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Weekly Viewpoint



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The Corrective Phase Continues

WEEK IN REVIEW

5/31/2010 – 6/4/2010

After posting the worst May performance since 1962, the market, as measured by the S&P 500, continued its downward spiral last week. While the market looks oversold on a near-term basis, investors appear to be struggling with what the catalyst will be to stop the decline.

Performance for Week Ending 6/4/2010

The Dow Jones Industrial Average (Dow) lost 2.03%, the Wilshire 5000 Total Market IndexSM (Wilshire 5000SM) fell 2.45%, the Standard & Poor's 500 Index (S&P 500) declined by 2.25% and the Nasdaq Composite Index (Nasdaq) shed 1.68%. Sector breadth was negative as all 10 of the S&P sector groups finished lower. The Materials sector (-5.21%) was the worst performing while Technology (-0.86%) was the best. The Canadian market, as measured by the S&P/TSX Composite Index, fell 0.87%.

Index*	Closing Price 6/4/2010	Percentage Change for Week Ending 6/4/2010	Year-to-Date Percentage Change Through 6/4/2010
Dow	9931.22	-2.03% ▼	-4.76% ▼
Wilshire 5000	11018.27	-2.45% ▼	-3.53% ▼
S&P 500	1064.88	-2.25% ▼	-4.50% ▼
Nasdaq	2219.17	-1.68% ▼	-2.20% ▼
S&P/TSX Composite	11569.61	-0.87% ▼	-1.50% ▼

*See Last Page for Index Definitions.

Market Observations: 5/31/2010 – 6/4/2010

The major market indices finished the week with moderate losses. Trading remained choppy as investors tried to determine what is discounted in the markets and what is coming to fruition. This “price discovery” process, in my opinion, will likely remain in play until further clarity emerges on how the European financial crisis has impacted the global economy. This could take several weeks, in my opinion, and will likely be centered on second quarter earnings season (which unofficially kicks off on 7/12) to see if the problems in Europe have filtered through to corporate earnings. Adding to the negative tone last week were rising political tensions in the Middle East and the Korean peninsula as well as the uncertainty surrounding the potential economic and political impact from the Gulf oil spill.

Correction Remains Intact. Corrections are defined by a pullback of at least 10% from a prior peak. After peaking on April 23, the S&P has retreated by 12.5% through the close on Friday, June 4. Since the rally began in March 2009, the S&P has been void of a corrective phase, so arguably we were overdue. While at this stage it's impossible to forecast whether this pullback will lead to the resumption of a bear market (defined by a 20% retreat from a prior high), I continue to believe the macro fundamentals in the United States are solid enough to limit the downside risk from here and possibly become an upside catalyst at some point in time. The question remains how long before investors shift their focus back to the fundamentals in lieu of all the headline noise?

Employment Report. The much anticipated May jobs report fell well short of investor expectations. The report was expected to show "blowout" numbers with some estimates calling for as many as 750K new nonfarm payroll jobs being added during the month. The fire was stoked by comments earlier in the week by President Obama and a handful of Federal Reserve Board (the "Fed") officials who "telegraphed" a strong showing. The Labor Department reported that nonfarm payroll in May rose by 431K, well short of the 536K expected by economists. The "nuts and bolts" of the report showed that government (Census) hiring accounted for the bulk of jobs while private payrolls only increased by 41K. While economists expected a surge in census hiring, private hiring fell well short of the expected 180K jobs. While overall the report was a big disappointment and takes some shine off the recovery story, there were some glimmers of hope in the numbers. For example, both average hourly earnings and the average work week expanded during the month. In addition, temporary help services—historically a precursor to actual hiring—rose for an eighth consecutive month. Also of note, since the beginning of the year, nonfarm payrolls have expanded by almost 1 million jobs, of which over half were in the private sector.

Political Tensions Heating Up. "Saber rattling" overseas (Middle East, North/South Korea) coupled with growing social acrimony stateside are adding another layer of uncertainty to the investment puzzle. Domestic flare ups are being sparked by the lack of progress in capping the oil well in the Gulf of Mexico and raising concerns over the long-term environmental as well as economic impact of the disaster. In addition, there remains a growing frustration with political incumbents and Washington's free-spending ways. This will likely be a key theme in the mid-term elections in November. While Republicans are likely to gain several seats, the growing discord for politicians on both sides of the aisle should make for much drama (and therefore investment uncertainty) over the next several months, in my opinion.

Europe. The crisis in Europe continues to weigh on investors' minds. While the issue is slowly falling off the front pages, the bottom line is things have yet to show much improvement. This was evident two Fridays ago when Spain's credit rating was downgraded a notch by one of the credit rating services. Also, late last week, Hungary indicated that talk of default is "not an exaggeration." While Hungary is not a member of the monetary union, the "heads up" reignited concerns that the problems in Greece et al, may be starting to spread to other corners of European Union.

Interestingly, the sovereign debt crisis (at least to this point) hasn't led to a further deterioration in Europe's economic conditions. This is likely explained by the "neutralizing" effect of the positive influence of a weaker euro. A weaker currency helps exports-driven countries like Germany (the eurozone's largest economy) by making its products more competitive in the global marketplace.

A Bumpy Recovery. While the weaker than expected jobs report definitely takes some shine off the budding U.S. economic recovery, other economic data last week confirmed the recovery is intact (albeit softening a touch). The recent choppiness of economic data is also a reminder that the road to recovery is very rarely a straight line and often contains potholes along the way.

Last week, the Institute for Supply Management (ISM) reported that its Manufacturing Index expanded for a tenth consecutive month. While the headline number of 59.7 fell slightly from the 60.4 reading in April, the New Orders component held steady while the Employment Index rose to a six-year high. The ISM also reported that its Services Index was flat in May at 55.4. The reading was slightly below economists forecast of 55.6, but still signaled expansion in the Services sector (the ISM indices are diffusion indexes where readings above 50 signals expansion while below 50 signals contraction).

On the housing front, the National Association of Realtors reported that pending home sales during the month of April rose 6.0% following the upwardly revised 7.1% gain in March. Pending sales have risen by a total of 23% in the three months, highlighting the favorable impact of the first time home buyer's tax credit. While housing data has been very strong, the weekly mortgage applications information from the Mortgage Bankers Association coupled with the recently reported building permits data may be indicating that a sharp slowdown is may be in the works. While mortgage applications in the week ended May 28 rose by 0.9%, the purchasing index fell by 4.1% and now stands at the lowest level since April 1997.

Technical Tea Leaves – A Pause to Refresh. Technical analysis (the study of price and volume trends) has been gaining momentum, in my opinion, as fundamentals are being pushed to the backburner. The S&P 500 broke below its 200 day moving average (dma) a few weeks ago, signaling a possible a change in the markets longer-term trend. While the downside violation is a definite yellow flag, I maintain that the trend of the 200 dma—which is still rising—is arguably more important. While the punch back above the 200 dma (currently at 1106) would be views as a near-term "win," I also believe that with the recent spike in fear (VIX Index), the oversold nature of the markets and the sharp plunge in investor sentiment, it appears too early to call an end to the current rally.

While many asset managers shrug off the use of technical analysis and consider it "market witchcraft," traders tend to use technicals to help shape and define risk. Remember if enough eyeballs are focused on something then the event becomes important.

Market Outlook

While there is still a lot of “noise” in the marketplace and the market could move lower before it stabilizes, I remain of the opinion that macro fundamentals 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, the 5.6% growth in the fourth quarter and the 3.2% (preliminary estimate) in the first quarter are still ahead of the 2.8% average growth rate that has occurred since 1980.
- B.** Earnings growth is 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 \$2.85 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 \$87.00/share, the S&P 500 is selling at only 12.3 times earnings.
- E.** Interest rates are low and the Fed is likely to remain on hold through mid-2011. Low rates encourage flow into “risk assets” and discourage holding low yielding (cash) vehicles.
- 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 14 months old and has produced gains of roughly 70%. 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.

- I.** Unused fiscal stimulus. Just over 30% of last year’s \$787 billion fiscal stimulus has been spent. Another 40% (approximately \$315 billion) will be allocated this year.

1250 Target Unchanged. 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 expand to 16x and 2010 earnings will expand to the \$78.00. From recent prices, a move to 1250 would equate to approximately a 15% 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.

Institute for Supply Management (ISM) Manufacturing and Non-Manufacturing Indices:

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 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.

National Association of Realtors (NAR) strives to be the collective force influencing and shaping the real estate industry. It seeks to be the leading advocate of the right to own, use, and transfer real property; the acknowledged leader in developing standards for efficient, effective, and ethical real estate business practices; and valued by highly skilled real estate professionals and viewed by them as crucial to their success.

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 Chicago Board Options Exchange Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

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