



# Weekly Market Commentary



October 4, 2010

## Our “One and a Half Cents” on the Fourth Quarter

### Jeffrey Kleintop, CFA

Chief Market Strategist  
LPL Financial

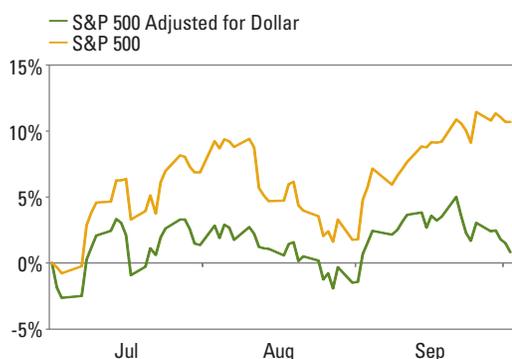
#### Highlights

A one and a half (not double) dip for the economy. We expect slow, but positive economic growth supporting modest stock market gains in the fourth quarter.

One and a half chambers of Congress go to the Republican Party in the mid-term election. The return of political balance in Washington between the parties may slow the pace of legislative change and result in the gridlock the market has historically favored.

QE 1.5 from the Fed. During the fourth quarter, the Federal Reserve is likely to announce additional stimulus measures to stimulate growth.

#### 1 The Dollar Made a Big Difference *S&P 500 and S&P 500 Adjusted for the Major Trade-Weighted Dollar*



Source: LPL Financial, Bloomberg 10/01/10

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

The stock market posted strong gains during the third quarter after rebounding from the low of the year that occurred near the end of the second quarter. The S&P 500 posted an 11% gain for the quarter. The strong gains during the quarter were far from steady. Volatility was high as the S&P 500 moved up and down within a 10% trading range. Cyclical, Mid-Cap, and European stocks fared the best during the quarter:

- The highly cyclical Materials, Industrial, and Consumer Discretionary sectors were among the best performers while the legislation-sensitive Financials and Health Care sectors lagged.
- Mid-Cap stocks outperformed their peers as merger and acquisition activity picked up during the quarter boosting premiums for mid-sized acquisition targets.
- Overseas stock markets, measured by the MSCI EAFE Index, fared even better than the U.S. market as sentiment on the European debt problems improved and as the euro fell it boosted returns in dollar terms.

In fact, this last point regarding the dollar deserves additional attention since foreigners were big investors in the U.S. stock market in the third quarter supporting the stock market while U.S. investors were net sellers. According to data from the U.S. Treasury, purchases of U.S. stocks by foreigners in the third quarter of 2010 were likely strong based on the latest data available for July. On average, demand in recent quarters has only been exceeded in the past by the surge in buying around the market peaks in 2000 and 2007.

However, those foreign investors saw almost none of the strong gains in the U.S. stock market translate into their holdings due to the decline in the value of the dollar. The performance of the dollar-denominated S&P 500, when adjusted for the value of the dollar against major trading partners, was relatively flat for the quarter. If foreign investors fear further declines in the dollar, they may restrict their buying of U.S. stocks.

Despite the strong gains, the stock market ended the third quarter not far from where it began the year. The volatility that has been the key characteristic of this year's stock market performance is likely to continue. However, investors may also look forward to gains in the fourth quarter as key drivers combine to lift stocks out of the range that bound much of the third quarter. In general, we recommend buying the dips. After a likely pause or brief pullback in the next few weeks, there are a number of potential catalysts that may renew the stock market's upward momentum of September. Here is our “one-and-a-half cents” on these potential catalysts:



The market's reaction to mid-term elections, as uncertainty fades, has almost always been positive, with fourth quarter gains averaging 8% in mid-term election years.

- **A one and a half (not double) dip for the economy.** We expect slow, but positive economic growth supporting modest stock market gains in the fourth quarter.
- **One and a half chambers of Congress go to the Republican Party (GOP) in the mid-term election.** The GOP is likely to take the majority in the House and will hold about half of the Senate. The return of political balance in Washington between the parties may slow the pace of legislative change and result in the "gridlock" the market has historically favored. In addition, depending on the outcome of the election, it is possible PAYGO (Pay-As-You-Go) rules that require budget offsets to any tax cuts are waived allowing the extension of many, if not all, of the Bush tax cuts into 2011.
- **Quantitative Easing (QE) 1.5 from the Fed.** At the Federal Reserve meeting on November 3 or December 14, the Fed is likely to announce additional stimulus measures to stimulate growth. The coming bond purchases will only be half the size of QE 1 (the first round of quantitative easing the Fed enacted during 2008 and 2009) as the Fed embarks on Operation Reflation.

Finally, as we have noted in prior commentaries, the fourth quarter of mid-term election years is almost always favorable for stocks. The market's reaction to mid-term elections, as uncertainty fades, has almost always been positive, with fourth quarter gains averaging 8% in mid-term election years. The only two exceptions to the gains in the fourth quarter of every mid-term election year since 1950 were 1978 and 1994, when the Fed was hiking rates aggressively, a critical factor highly unlikely to take place this quarter. So far, the stock market performance in 2010 has tracked the typical pattern for U.S. stocks in mid-term election years, albeit with a bit more than the usual volatility.



---

**IMPORTANT DISCLOSURES**

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.

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.

MSCI EAFE is an index of approximately 1,045 equity securities issued by companies located in 19 countries and listed on the stock exchanges of Europe, Australia, and the Far East. All values are expressed in U.S. dollars.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Mid capitalization, companies are subject to higher volatility than those of larger capitalized companies.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

**Materials Sector:** Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

**Industrials Sector:** Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

**Consumer Discretionary Sector:** Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

**Financials Sector:** Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

**Health Care Sector:** Companies are in two main industry groups—Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit