Weekly Market Commentary

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Who is to Blame?

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Highlights

- On January 20, the stock market began a 6.6% pullback as six of the past eight days saw a decline in the S&P 500 index despite solid economic and earnings data.
- Stock market pullbacks of 5-10% are very common. In fact, this is the third 5-10% pullback during the stock market rally that began in March 2009. A pullback has accompanied each earnings reporting season since the March 2009 low.
- We are watching sentiment, technical levels, and data on China particularly closely.
- We continue to forecast a shift from tailwinds to headwinds as 2010 unfolds likely leading to market declines as the year goes on. However, we believe the tailwinds for growth remained intact during January and the recent pullback may be typical of earnings season and be reversed in the coming weeks.

What happened? The year was off to a fine start with the S&P 500 posting a 3% gain by mid-January. Then, on January 20, the stock market began a 6.6% pullback as six of the past eight days saw a decline in the index. Who or what is to blame for this abrupt drop?

Don't Blame Earnings

Earnings have been strong as companies are beating estimates by a wide margin and raising their outlook for 2010. At about the halfway point in the fourth quarter earnings-reporting season, 67% of companies in the S&P 500 index have beaten Wall Street analysts' consensus estimates on revenues, and 78% have been beating earnings estimates—just one percentage point below the all-time record set last quarter. In aggregate, companies have reported earnings that are 17% ahead of expectations which is a new all-time record and well above the historical average of 2%.

Clearly, the weakness in the stock market has had nothing to do with the fourth quarter earnings results. Also, expectations for future quarters have been rising. Interestingly, the Information Technology sector has been the worst performer during the stock market's recent 6% decline. Yet, the sector that contributed the most to the better than expected results has been Information Technology—with 40 of the 41 companies that have reported so far beating estimates.

More good news may be on tap for this week. This week is the peak week for earnings reports with almost 100 companies in the S&P 500 index scheduled to report over the next five days.

It Wasn't the Economy's Fault

Last week's economic data included the first look at fourth quarter GDP which surprised to the upside with a very strong 5.7% growth rate. The strength was broad across economic sectors. Consumer confidence and regional manufacturing data was strong and bode well for job growth. While housing data reported for December was weak, it reflected the temporary expiration of the new homebuyer tax credit, which was reinstituted and should, led to the return of better sales in the coming months. The composite Index of Leading Indicators, which tends to predict the direction of economic growth, posted a strong advance and was well above economists' expectations.

While the LPL Financial Current Conditions Index fell last week, it was mainly due to the increasing volatility in the stock market rather than from the components tracking economic activity. The index still points to an environment supporting solid economic growth.

Was it Washington?

The blame game in Washington is in full swing, but is the news flow out of Washington responsible for the market decline? Washington events have dominated the news over the past week and a half, including:

- the President's proposals targeting the top banks,
- the Federal Reserve meeting on interest rates,
- the State of the Union address, and
- Fed Chairman Ben Bernanke's contentious Senate confirmation vote.

It could be argued that the heightened uncertainly in the markets contributed to by these events could leave Washington to blame for the pullback. However, stocks failed to rally on Friday as the uncertainly lessened. These events are now mostly out of the way with only the Obama administration's 2011 fiscal year budget to be released this week with implications for various legislative and regulatory sensitive sectors.

Is It Normal?

Stock market pullbacks of 5-10% are very common—especially during earnings reporting season—and have accompanied every recovery. In fact, this is the third 5–10% pullback during the stock market rally that began in March 2009.

- During the second quarter earnings reporting season, from June 12–July 10, the S&P 500 pulled back about 7.1%.
- During the third quarter earnings reporting season, from Oct 19 to Oct 30, the index fell 5.6%.
- During the fourth quarter earnings reporting season, from Jan 19 through Friday, the S&P 500 was down about 6.6%.

During the four and a half year bull market from March 11, 2003 to October 9, 2007, the S&P 500 experienced a pullback eight times. While the magnitudes of the pullbacks were all very similar—in the 5-10% range—the duration of these pullbacks varied. Some were relatively abrupt and lasted only a week and a half, while others took nearly 11 weeks to unfold.

Pullbacks happen. There are often no clear reasons why they occur. They are merely part of the normal process of buyers and sellers digesting market gains.

PULLBACKS DURING S&P 500 RALLY FROM LOW OF MARCH 11, 2003 TO HIGH OF OCTOBER 9, 2007

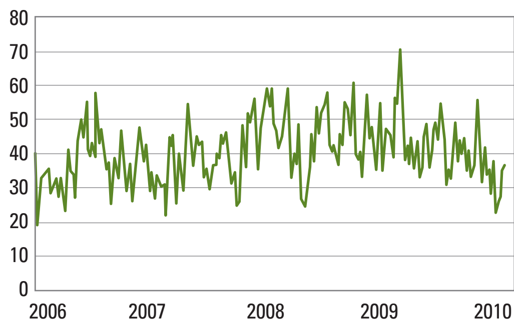
Start of Pullback	End of Pullback	Duration of Pullback in weeks	Magnitude of Pullback
3/21/03	3/31/03	1.5	-5.3%
3/5/04	5/17/04	10.5	-6.3%
6/23/04	8/12/04	7	-7.1%
3/7/05	4/20/05	6.5	-7.2%
9/9/05	10/13/05	5	-5.2%
5/5/06	6/13/06	5.5	-7.5%
2/20/07	3/5/07	2	-5.8%
7/10/07	8/15/07	5	-9.3%

Source: LPL Financial, Bloomberg

What We Are Watching

Perhaps we can blame a 5–10% decline on normal market behavior. Nevertheless, we are watching several factors particularly closely this week to assess the likelihood of a further decline.

1 Bearish Sentiment had Dropped to Multi-Year Lows Prior to Pullback
American Association of Individual Investors Survey — Percent Bearish



Source: LPL Financial, Bloomberg

- **Sentiment –** Pullbacks are often defined by changes in sentiment from bullish to bearish. Stocks tend to peak when bears become scarce. The American Association of Individual Investors survey reflected a decline in the percentage of investors calling themselves bearish during the early weeks of January as the market climbed to the recent high. This dip to below 25% bears was the lowest reading since 2007. This percentage has climbed back to the average level of the past six months at around 37% and is likely to have bounced even higher last week reflecting a rapid turnaround in investor sentiment from overly bullish to overly bearish.
- **Technical support levels –** We are watching the support levels and oversold indicators on the major indexes very closely along with the behavior that typically marks turning points in market movements.
- **China's economic data –** Some data on China will be released as this week gets underway. However, it is on February 9–11 that we will get loan growth, money supply growth, and other key drivers of economic growth in China. The pullback began with news from China designed to curb loan growth. The data will provide us with further insight into any impact the actions by Chinese policy makers is having to slow the rapid pace of economic growth.

We continue to forecast a shift from tailwinds to headwinds as 2010 unfolds likely leading to market declines as the year goes on. However, we believe the tailwinds for growth remained intact during January and the recent pullback may be typical of earnings season and will reverse in the coming weeks.

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