Weekly Market Commentary

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Renewed Rally

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Highlights

- We raised our recommended stock weighting just prior to last week as the earnings reporting season was about to get underway. During the past two quarters, the stock market moved sideways in the two weeks prior to the start of earnings season then rallied as the reports came in. This pattern appears to be unfolding again this season.
- While we are excited by the prospects for a renewed rally in the stock market, we are vigilant for signs that the tailwind of extraordinary market support provided by the Fed could turn into headwind with negative consequences for investors.
- If the dollar's weakness becomes driven by a loss of confidence by foreign investors the Fed would likely pursue earlier and more aggressive rate hikes, posing real challenges for the economy and markets. This would be cause for concern and defensive actions in portfolios.

1 Dollar Decline
Value of the Major Trade Weighted Dollar, Past 12 Months

Source: Bloomberg, LPL Financial,

Last week's 5% stock market rally, as measured by the S&P 500, was driven primarily by a positive start to the third quarter earnings season. While we cautioned last week about drawing conclusions on third quarter results too early, we can't help but note that a number of companies gave us just what we were looking for by posting better than expected sequential revenue growth and a high 74% of companies are beating expectations.

We had expected a renewed rally to begin last week after stocks have been in a range of 1025 to 1075 on the S&P 500 for the past month. We raised our recommended stock weighting just prior to last week as the earnings reporting season was about to get underway. During the past two quarters, the stock market moved sideways in the two weeks prior to the start of the earnings season then rallied as the reports came in. This pattern appears to be unfolding again this season.

While we are excited by the prospects for a renewed rally in the stock market, we are vigilant for signs that the tailwind of extraordinary market support provided by the Fed could turn into headwind with negative consequences for investors. One indicator we are watching closely is the dollar. While the dollar fell again last week, this is not necessarily a bad thing since it has fallen steadily since the market low in March without negatively affecting the recovery in the economy or the markets. However, the driver of the dollar's decline may change triggering a series of linkages that could end the recovery.

Currency declines are often associated with the withdrawal of foreign investors from a country's markets. This is typically part of a broader chain of events. As foreign investors lose confidence or find better alternatives, capital flees the country causing the currency to plunge, inflation and interest rates to rise, and the economy to fall into recession. This combination often leads to a deep and painful recession. The best example is Thailand in 1997. During the prior 10 years, Thailand's economy grew at a nearly 10% annualized pace. Foreign capital flooded the country, but as that capital began to flow elsewhere a financial crisis unfolded. During the summer of 1997, the Thai baht, which had been pegged to the U.S. dollar, began a slide that lost more than half of its value, Thailand's booming economy hit a wall and plunged into a deep recession, and the Thai stock market dropped 75%. [Chart 2]

Fortunately, the trigger of these linkages does not describe the recent decline in the dollar. Foreign investors have been eager to invest in the U.S. and purchases of Treasury debt has met supply with enough demand

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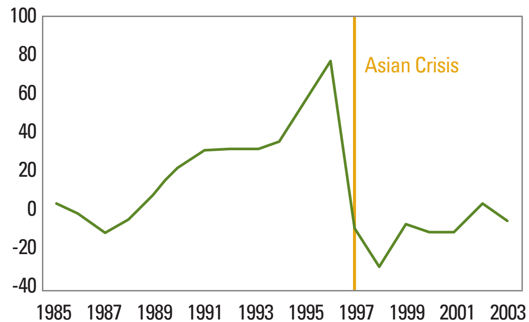
2 Asian Financial Crisis Preceded by Capital Flight
Net Private Capital Flows for Thailand, Malaysia, Indonesia, Philippines, and South Korea, 1985-2003 in $ Billions



Source: Bloomberg

to push bond prices higher and drive yields to near record lows. Therefore, a more plausible explanation of the dollar's weakness is the one that we highlighted a couple of weeks ago: as markets rally, leveraged investors around the world borrow at very low rates in the U.S. then sell those dollars to buy foreign denominated investments. As a result, the dollar's weakness has best explained by the return of risk appetite and not a loss of confidence and not the more worrisome withdrawal of foreign investors from U.S. markets.

However, last week's reports of meetings among Middle East oil producers and their customers, including China and Japan, to replace the dollar with a basket of currencies suggests that confidence in the dollar may be waning. While public comments denied the meetings took place and this type of rumor has been heard several times before making the story implausible, but not impossible. Also last week, Fed chairman Ben Bernanke discussed raising interest rates when necessary. Should the dollar weakness become driven by a loss of confidence by foreign investors – rather than by the return of risk appetite - the linkages of rising inflation expectations and interest rates would be triggered and likely prompt a response by the Fed in the form of earlier and more aggressive rate hikes, posing real challenges for the economy and markets.

We continue to believe the dollar is an important signal to investors. A sharp drop in the dollar driven by a loss of confidence would be cause for concern and defensive actions in portfolios. Instead we have witnessed a slow and steady 5% decline over the past four months that has accompanied gains in the world's stock and bond markets as risk appetite has been returning. The markets continue to climb the wall of worry, since individuals remain pessimistic - as can be seen in investor and consumer confidence surveys - and are slowly putting to work very high cash balances.

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The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise and are subject to availability and change in price.

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