Weekly Market Commentary

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Back to the Future: Will 2010 Look Like 2004?

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Highlights

- While some forecasters are reaching back to the 1930s to find comparisons to the environment the markets are likely to encounter in 2010, we find a more recent comparison to be compelling.
- 2010 is likely to be similar to 2004 in a number of areas, including: earnings growth for S&P 500 companies, the actions by the Federal Reserve, the outcome of the congressional elections, and the performance of the stock and bond markets.

While some forecasters are reaching back to the 1930s to find comparisons to the environment the markets are likely to encounter in 2010, we find a more recent comparison to be compelling. We believe that 2004 could be a useful guide to what may happen in 2010.

The idea that 2010 could be similar to 2004 in many ways may not be as far fetched as it may seem. After all, 2009 looked a lot like 2003. Consider that in both 2003 and 2009:

- The S&P 500 index started the year at about the 900 level and closed in on 1100 as the year wore on.
- The stock market made its low in March in the aftermath of a recession brought on by a bursting bubble in the financial markets.
- Key economic barometers like the Institute for Supply Managements Purchasing Mangers Index (ISM) rose above 50 in the second half of the year signaling the return of expansion in the manufacturing sector.
- The dollar fell and commodity prices rose.

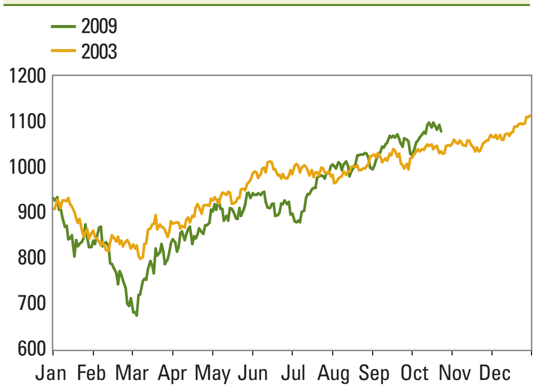
Heck, not only did the charts look similar, the years even sounded the same: the best selling album in 2009 is actually a compilation from 2003, Michael Jackson's Number Ones.

Just as 2009 echoed 2003, 2010 is likely to be similar to 2004 in a number of areas, including: earnings growth for S&P 500 companies, the actions by the Federal Reserve, the outcome of the congressional elections, and the performance of the stock and bond markets.

In 2004, earnings growth for S&P 500 companies rebounded 25%. That is the same gain forecast by the analyst consensus for 2010. This is similar to a typical post-recession profit rebound for S&P 500 companies despite the far deeper than normal trough in profits during the recession. By year-end 2010 the forecast rebound would take S&P 500 earnings only back to about $76 where they were in 2005, which is about 20% below the trailing four quarter earnings peak that took place back in mid-2007. We believe this is reasonable given the mix of drivers in 2010 including very wide profit margins driven by aggressive cost cutting.

The Federal Reserve began to hike interest rates in mid-2004 as it began to take back the stimulus provided in the aftermath of the bursting of the Tech stock bubble when it cut rates by 550 basis points. Similarly, we expect the Fed will to begin to hike rates in mid-2010 as it begins the process of taking back the stimulus it provided in the aftermath of the housing bubble,

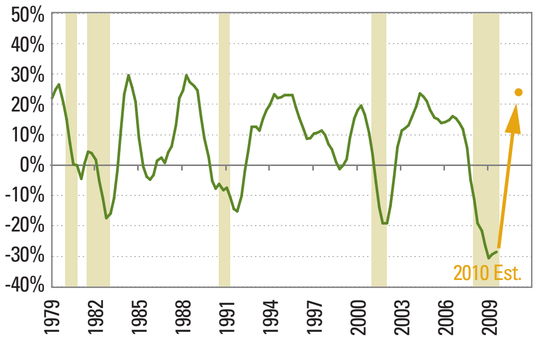
1 Stocks Followed a Similar Path in 2003 and 2009
S&P 500 Index in 2003 and 2009



Source: Bloomberg, LPL Financial

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

2 2010 Earnings Rebound Echoes 2004
S&P 500 Operating Earnings Year-Over-Year Change in Four Quarter Sum



Source: Bloomberg, LPL Financial

when it cut rates by 525 basis points. Also, we expect the Fed to abandon use of the phrase "extended period" in their statements as it relates to how long the Fed intends to keep rates low in the early part of 2010, just as they abandoned a similar phrase "considerable period" in early 2004, signaling the rate hikes to come.

In 2004, the Republicans picked up seats in both the House and Senate. Based on polling, Republicans appear likely to pick up at least 15 seats in the House of Representatives and their gains could go as high as 40 seats. In the Senate, given the seats up for election in 2010, a gain of 3-4 seats appears likely. This would eliminate the likelihood of filibuster-proof margins for the Democrats in the Senate and reduce the uncertainty associated with the potential for sweeping changes to legislation.

The bond market, measured by the Barclays Aggregate Bond index, posted a gain of 4%--similar to our outlook for weak returns in the bond market in 2010. The S&P 500 was up 9% in 2004 and ended the year around 1200, similar to our outlook for a mid-to-high single-digit gain. However, there are differences in the pattern of performance in 2004 and what we expect for 2010. The first half of 2004 was weak for stocks and bonds; all the gains were achieved in the second half. That is the opposite of what we expect in 2010 when the impact of Fed rate hikes in the second half of the year may reverse some of the gains achieved by the markets early in 2010.

In a number of ways, 2004 provides similarities to what we expect for 2010. However, every year brings its own unique set of risks and opportunities. We look forward to publishing our comprehensive Outlook for 2010 in about six weeks.