Weekly Market Commentary

February 21, 2012

Following the Path

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

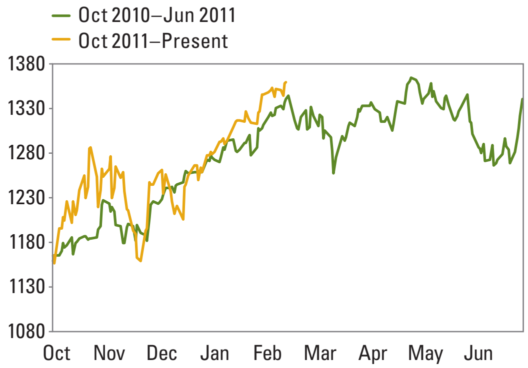
Highlights

The stock market, measured by the S&P 500, has posted a high single-digit gain for the year, and the S&P 500 index is around 1,350. Sound familiar? It should. It is exactly what happened last year.

Last year, stocks shed their gains for the year over the weeks following the run-up into the President's Day holiday.

While we do not believe the S&P 500 has reached its high for the year, the index may be due for a modest pullback, driven by a combination of: stalling earnings growth, mounting fiscal headwinds, and European debt and economic concerns resurfacing.

1 Stocks Following Last Year's Path



Source: LPL Financial, Bloomberg data 02/17/12

Just seven weeks into 2012 and the markets are off to a strong start. The stock market, measured by the S&P 500, has posted a high single-digit gain for the year, and the S&P 500 index is around 1,350. Sound familiar? It should. It is exactly what happened last year, as you can see in Chart 1.

If stocks continue to follow this pattern they are set for a pullback. Last year, stocks shed their gains for the year over the weeks following the run-up into the President's Day holiday. Over the four weeks that followed, the S&P 500 slid back to exactly where it had started the year, only to begin a rebound and a pattern of volatility that lasted into the summer months.

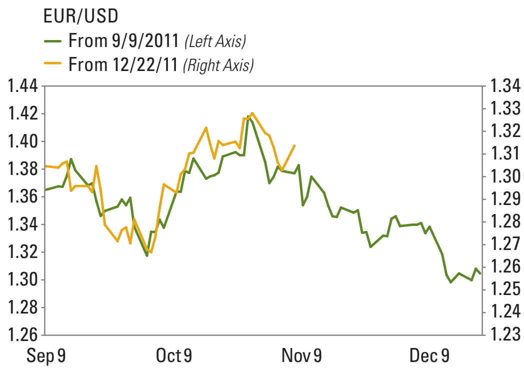
Indeed, stocks may be due for a modest pullback, in line with last year's pattern, driven by a combination of:

- **Stalling earnings growth**–Stocks have relied heavily on earnings gains for performance over the past three years with earnings and stocks rising by the same amount. Earnings growth for S&P 500 companies is likely to be flat in the first quarter, posing a risk for stocks.
- **Mounting fiscal headwinds**–As last week's passage of the payroll tax cut highlights, it will be very difficult to address the U.S. fiscal imbalances. The 2013 budget is already going to have the biggest impact of any budget in decades, even if no action is taken in Washington. The fiscal headwind comprised of both tax increases and spending cuts under current policy totals over $500 billion, or 3.5% of GDP. The United States has never experienced a deficit cut by more than 2% of GDP that did not end in a sharp decline in GDP.
- **European debt and economic concerns resurfacing**–Recent policy actions in Europe including actions by the European Central Bank, the fiscal compact agreed to by European leaders, and the path to reforms undertaken by some key countries have resulted in a significant reduction in perceived risks to the financial system and global economy. However, deteriorating economic growth in Europe, the stall in the trend toward declining rates for core European nations, and upcoming elections in France and Greece raise questions about the commitment to achieving the reforms and support necessary to stabilize the markets.

Much like the S&P 500, there are other markets retracing familiar patterns, as well. The euro is following last quarter's pattern. Why would it do that? Greece needs money in about a month to meet maturing debt payments totaling 14.5 billion euros. The so-called troika (consisting of the ECB, IMF

LPL Financial

2 Euro Following Last Quarter's Path



Source: LPL Financial, Bloomberg data 02/17/12

Past performance is no guarantee of future results.

and European Commission) has demanded further austerity. Greek leaders resist these demands and make some bold moves, fearing the domestic backlash to austerity. The EU leaders cancel meetings to make the point that they are serious about their demands, and Greece grudgingly agrees.

Does this scenario sound familiar? It should, since it is a repeat of what played out late last year after former Greek PM Papandreou submitted his referendum proposal in November and stepped down. The euro is repeating the same pattern it traced during the last time this Greek drama played out. If it continues to play out the same way—that Greece dodges another bullet, but is still in front of the firing squad—then maybe the euro continues follows the same path as it did late last year and slides further, as you can see in Chart 2.

While these patterns could be coincidences, they are more likely to be indicative of the most likely reaction by the markets to the events evolving around the world. While we do not believe the S&P 500 has reached its high for the year, the index may be due for a pullback in the coming weeks after a strong four-and-a-half-month run-up of about 25% as it climbed back to the post-crisis highs. ■

LPL Financial