Weekly Market Commentary

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Spring Allergies or Something Worse?

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

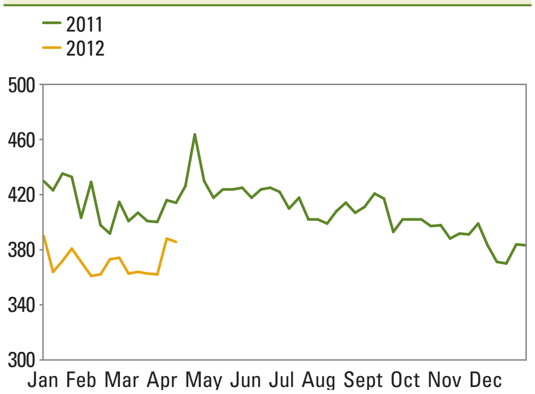
Highlights

In April, the markets seem to be suffering from a case of spring allergies. Like pollen-induced sneezes, the spasms at each of the data points have resulted in a noticeable uptick in volatility after a very quiet first quarter.

The symptoms are not likely to clear up this week with many allergens floating around: the Fed meeting, first quarter earnings reports, key economic data, the French elections, the worsening recession in Europe, and earnings reports from Spanish banks.

Investors' immune systems may be hypersensitive after the past five years. But the market's symptoms may also be signs of an oncoming illness potentially leading to a sustained pullback.

1 Another April Spike in Initial Jobless Claims Coming?



Source: LPL Financial, Bloomberg Data 04/23/12

In April, the markets seem to be suffering from a case of spring allergies. One day they are feeling better and climbing higher, the next they weaken and drop. Like pollen-induced sneezes, the almost involuntary market spasms at each of the data points have resulted in a noticeable uptick in volatility after a very quiet first quarter. In fact, so far during April nearly half of the trading days, six out of 14, have seen more than a 1% swing in the S&P 500. This is just one day less than the seven 1% swing days in the stock market during the entire first quarter.

The symptoms are not likely to clear up this week. The allergens floating around the U.S. this week that markets may react to include: the Fed meeting, first quarter earnings reports, and key economic data.

- The Fed may not offer enough insight on a potential QE3—a third round of quantitative easing—that investors seem to be looking for after recent economic data.
- First quarter earnings reports thus far generally exceeded analyst estimates by a wide margin without material downward revisions to upcoming quarters' estimates. Yet the stock market, as measured by the S&P 500, was up only about 0.6% last week and investors' bar of expectations may now be even higher as the earnings reporting season nears the halfway point later this week.
- Among the economic data released this week, initial jobless claims will be closely watched to see if they make a third consecutive week of deterioration and qualify as red flag number five out of our 10 leading indicators of another spring slide in the stock market and other "risk assets." (See the *Weekly Market Commentary* "10 Indicators to Watch for Another Spring Slide" from March 26, 2012 for more details).

The real test for the markets this week may come from overseas as markets react to: the French elections and accompanying policy uncertainty, the recession worsening in Europe, and finally Spanish banks will report their earnings.

- We will have to see what Socialist Party candidate Francois Hollande's victory in the first round French presidential election on Sunday, April 22 means to European politics and the French-German relationship in leading the unified anti-crisis programs. Hollande's socialist political ideology may make for a difficult relationship with Germany's right-leaning Chancellor Angela Merkel. In addition, French domestic politics could change with

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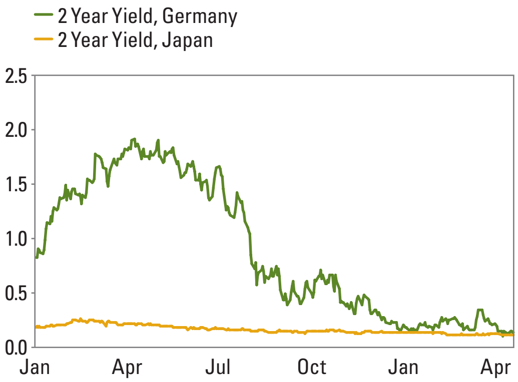
2 German Yields Drop Below Those of Japan



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higher spending proposals likely under Hollande—he has stated an intention to renegotiate European treaties on deficit limits—and could push French bond yields higher.

- As the European recession deepens—evidenced this week by a disappointing European manufacturing report for April—for the first time since before Japan entered its multi-decade slump, German 2-year bond yields have dipped lower than those of Japan, at around 0.1%. This decline in 2-year yields to near zero reflects both a flight to quality within Europe, as money leaves Spanish and Italian bonds, and a deteriorating outlook for growth. The specter of a lost decade is overhanging Europe as it echoes the post-bubble Japanese economy in the 1990s defined by troubled banks, a deepening recession, a volatile stock market, and very low yields.
- Many Spanish banks will report first quarter earnings this week, including heavyweights Banco Popular, Santander, and BBVA. Spain's problems lie largely with its banks. Markets have been pricing in an increasing probability of a bank default in recent weeks, suggesting injections of capital may be necessary. Investors will be looking for the scope of the damage to balance sheets resulting from the ongoing real estate declines and recession along with the accompanying need for government capital. The scrutiny will be intense, with Spanish 10-year bond yields back up to around 6% from as low at 4.8% in February, despite the International Monetary Fund (IMF) getting pledges for an even bigger financial crisis backstop.

Investors' immune systems may be hypersensitive after the past five years. But the market's symptoms may also be signs of an oncoming illness. Despite worries, stocks climbed 30% during the past two quarters. With volatility now returning and the market advance becoming led by fewer stocks (the average S&P 500 stock is stuck at the level reached in early February), further signs are emerging in market behavior that it may be vulnerable to a pullback. ■

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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.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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