the recession may have ended, the feeling of gloom amongst the average citizen will likely persist for the foreseeable future. This was evident in last week's consumer confidence survey. The Conference Board reported that consumer confidence fell to 47.7 in October, well short of economists' expectations for a rise to 53.5. In general, consumer confidence readings tend to be impacted by the trend in gasoline prices. Last week, the American Automobile Association reported that gasoline prices hit their highest level since the summer peak reached in early June. Gasoline prices tend to be very visible and a rise in prices is felt almost immediately. The uptick in prices could create another potential headwind for the consumer heading into the holiday season.

**Housing Recovery Stalling?** New Home Sales fell 3.6% during September to an annualized pace of 402,000 units. The results fell short of the 440,000 units expected by economists and mark the first month-over-month decline since March. Adding fuel to the fire was a report from the Mortgage Bankers Association that showed mortgage applications in the week ended October 23 fell by 12.3%. Both the refinancing (-16.2%) and the purchase (-5.2%) components contributed to the weakness. This was the third consecutive week of decline, and likely reflected the recent rise in borrowing costs and uncertainty surrounding the first time home buyers tax credit.

The housing market may get some additional relief after a group of senators last week voiced support for extending and expanding the \$8,000 home buyer tax credit. While still subject to vote, the proposal is to extend the current program through April of next year. In addition, income limits would be raised to give higher income earners a chance to participate. The program would also be opened up to current homeowners who have occupied their current residence for at least five years. This group would become eligible to receive a \$6,500 tax credit if they purchase a new primary residence.

**Third-Quarter Earnings.** As of Friday, 344 members of the S&P 500 have reported with 81% exceeding estimates, 6.4% meeting and 12.5% falling short. With almost 70% of results reported, overall earnings are now off by 21.1% on a year-over-year basis. The better than expected trend has forced analysts to upwardly revise their estimated growth rate for the overall quarter. When all reports are in, analysts now expect earnings to decline by 15.2% versus a 22.3% loss forecast in early September.

Investing tends to be a world where expectations set the tone of trading. Reality tells us that the third quarter is on track to be the ninth quarter in a row where earnings have contracted. According to Bloomberg data, this streak is expected to end in the fourth quarter, where earnings are currently projected to grow by 68.2%.

**Sentiment.** Each week the American Association for Individual Investors (AAI) polls their members and asks their opinion about the market's direction over the next six months (Bullish, Neutral or Bearish). This week the percent of investors who consider themselves Bearish to Neutral rose to 66.35%. This reading is the highest level reached since mid-July and coincides with the end of the sideways trading range (corrective phase) that developed in the May through mid-July period. Sentiment readings tend to be contrarian in nature, meaning investors tend to be most bearish at market bottoms and most bullish at market tops. The growing level of negative sentiment could signal that additional downside risk in the markets is limited.

**Looking Ahead.** The focal points of the upcoming week are the two-day Federal Open Market Committee Meeting (FOMC) and Friday's employment data. While the FOMC meeting is expected to conclude without any adjustments to interest rates, investors will pay close attention to the after-meeting communiqué for clues to the eventual exit strategy the Federal Reserve Board (the “Fed”) will employ to remove stimulus from the economy. In regards to Friday's payroll data, the consensus among economists is the economy lost 175,000 nonfarm payroll jobs in October and the unemployment rate will rise to 9.9%.

## Market Viewpoint

**Maintain Positive Intermediate Term 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

**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.

**The MSCI World Index** is a capitalization weighted index that monitors the performance of stocks from around the world.

**The National Bureau of Economic Research (NBER)** is a private, nonprofit, nonpartisan research organization dedicated to promoting a greater understanding of how the economy works. The NBER is committed to undertaking and disseminating unbiased economic research among public policymakers, business professionals, and the academic community.

**The Consumer Confidence Index (CCI)** is an indicator designed to measure consumer confidence to that measures how optimistic or pessimistic consumers are with respect to the economy in the near future. The Conference Board bases the measurement of this Index on a survey of 5,000 households.

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.

**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.

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

**The AAII 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.

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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