



Weekly Market Commentary



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Soft Spot

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Highlights

Historically, immediately following a peak in leading indicators, which most often comes about a year after a recovery begins, an uneven pattern in the economic data and market performance emerges that we call a “soft spot.”

These soft spots include a weakening in closely watched economic data such as the ISM Index, weekly initial claims for unemployment benefits, and consumer confidence. In addition, the S&P 500 typically falls below its 200-day moving average.

If the current soft spot proves to be a reflection of uneven data points, rather than a double-dip recession, the markets are likely to rebound as more data emerges. The typical bounce in the S&P 500 was 7.9% after one month and 10.9% after three months.

Back at the beginning of this quarter, we forecasted that leading indicators of economic and profit growth would be peaking during the second quarter (*Weekly Market Commentary*, “When Leading Indicators Peak,” April 5, 2010). We believe that the upward momentum in these measures has now peaked, including the closely followed Leading Economic Index (LEI) and the Institute for Supply Management’s Purchasing Managers Index (ISM). (We note that the upward momentum in our *LPL Financial Current Conditions Index* has also stalled.) We had forecast that with leading indicators peaking stock market performance was likely to stall and become more volatile. Now that this has unfolded, what is next for the economy and markets?

Historically, what ultimately follows a peak in leading indicators has typically been a successful transition to a multi-year period of economic growth. However, immediately following the peak in leading indicators, which most often comes about a year after a recovery begins, is an uneven pattern in the economic data and market performance. We call these “soft spots” in the data. With the recent recession still fresh in the minds of investors, any soft data point is seen as evidence the economy may be backsliding into recession. Investors are quick to sell when a soft spot emerges fueling a pullback that takes the S&P 500 below its 200-day moving average.

Looking back over the past 60 years, we can see that around the time of prior soft spots:

- ISM consistently fell back to about the break-even level of 50.
- The weekly number of first-time filings for unemployment benefits rose by 49,000.
- Consumer confidence declined by 13 points.
- The S&P 500 fell about 5% below its 200-day moving average.

Economic and Market Performance Around Recovery Soft Spots

Recovery Began	Soft Spot Started	ISM Decline		Claims Rise in 000s*	Consumer Confidence Decline*	S&P 500 Max Below 200 Day
		Peak	Trough			
Oct 1949	Jul 1950	77.5	59.2			-3.1%
May 1954	Mar 1955	69.5	44.2			
Apr 1958	May 1959	68.2	48.3			-3.3%
Feb 1961	Dec 1961	64.2	49.5			-22.5%
Nov 1970	Feb 1971	54.8	51.2	43.8	2.0	-8.8%
Mar 1975	Feb 1976	61.5	51.7	64.3	13.9	-3.4%
Nov 1982	Dec 1983	69.9	47.1	85.0	2.9	-7.4%
Mar 1991	Sep 1991	54.9	46.8	36.7	33.8	-1.6%
Apr 2003	May 2004	61.4	51.0	13.5	13.1	-3.9%
	Average	64.7	49.9	48.7	13.1	-6.8%
Current	May 2010	60.4				-5.1%

Source: LPL Financial, Bloomberg 06/21/10

*data begins in late 1960s

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

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.



Despite the concerns, these soft spots were not signs that the recovery was going to fail. In fact, in every case the recovery was successful and a multi-year period of economic growth followed.

Currently, the combination of Europe's debt problems and evidence of slower growth in China are adding to the anxiety over the slowing of the pace of improvement in the U.S. economy. However, if the current soft spot proves to be a reflection of uneven data points as the economy transitions from recovery to sustainable growth, rather than a double-dip recession, the markets are likely to respond as they have in the past and rebound as more data emerges. The typical bounce in the S&P 500 after reaching the soft spot low point versus the 200-day moving average was 7.9% after one month and 10.9% after three months. Also, it is worth noting that over recent periods where data for smaller company stocks is available, they have tended to outperform larger companies during the rebounds. We continue to advocate an overweight to small company stocks.

While every recovery has encountered at least one soft spot as it matured, some had many soft spots that contributed to above average volatility for an extended period. We believe a period of above-average volatility lies ahead for investors, which we believe favors a tactical approach to investing that seeks to take advantage of pullbacks while also seeking to protect profits as markets rebound.

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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.

Stock investing involves risk including loss of principal.

ISM Manufacturing Index: An index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The index of leading economic indicators (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

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