



Weekly Market Commentary



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Missed Opportunity

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Highlights

In the first quarter, the markets were focused on a slowdown in China, in the second quarter the concern moved to a slowdown in Europe, and in the third quarter the growth scare has shifted to the United States. In each of the prior quarters, markets made their low at the midpoint of the quarter as a policy announcement turned the tide on investor sentiment.

It appears that the Fed missed the opportunity to turn sentiment around with their mid-quarter policy announcement last week. Without a potent policy driver, the fear surrounding the U.S. outlook may not dissipate as quickly this quarter as it did during the first two quarters of the year and linger into the fourth quarter.

The mid-quarter policy driver during the fourth quarter may be the mid-term elections held in November. This event may be potent enough to turn sentiment around and produce gains for the year in line with our forecast for modest single-digit gains.

1 Hang Seng Index During First Quarter



Source: LPL Financial, Bloomberg 8/13/10

The Hang Seng Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

This year has been defined by three growth scares. In the first quarter, the markets were focused on a slowdown in China, in the second quarter the concern moved to a slowdown in Europe, and in the third quarter the growth scare has shifted to the United States. In each of the prior quarters, the concern peaked at the midpoint of the quarter:

- During the first quarter, the Chinese stock market, measured by the Hang Seng Index, bottomed around the middle of the quarter on February 8.
- During the second quarter, the European stock market, measured by the S&P 350 Europe Index, bottomed around the middle of the quarter on May 25.

We have reached the midpoint of the third quarter and so it may come as no surprise that there is a lot of pessimism about the U.S. economic outlook. Although, the U.S. stock market, measured by the S&P 500, remains up about 6% from the third quarter low on July 2, the S&P 500 fell by a sharp 4% since Monday (August 9) of last week.

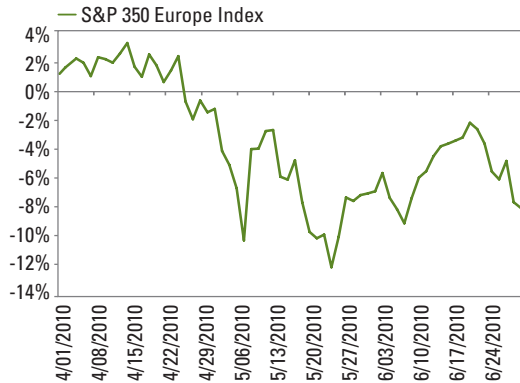
In each of the prior quarters, the midpoint of the quarter coincided with a policy announcement that turned the tide on investor sentiment:

- In the first quarter, the change in sentiment was driven by the monthly economic reports in China released on February 9 and 10 that reflected solid growth and were not accompanied by any new policy announcements intended to slow the economy. In prior months, the mid-month data releases had coincided with announcements of policy changes intended to slow growth in the Chinese economy.
- In the second quarter, the change in sentiment was driven by the passage of the trillion dollar European rescue package. The debt problems were addressed by this program that ensured adequate capital to meet the financing needs over the next few years for Europe's most troubled economies.

It appears unlikely that the mid-quarter policy driver for the third quarter was the Fed's announcement last week that they will reinvest proceeds from interest and principal from maturing mortgage-backed bonds into the bond market. While this news initially led to a stock market rally after it was announced at 2:15 pm on Tuesday and stocks returned to, the three-month high in the S&P 500 set the day before, the stock market later decided this action was not what it had hoped for and opened down sharply the following morning. We noted in last week's commentary, entitled *Uncertain Fed Means Certain Outcome*, that the Fed typically provides added economic stimulus at this point in the economic cycle. The disappointment in the lack



2 S&P 350 Europe Index During Second Quarter Quarter to Date Performance



Source: LPL Financial, Bloomberg 8/13/10

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of a more substantial action from the Fed was obvious and both stocks and bond yields dropped. It appears that the Fed missed the opportunity to turn sentiment around in a way similar to the policy-driven shifts in the first and second quarters.

Without a potent policy driver, the current growth scare may not dissipate this quarter as it did during the first two quarters of the year. Much of the economic data of late has come in worse than the consensus economist expectations and worse than the prior month. Our view remains that economic growth will decelerate but remain positive, in the second half of 2010. This is likely to keep the stock market volatile and range-bound during the remainder of the third quarter.

The fourth quarter may hold the key to the year for stock market performance. The restoration of a balance between the parties in Washington may be welcomed by markets. The market's reaction to mid-term elections has nearly always been positive, even when the balance of power has shifted in one or both houses of Congress—as we expect this year with the Republicans having a good chance of taking the House on November 2. The average gain for the S&P 500 in the fourth quarter of a mid-term election year is a solid 8% (see the *Weekly Market Commentary* from August 2 entitled “Mid-Term Market Moves” for more information). This mid-quarter policy driver may be potent enough to turn sentiment around and produce gains for the year in line with our forecast for modest single-digit gains.

IMPORTANT DISCLOSURES

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The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The S&P Europe 350 Index is a stock index of European stocks. It is a part of the S&P Global 1200. The intent of the index is to track at least 70% of European equity market capitalization. The constituent shares are selected for relevance to the broad market, including industry sector balance, longevity (to minimize index turnover) and liquidity of the shares.

The Hang Seng Index is a market capitalization index of the top 33 companies listed on the Hong Kong stock exchange, administered by the Hang Seng Bank.

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