Weekly Market Commentary

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Spring Slide Indicators Update

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Highlights

In each of the past two years the stock market began a slide in the spring that lasted well into the summer months.

This week we update the status of the 10 indicators we identified that foreshadowed the declines in 2010 and 2011.

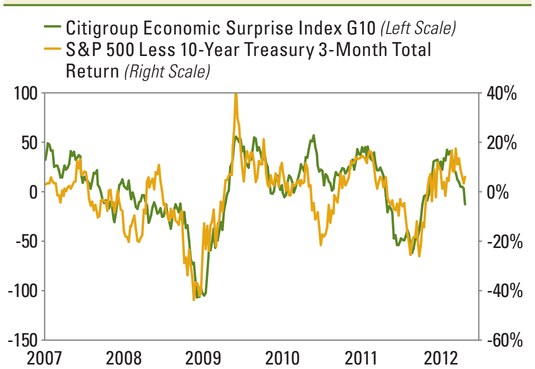
So far, about half of the 10 indicators are waving a red flag, while four are yellow for caution, and only one is green. On balance the indicators point to a significant risk of a repeat of the spring slide this year.

One month ago we provided our list of the 10 indicators to watch that seemed to precede the stock market declines in 2010 and 2011 and may warn of another spring slide. In both 2010 and 2011 an early run-up in the stock market, similar to this year, pushed stocks up about 10% for the year by mid-April. On April 23, 2010 and April 29, 2011, the S&P 500 made peaks that were followed by 16–19% losses that were not recouped for more than five months, a phenomenon often referred to by the old adage "sell in May and go away." Now that the time the prior slides have begun has arrived it is time to revisit the status of the indicators.

So far, about half of the 10 indicators are waving a red flag, while four are yellow for caution, and only one is green. On balance the indicators point to a significant risk of a repeat of the spring slide this year. We will continue to monitor these closely in the coming weeks.

1. **Fed stimulus –** In each of the past two years, Federal Reserve (Fed) stimulus programs known as QE1 & QE2 came to an end in the spring or summer, and stocks began to slide until the next program was announced. The current program known as Operation Twist was announced on September 12, 2011 and is coming to an end. It is scheduled to conclude at the end of June 2012. The Fed's communications in April appeared no closer to announcing QE3, raising the risk of a repeat of the spring slide.
2. **Economic surprises –** The Citigroup Economic Surprise index [Figure 1] measures how economic data fares compared with economists' expectations. The currently falling line suggests expectations have become too high; this typically coincides with a falling stock market relative to the safe haven of 10-year Treasuries.
3. **Consumer confidence –** In 2010 and 2011, early in the year the daily tracking of consumer confidence measured by Rasmussen [Figure 2] rose to highs just before the stock market collapse as the financial crisis erupted. The peak in optimism gave way to a sell-off as buying faded. Investor net purchases of domestic equity mutual funds began to plunge and turned sharply negative in the following months. This measure of confidence is once again beginning to fall from the highs.
4. **Earnings revisions –** Last week was about earnings and the news was good. S&P 500 profits were up 7% (4.7% ex-Apple) from a year ago with 72% of companies beating expectations, relative to 68%

1 Economic Surprises and Market Performance



Source: LPL Financial, Bloomberg data 04/30/12

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

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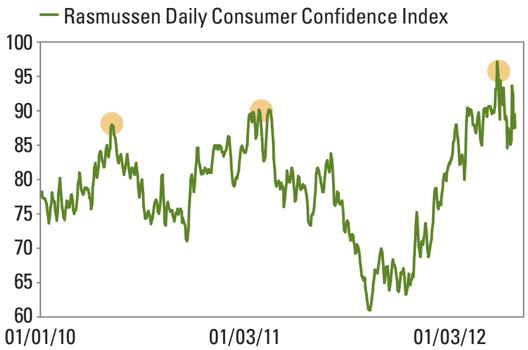
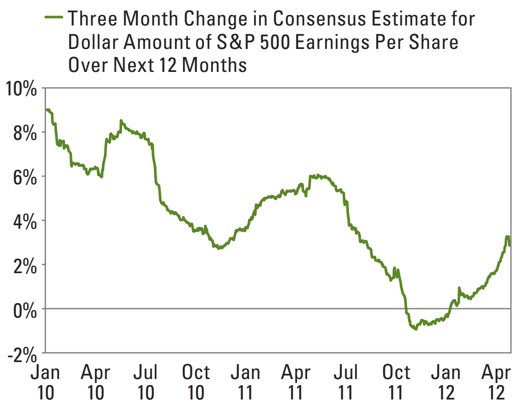
2 Consumer Confidence



Source: LPL Financial, Bloomberg data 04/30/12

3 Earnings Revisions



Source: LPL Financial, FactSet Research Systems 04/30/12

in the past four quarters. However, strong first quarter earnings reported in April of 2010 and 2011 were not enough to avoid the spring slide. The first couple of weeks of the first quarter earnings season in April 2010 and April 2011 drove earnings estimates for the next 12 months higher, but as the second half of the earnings season got underway in May 2010 and May 2011, guidance disappointed analysts and investors as the pace of upward revisions began to decline. This year the earning revisions have followed a similar pattern, so far. It is too early to say whether this indicator is flashing a warning sign. We will be watching to see if estimates begin to taper off now that earnings expectations have risen on the initial reports.

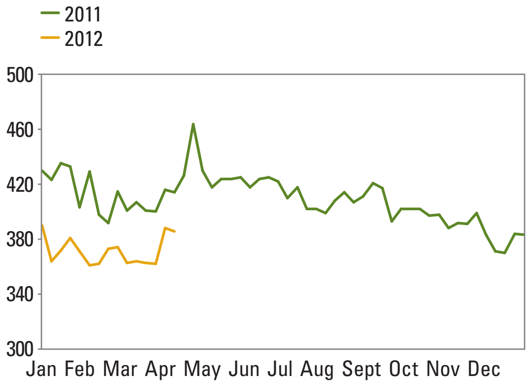
5. **Yield curve** – In general, the greater the difference between the yield on the 2-year and the 10-year U.S. Treasury notes, the more growth the market is pricing into the economy. This yield spread, sometimes called the yield curve because of how steep or flat it looks when the yield for each maturity is plotted on a chart, peaked in February of 2010 and 2011 at 2.9%. Then the curve started to flatten, suggesting a gradually increasing concern about the economy, as the yield on the 10-year moved down to around 2%. This year the market is pricing a more modest outlook for growth, but we will be watching to see if the recent flattening in the yield curve continues with the yield on the 10-year having moved back to 2% during April 2012.

6. **Oil prices** – In 2010 and 2011, oil prices rose about $15–20 from around the start of February, two months before the stock market began to decline. This year oil prices have climbed back to the levels around $105 that they reached in April of last year. However, they have risen only about $10 since around the start of February 2012 and seem to have stabilized. A further surge in oil prices would make this indicator more worrisome.

7. **The LPL Financial Current Conditions Index (CCI)** – In 2010 and 2011, our index of 10 real-time economic and market conditions peaked around the 240-250 level in April and began to fall by over 50 points. This year, the CCI recently reached 249 and has started to weaken and currently stands at 224.

8. **The VIX** – In each of the past two years the VIX, an options-based measure of the forecast for volatility in the stock market, fell to a low around 15 in April before ultimately spiking up over 40 over the summer. Last week, the VIX declined once again to 16. This suggests investors have again become complacent and risk being surprised by a negative event or data.

4 Initial Claims for Unemployment Benefits Tracking Last Year's Pattern



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

9. **Initial jobless claims –** It was evident that initial filings for unemployment benefits had halted their improvement by early April 2010, and beginning in early April 2011, they deteriorated sharply. In 2012, April has again led to deterioration in initial jobless claims as they have jumped by about 30,000 to nearly 390,000 [Figure 4]. A continued climb this week would echo last year's spike.

10. **Inflation expectations –** The University of Michigan consumer survey reflected a rise in inflation expectations in March and April of the past two years. In fact, in 2011, the one-year inflation outlook rose to 4.6% in both March and April. This year, inflation expectations also jumped higher in March, but receded a bit from the March jump that echoed what we saw in 2010 and 2011.

Finally, one issue not addressed specifically in the indicators, but important in the markets, is the rising European stresses—evident in the spring of 2010 and 2011. European policymakers including those at the European Central Bank, who meet later this week (May 3, 2012), have been facing a lot of pressure to act and do something about the renewed fears evident in the yields on Spanish and Italian debt and European stocks. European leaders have once again refocused away from unpopular austerity to talk of stimulating growth, at the expense of rising bond yields. If leaders continue to do little to address the market's concerns it could again accelerate the bond market sell-off and begin to affect stocks here in the U.S. similar to the spring slides in 2010 and 2011.

This week most of the attention will be directed towards the Institute for Supply Management (ISM) and employment reports for April 2012. But as we pointed out a month ago, these measures did not deteriorate ahead of the market decline, but along with it. It is not that they are not important; it is just that they did not serve as useful warnings of the slide to come, while the above 10 indicators did.

The return of daily volatility in April 2012 and the fact that April 2012 ended up as a flat month for stocks after six months of strong gains may suggest we are near a turning point. Given this year's double-digit gains and the possibility of another spring slide for the stock market, investors may want to watch these indicators closely for signs of a pullback. ■

IMPORTANT DISCLOSURES

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing may involve risk including loss of principal.

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 ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. When sentiment reaches one extreme or the other, the market typically reverses course. While this is not necessarily predictive it does measure the current degree of fear present in the stock market.

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