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Mike Schwager, Chief Market Strategist

Weekly Viewpoint



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Strong Earnings Bring Buyers Back into the Markets

WEEK IN REVIEW

7/19/2010 – 7/23/2010

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Note: The *Weekly Viewpoint* will not be published next week but will return on Monday August 9.

Performance for Week Ending 7/23/2010

The Dow Jones Industrial Average (Dow) added 3.24%, the Wilshire 5000 Total Market IndexSM (Wilshire 5000SM) rose 3.87%, the Standard & Poor’s 500 Index (S&P 500) gained 3.55% and the Nasdaq Composite Index (Nasdaq) tacked on 4.15%. Sector breadth was positive as nine of the 10 of the S&P sector groups finished higher. The Industrial sector (+7.16%) was the best performing while Healthcare (-0.67%) was the laggard. The Canadian market, as measured by the S&P/TSX Composite Index, added 1.25%.

Index*	Closing Price 7/23/2010	Percentage Change for Week Ending 7/23/2010	Year-to-Date Percentage Change Through 7/23/2010
Dow	10424.62	+3.24%▲	-0.03%▼
Wilshire 5000	11389.45	+3.87%▲	-0.28%▼
S&P 500	1102.66	+3.55%▲	-1.12%▼
Nasdaq	2269.47	+4.15%▲	+0.01%▲
S&P/TSX Composite	11714.21	+1.25%▲	-0.27%▼

*See Last Page for Index Definitions.

Market Observations: 7/19/2010 – 7/23/2010

The major market indices finished the week higher reflecting solid second quarter earnings, improving economic conditions in Europe, and no “smoking gun” in the European stress test results.

Ultimately, markets are a reflection of what is happening in the corporate world. As such, last week’s strong second quarter outweighed concerns over the recent “soft patch” in economic data. While there is no arguing that the pace of economic growth in the U.S. is slowing, the good news is that the economy continues to expand and should continue to do so through next year, in my opinion. While the pace of the recovery has been disappointing, the simple fact is that over the past three quarters, the expansion has averaged about a 3.5% growth rate – which happens to be well above the 2.8% trend

line growth average since 1980. While I continue to believe the economy remains in the process of transitioning from the recovery stage to the expansionary phase, this process rarely happens in a straight line and potholes and speed bumps are almost always evident on the road to recovery.

There continues to be a lot of talk over whether a double-dip recession is forming in the U.S. While anything is certainly possible, I continue to believe the probability of such an event remains low. Interestingly, only a couple months ago, Europe was seen as the weak link in the global recovery; that, however, seems to be in the process of reversing. In fact, while the economic data in the U.S. appears to have hit a soft patch, the data coming out of Europe has generally been well ahead of expectations. This renewed strength in Europe has also started to allay fears of a global double dip recession.

Q2 Earnings Summary

As of Friday, 175 members of the S&P 500 have reported quarterly results, with overall earnings up 58.4% on a year-over-year basis. More than 78% of the companies have beaten analyst expectations while only 13% have fallen short. While still early in the reporting season, the “beat” rate is significantly better than the historical 61% average. Revenues are up 8.8% so far in the quarter. Interestingly, the Technology sector has shown very strong top-line results (+28.3%) with 76% of the companies beating top-line expectations. This is important because at 19.1%, the Technology sector carries the heaviest weighting in the S&P 500.

Overall quarterly results are being fueled by the Technology, 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 41.6%.

Of particular interest were strong results from companies like 3M, UPS and Caterpillar. These companies are very well diversified on a global basis and are looked to as proxies for the underlying health of the global economy. All three companies exceeded analysts’ expectations and issued upbeat forward outlooks. Also of note, were the very strong results from Apple. The company’s earnings were well ahead of Street expectations and company management issued upside guidance on forward revenues. Since Apple’s products are mostly sold within the consumer channel, the company’s results tend to be a good barometer for consumer sentiment.

Bernanke Testimony

Twice a year, the Federal Reserve (the “Fed”) Chairman Bernanke is required by law to testify to Congress on monetary policy. This year’s testimony contained no real surprises although the term “unusually uncertain” used to describe the current economic outlook was not well received. The phrase was interpreted as a confirmation that the economic outlook has weakened significantly. While the content of the report was very similar to recent updates from the Fed, investors appeared disappointed that Bernanke offered no specific game plan to help resurrect the economy.

Stress Tests

On Friday the results from the long awaited “stress tests” on 91 European banks were released. The results were generally good with 84 out of the 91 passing. The tests were being done to assure investors that European banks are strong enough to weather an unexpected decline in economic growth or a sharp deterioration in the value of European government bonds. The fact that some banks failed the test was not surprising because if all banks were allowed to pass, the credibility of the underlying tests would be questioned. The seven banks that failed will now be required to raise new capital to shore up their finances.

The debate over the “validity” of these tests will likely be called into questions in the same way the U.S. stress tests were scrutinized. Regardless, of their validity, the stress testing of the U.S. banking system instilled underlying confidence in the U.S. banking system and in hindsight proved to be a crucial turning point for the Financial sector.

China – Back in the Saddle

China’s Shanghai Composite Index gained for five straight sessions last week, adding 6.1% for the week. The gains likely reflected speculation that the government will begin to ease its foot off the brakes and let the economy start growing again. This is good news as China continues to be looked to as the engine of global economic growth.

Shipping Index Stops Sinking

In another sign the global economy may be stabilizing, the Baltic Dry Index, which measures shipping prices for things like coal and other raw materials, advanced for a sixth straight session. This follows a string of 35 consecutive down days. Historically, the Baltic Dry has been a pretty good barometer of global economic activity.

Looking Ahead:

This will be the peak week for earnings with approximately 160 members of the S&P scheduled to report. The economic calendar will also be a focal point with reports on new home sales, consumer confidence, durable goods orders, the Beige Book, and the initial reading of the second quarter GDP.

Market Outlook

After gaining almost 80% from the March 2009 low to the recent peak in late-April, the market appears to be 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 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 \$91/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 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 makes 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 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 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. This assumes the P/E (price to earnings) multiple will expand to 16x and 2010 earnings will expand to \$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-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 Shanghai Stock Exchange Composite Index is a capitalization-weighted index. The index tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. The index was developed on December 19, 1990 with a base volume of 100.

The Baltic Dry Index (BDI) is a shipping and trade index created by the London-based Baltic Exchange that measures changes in the cost to transport raw materials such as metals, grains and fossil fuels by sea. The Baltic Exchange directly contacts shipping brokers to assess price levels for a given route, product to transport and time to delivery (speed). The index is a composite of three sub-indexes that measure different sizes of dry bulk carriers (merchant ships) - Capesize, Supramax and Panamax. Multiple geographic routes are evaluated for each index to give depth to the index's composite measurement.

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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CLAYMORE®

A GUGGENHEIM PARTNERS COMPANY

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

866-417-4640
www.claymoreinvestments.ca