

Mike Schwager, Chief Market Strategist

Weekly Viewpoint



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Economic Concerns Rain on the Earnings Parade

WEEK IN REVIEW

10/19/09 – 10/23/09

The major market indices finished lower for the first time in three weeks as spotty economic data outweighed generally better than expected earnings reports.

Performance for Week Ending 10/23/09

The Dow Jones Industrial Average (Dow) lost 0.24%, the Standard & Poor's 500 Index (S&P 500) fell 0.74% and the Nasdaq Composite Index (Nasdaq) shed 0.11%. Sector breadth was negative as nine of the 10 S&P sector groups finished lower. The Technology (+1%) sector was the best performing sector while Materials (-1.8%) was the worst. The Canadian market, as measured by the S&P/TSX Composite Index, lost 1.07%.

Index*	Closing Price 10/23/09	Percentage Change for Week Ending 10/23/09	Year-to-Date Percentage Change Through 10/23/09
Dow	9972.18	-0.24% ▼	+13.63% ▲
S&P 500	1079.60	-0.74% ▼	+19.52% ▲
Nasdaq	2154.47	-0.11% ▼	+36.62% ▲
S&P/TSX Composite	11382.13	-1.07% ▼	+26.64% ▲

*See Last Page for Index Definitions.

Market Observations: 10/19/09 – 10/23/09

After two consecutive weeks of gains, the major market indices finished lower last week. Spotty economic data and the overbought condition of the market appears to have traders worried that a gap may be developing between what is discounted in the markets and what is coming to fore. The concerns offset the generally better than expected third quarter earnings results.

Recession Likely Over ... Recent data released by The Conference Board suggests that the recession likely ended at the end of June. The Conference Board's Composite Index of 4 Coincident Indicators (CCCI) moved to 99.90 in September after troughing at 99.70 in June. The CCCI is closely watched as it tracks the four primary indicators (payrolls, production, income, and business sales) that are used by the National Bureau of Economic Research to date the start and end of recessionary periods. The CCCI has a stellar track record of peaking and troughing at the beginning/end of almost every recession since 1970. The bottoming in the data generally syncs with the consensus call from economists upholding the economy

transitioned to an expansionary phase at the start of the third quarter. The action since the trough also appears to be in line with expectations of a muted recovery.

... **But Only Statistically.** While statistically the recession may have ended, the feeling of gloom amongst the average citizen will likely persist for the foreseeable future. This is understandable in light of the high levels of unemployment and the sharp decline in household net worth over the past two years.

Third-Quarter Earnings. The bullish bent to third-quarter earnings remains intact. As of Friday, 196 members of the S&P 500 have reported with 80.1% exceeding estimates, 7.7% meeting and 12.2% falling short. With almost 40% of results reported, overall earnings are off 10.3% 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. Analysts are now expecting earnings to decline by 17.7% versus a 19.9% loss forecast two weeks ago. The better results continue to argue that the uptick in economic activity over the past few months is beginning to filter through into corporate America.

Growth Engine Status Intact. China, which many analysts expect to be the engine of growth for the global recovery, reported a series of strong economic data points last week. Gross Domestic Product (GDP)—which measures the value of all goods and services produced in a country—rose by 8.9% in the third quarter. The strong results reflect the barrage of government stimulus initiatives and the resulting favorable impact on growth. On a year-over-year basis, growth is tracking at a 7.9% rate, putting the nation on target to reach the government's forecasted full year growth rate of 8%, a rate Chinese officials estimate will keep employment levels healthy. The rapid pace of growth, however, is starting to raise some concerns that the economy could overheat and inflation could run rampant unless stimulus is reeled in. The concerns over inflation seem a bit premature in light of last week's Consumer Price Index report that showed prices **falling** by 0.8% in September on a year-over-year basis.

Housing Data Mixed. Housing-related data sent mixed signals to the market last week. Early in the week, the Commerce Department reported that both Housing Starts and Building Permits fell short of analysts' expectations. The data, coupled with a disappointing reading on homebuilder sentiment, raised concern that the recovery in housing is beginning to falter. Adding to the negative sentiment was news that the average rate on 30-year mortgages rose to 5.0% after spending three weeks below that level.

On a positive note, existing home sales jumped 9.4% in September to an annualized rate of 5.57 million units. Results were solidly ahead of the 4.9% gain expected by economists and stand at their highest level in more than two years. The report also highlighted that the inventory of previously owned homes on the market fell to 3.63 million units. At the current pace of sales, that equates to about 7.8 months of inventory, the lowest level since March of 2007.

A recovery in the housing market, in my opinion, continues to be a prerequisite for a durable recovery in the overall economy. While one round of data does not make a trend, last week's housing data was a reminder that the road to recovery is rarely a straight line. Much of the stabilization in housing has been due to government stimulus and

with the \$8K first time home buyers' tax credit scheduled to expire at the end of next month, concerns seems to be building that the still fragile recovery could be put in jeopardy. While maybe an extreme example, a similar situation played out in the auto sector with the Cash for Clunkers program. The program led to a surge in auto sales during August (14.1 million seasonally adjusted units were sold), but when the "sugar high" was removed, September sales plunged to 9.2 million units.

Dollar Continues to Trend Lower. The dollar fell for a third consecutive week on higher interest rate prospects outside of the United States. The negative sentiment was spurred by media reports that two global central banks may be preparing to raise interest rates. Last week Bank of England Governor Mervyn King warned consumers to be prepared for rising interest rates in the future, while Reserve Bank of New Zealand Governor Alan Bollard also said a strengthening currency isn't an obstacle to raising rates. The statements followed an actual rate hike in the prior week by Australia's central bank.

The dollar, in my opinion, is likely to remain in a downtrend as global risk appetites increase and traders look to it as a funding currency. The "carry trade" seems alive and well as the low interest rate environment in the U.S. seems pitted against the potential for higher interest rates around the globe. The uptick in global rates has basically fostered a trade where you can borrow funds in the U.S. on the cheap and reinvest those funds in other higher yielding currencies.

The Federal Reserve Board (the "Fed") basically established that interest rate increases are on hold for the foreseeable future. In addition, the Fed has a dual mandate to maximize employment while keeping prices stable. With inflationary pressures almost nonexistent, it's currently in the Fed's best interest, in my opinion, to keep monetary policy very loose or they may risk choking off the still fragile recovery.

As I have stated in past updates, while dollar weakness carries a negative connotation, many consider it a prerequisite for the economic recovery to continue and to nip deflation in the bud. As we know, dollar weakness generally leads to asset price inflation and makes U.S. products more competitively priced in the global arena. This, in turn, should generate an uptick in exports and help jumpstart profits among multinational companies in the S&P 500 (which account for roughly 50% of S&P 500 earnings).

Technical Considerations Coming into Play? Technical considerations may have been at work last week reflecting the Dow's inability to stay above the psychological 10,000 level. (Technical analysis is the study of price-related action to try and predict future trends.) In addition, the sell-off was accompanied by an uptick in trading volume, a potential sign of distribution. While many portfolio managers view technical analysis as the equivalent of market witchcraft, traders tend to use technicals to help shape and define risk. If enough eyeballs are focused on something, then the event becomes important. With the markets in "overbought" territory, many traders are likely to have itchy trigger fingers and take a "sell first, ask questions later" attitude. Remember the reaction to the news is always more important than the actual news. The market's inability to rally over the past week, despite better than expected third quarter results, may be a sign of buyers' exhaustion and a precursor to a period of consolidation.

Market Viewpoint

Maintain Positive 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

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 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.

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 Conference Board’s Composite Index of Coincident Indicators is an index published by the Conference Board that is a broad-based measurement of current economic conditions, helping economists and investors determine which phase of the business cycle the economy is currently experiencing. The Composite Index of Coincident Indicators comprises four cyclical economic data sets:

1. The number of employees on non-agricultural payrolls (released by the Bureau of Labor Statistics)
2. The Index of Industrial Production
3. The level of manufacturing and trade sales
4. The aggregate amount of personal income excluding transfer payments

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

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 Investments, Inc.
200 University Avenue, 13th Floor
Toronto, Ontario M5H 3C6
866-417-4640
www.claymoreinvestments.ca