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Weekly Viewpoint

DECEMBER 21, 2009

Year-End Portfolio Jockeying Leaves Markets Mixed

WEEK IN REVIEW

12/14/09 – 12/18/09

The major market indices finished the week mixed as investors booked profits and reallocated portfolios ahead of the year end.

Please Note:
This is the final publication for the year. The *Weekly Viewpoint* will resume its regular publishing schedule on January 11, 2010. I would like to wish you a very happy holiday season and a prosperous New Year. – Mike Schwager

Performance for Week Ending 12/18/09

The Dow Jones Industrial Average (Dow) fell 1.4%, the Standard & Poor's 500 Index (S&P 500) lost 0.4% and the Nasdaq Composite Index (Nasdaq) tacked on 1%. Sector breadth was negative as seven of the 10 S&P sector groups finished lower. The Telecom sector (-2.3%) was the worst performing while Technology (+1.1%) was the best. The Canadian market, as measured by the S&P/TSX Composite Index, gained 0.4%.

Index*	Closing Price 12/18/09	Percentage Change for Week Ending 12/18/09	Year-to-Date Percentage Change Through 12/18/09
Dow	10328.89	-1.36%	+19.16%
S&P 500	1102.47	-0.36%	+23.78%
Nasdaq	2211.69	+0.98%	+42.63%
S&P/TSX Composite	11463.40	+0.35%	+29.81%

*See Last Page for Index Definitions.

Market Observations: 12/14/09 – 12/18/09

TThe major market indices finished the week mixed. While the week was chock full of market-moving events, most of which were upbeat, investors appear to have moved into "gains protection" mode as they gear up for the upcoming holidays and the conclusion of the year.

While the bull market rally that has been in place since March appears "tired," I believe the sideways trading range that the S&P 500 has been stuck in since October is more of a resting phase and not the start of prolonged contraction. After rallying in excess of 60% since early March and in light of the poor performance in 2008, investors appear to have some performance anxiety and have likely booked gains over the past several weeks. As mentioned before in these missives, following the strong gains over the past several months, the winding down of the calendar is likely fostering a strategy focused on capital preservation versus trying to capitalize on additional upside.

FOMC Meeting: The Federal Open Market Committee (FOMC) held its last gathering of the year last Tuesday and Wednesday. As expected, the Committee left its benchmark interest rate unchanged at a range of 0.0%-0.25%. Although the after-meeting communiqué was little changed, the tone of the economic assessment was a tad more upbeat. In addition, the committee reiterated its pledge to keep rates "exceptionally low for an extended period of time." The statement also noted that economic activity has continued to pick up and that the deterioration in the labor market is abating. Additionally, the housing sector has shown some signs of improvement over recent months, household spending appears to be expanding at a moderate rate and inflation trends remain subdued. The outcome of the meeting seemed to pacify investor concerns that the FOMC would start removing stimulus from the economy sooner rather than later.

Also, to avoid being labeled as "the Grinch," the FOMC rarely tightens during the month of December. Looking at FOMC data going back to 1979 shows only four rate hikes during the month of December. Changes in Federal Reserve Board (the "Fed") policy are usually well "telegraphed," allowing the market to start baking the change into the "cake." The first clue the Fed is starting to prepare the market for a change will likely be when the "extended period" phrase is removed from the statement, in my opinion. The next opportunity for change will be at the first FOMC meeting of the new year—January 27, 1020.

Bernanke—Four More Years?: The Senate Banking Committee voted last week by a 16-7 margin to recommend the confirmation of Federal Reserve Chairman Ben Bernanke to a second four-year term as head of the central bank. The vote now moves to the Senate floor in early January for a full vote. While Mr. Bernanke is unlikely to receive unanimous approval, he is expected to capture enough votes for confirmation. According to Intrade Prediction Market, a closely watched Web exchange for futures contracts based on political outcomes, there is currently a 95% probability Mr. Bernanke will be approved for a second term. While many politicians have been "grandstanding" against his approval, they also know, in my opinion, with the economic recovery still on fragile ground, now is not the time to rock the boat. Arguably, Mr. Bernanke, through creative policy measures, has been instrumental in cushioning the damage to the economy. The toughest challenges are yet to come as the Fed Chairman will need to start removing the large amounts of stimulus from the economy without being too hasty and risk pushing the economy back into recession. I believe he remains the most logical choice to complete the task.

Market Viewpoint

While the past 18 months will be a period that many investors will never forget, I believe 2010 will be a forgetful year, relatively speaking. The upcoming year will likely be characterized by the ongoing march to "normal" as both the economy and markets continue to stabilize.

While the healing of the economy is well on its way, the "rehab" process is far from complete. The markets and economy will continue to face headwinds over the next 12 months including an elevated rate of unemployment and the still feeble housing recovery (the epicenter of the problems over the past two years, in my opinion). Through December 18, the market, as measured by the Standard and Poor's 500 Index ("S&P 500") has gained almost 63% off the March lows. Despite these gains, I continue to believe that additional upside is likely over the next 12 months. While the "easy money" in the markets has been made and the pace of gains will likely slow, the combination of low interest rates, an expected turn in the corporate earnings cycle, and the building economic recovery, likely means the bull market rally has further room to run.

In addition, bull market rallies rarely end at the early stages of a recovery in corporate profits. The markets are generally a mirror reflection of what is happening in the corporate world. After nine consecutive quarters of negative year over year earnings growth, consensus expectations are for S&P 500 earnings growth to turn positive in the current quarter (Q4).

While I continue to believe the economy is currently in the process of transitioning from recession to recovery, the process rarely happens in a straight line and potholes are almost always present on the road to recovery. With that said, the economy should continue to move forward reflecting the large injection of stimulus spending due to hit the economy early in the new year as well as the expectations of corporate inventory restocking to replenish bare bone inventory levels.

As Sir John Templeton said, "Bull markets are born in despair, grow amid skepticism, mature in optimism and die on euphoria." The rally off the March lows has generally been met with high levels of skepticism and doubts about its sustainability. In addition, the mood among investors generally remains noncommittal (as witnessed by the elevated levels of cash on the sidelines and anecdotal evidence that large investors have been generally underweight their equity benchmarks). Paradoxically, with market risks skewed to the upside, the large cash weightings and below benchmark exposure to equities should buffer the downside risk and could provide significant "fire power" with improving macro considerations. In addition, "performance anxiety" amongst portfolio managers, in light of a trending market, could prompt skeptics and fence sitters to reenter the markets.

1250 Target: 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 revert back to its long term mean of 16.6x (uses the ten year rolling earnings since 1920) and 2010 earnings will expand to the $75.50 (as being forecast by S&P). From the current price of around 1100, the move to 1250 would equate to approximately a 13% return.

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. The combination 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 out beyond the next 12 months due to the many twists and turns that could potentially takes place (e.g. outcome of mid-term elections, geopolitical events, etc.), there are imminent speed bumps along the way. While at this point in time, 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 the ability to peak 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 that are presented in the form of elements such as valuation, reaction to positive/negative news, sector rotation, deteriorating internals, technical patterns, and outperformance of risk adverse 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 6 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.

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.

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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