Weekly Market Commentary

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Summertime Blues

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Highlights

Last week's reading on the ISM Index confirmed that the economy has entered a period of slower growth and stock market performance is likely to be modest and volatile in the months ahead. However, we do not envision a return to recession or a bear market for stocks.

While there is no cure for the summertime blues that accompany slow and uneven growth in the economy, there is portfolio medicine that may buffer the volatility.

While stocks should be considered as a component of a diversified portfolio, other asset classes such as high-yield bonds and commodities asset classes may offer better prospects and valuable diversification in the near future.

Last week provided more reasons for investors to take a defensive posture. The weaker-than-expected economic data extended the slide in the S&P 500 to five straight weeks totaling a decline of -4.6% and cutting the year-to-date total return in half as the summer gets underway.

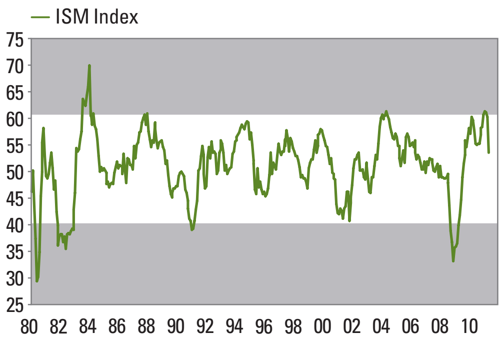
We adhere to our 2011 forecast of modest single-digit gains for the stock market in 2011, despite recent economic data introducing more market volatility. We do not envision a return to recession or a bear market for several reasons, including:

- The economy has created about 200,000 new private sector jobs per month this year — the strongest pace since before the financial crisis.
- Businesses are now increasing their spending and driving growth after a decade of under-investing.
- Financing conditions for the consumer and business are improving rapidly; banks have lowered lending standards and junk bond yields are the lowest in history.
- The declining US dollar is boosting earnings and making U.S. products more competitive globally.
- Inflation is likely near its peak in China — wholesale food prices have declined 10% from the recent peak — and in other nations suggesting rate hikes may soon abate.
- U.S. businesses have plenty of cash to spend on hiring, capital, dividends, and acquisitions.

Nevertheless, we believe the recent spate of weaker-than-expected economic reports, while driven in part by a number of temporary factors such as supply chain disruptions stemming from the Japan earthquake and tsunami, signal the economy has entered a period of slower and uneven growth. The clearest indicator of this slow down came in last week's ISM report.

The ISM is one of the best leading indicators for the economy and markets. The Institute for Supply Management (ISM) is a group that represents purchasing managers at U.S. corporations. They survey these managers each month and publish the results in the form of an index. Purchasing managers are at the front of the line when it comes to activity in manufacturing. Manufacturing companies need supplies to produce products and purchasing managers order these supplies. When demand starts to pick

1 ISM Over the Past 35 Years



Source: LPL Financial, Bloomberg Data 06/02/11

The ISM Index and S&P 500 Price Changes

	S&P 500 Price Change		
ISM Peak	12 Months Before Peak in ISM	6 Months After Peak in ISM	12 Months After Peak in ISM
Feb. 1976	22.2%	3.2%	0.1%
Jul. 1978	1.9%	-0.7%	3.1%
Nov. 1980	32.4%	-5.6%	-10.1%
Dec. 1983	17.3%	-7.1%	1.4%
Oct. 1987	3.2%	3.8%	10.8%
Oct. 1994	1.0%	9.0%	23.1%
Jul. 1997	49.1%	2.7%	17.4%
Nov. 1999	19.4%	2.3%	-5.3%
May 2004	16.3%	4.7%	6.3%
Average	**18.1%**	**1.3%**	**5.2%**
Feb 2011	20.2%	-0.5%*	

Source: LPL Financial, Bloomberg Data 06/02/11

*Three months from ISM report on 03/01/11 to 06/02/11

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

up for manufactured goods, these managers need to order more supplies. Conversely, when demand pulls back, they respond by trimming their orders.

Although manufacturing businesses make up only about 40% of S&P 500 company earnings, demand for manufactured goods has been a timely barometer of business activity of all types. This Index is published at the beginning of each month offering one of the earliest signals as to how the economy and outlook for business is faring each month.

The long history of the ISM shows us how effective it has been in signaling economic momentum. While the ISM has given a consistent signal when the recession is ending, it has also signaled when the recovery momentum peaks and the economy begins to transition to a new stage. Looking back at the ISM over the past 35 years we can see that there have been a number of peaks and troughs that led the direction of economic and profit growth. The Index has typically troughed in the range of 30–40 and peaked around 60.

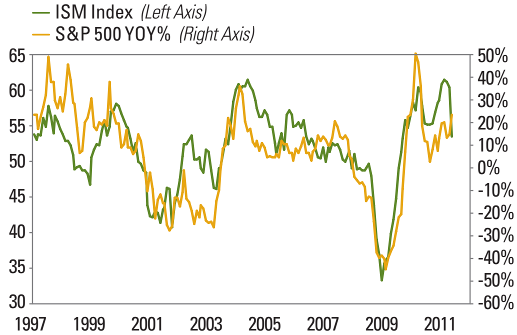
Last week, on June 1, the ISM was reported for the month of May 2011 and declined sharply to 53.5 from the April 2011 reading of 60.4, confirming that February 2011 was the peak at 61.4. The sharp pullback was in part driven by the supply chain disruptions from the Japan earthquake and tsunami along with unusual and disruptive weather patterns in the United States. However, it is normal for the ISM to retreat to around 50 at this middle stage of the business cycle after the recovery stage. As we pointed out back in March, the February peak in the ISM means stock market performance is likely to be modest and volatile in the months ahead.

The S&P 500 has tended to perform well during the year leading up to the peak in the ISM. Over the past 35 years, the S&P 500 was up 18%, on average, in the 12 months prior to the peak in the ISM. However, once reaching the peak, returns were flat and volatile. Over the six months following the peak, stocks were up only 1%, on average. It is interesting to note that the S&P 500 was up and very close to the historical average in the 12 months before the February 2011 ISM was released on March 1, 2011. Over the three months since the release of that peak reading on March 1, 2011, the S&P 500 has been flat suggesting a weak start to what could be a soft period for stock market returns, as the pace of growth slows.

How closely the performance of the stock market and the ISM track each other can best be seen in Chart 2. With momentum in the ISM past its peak, stock market performance is likely to soften on a year-over-year basis. The second half of 2011 is unlikely to match the powerful gains of the second half of 2010, leaving year-over-year gains to fade. Consistent with this relationship between the ISM and the S&P 500, we adhere to our forecast of a modest single-digit gain for the S&P 500 in 2011.

The ISM points to a further slowdown in earnings growth in the second half of the year, as you can see in Chart 3. Earnings bounced back sharply in 2010, but are poised for a return to an average single-digit growth rate over the course of the coming quarters. The next several weeks constitute the pre-announcement season for second quarter 2011 earnings reports. We

2 ISM Index Level and S&P 500 Year-Over-Year Performance



Source: LPL Financial, Bloomberg Data 06/01/11

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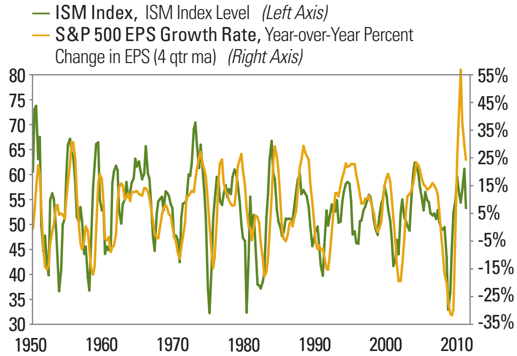
3 ISM Index Level and S&P 500 Year-Over-Year Earnings Growth



Source: LPL Financial, Bloomberg Data, ThomsonONE Data 06/01/11

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would not be surprised to hear corporate leaders reining in expectations for growth in the second half of 2011.

The summer may prove to be a volatile period for stocks. While there is no cure for the summertime blues that accompany slow and uneven growth in the economy, there is portfolio medicine that may buffer the volatility. While stocks should be considered as a component of a diversified portfolio, other asset classes such as high-yield bonds and commodities asset classes may offer better prospects in the near future. The added diversification from these asset classes can help to buffer volatility in the stock market and potentially boost portfolio performance. This is important as we enter the stage of the business cycle signaled by the ISM Index during which we expect the pace of economic momentum to slow along with overall market performance.

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