Weekly Market Commentary

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Will Economic Surprises Bring a Market Surprise?

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Highlights

In the past few weeks, market and economic performance have decoupled.

This may be explained by the weak economic data increasing the odds of a new Federal Reserve (Fed) stimulus program that may be holding Treasury yields down even as it boosts the stock market.

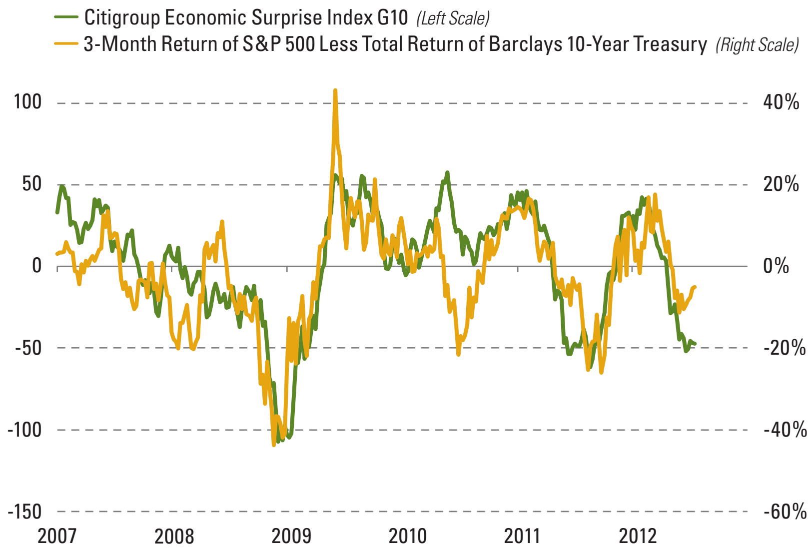
A gap in market and economic performance similar to the current one appeared in July of 2011, only to close with a sharp drop in the S&P 500.

Economic data continues to disappoint. The economic surprise index, which measures whether data reports come in better or worse than economists' estimates, has continued to fall for the world's largest 10 economies.

The performance of the stock versus the bond market over the prior three months has tended to track the economic surprise index closely in recent years. But in the past few weeks, market and economic performance have decoupled, as you can see in Figure 1.

Consistent with this pessimistic tone of the economic data, the yield on the 10-year Treasury note has fallen to near all-time lows as investors bid up prices for Treasuries by 4% over the past few months as they seek a safe haven from risk. Yet stocks proved resilient to the data in recent weeks as the S&P 500 recouped some of the earlier losses and are now about flat over the past three months. This relative performance is a far cry from the 20% gap suggested by the economic surprise index.

1 Markets Have Decoupled From Economic Performance



Source: LPL Financial, Bloomberg Data 07/20/12

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

Citigroup Economic Surprise Index (CESI) measures the variation in the gap between the expectations and the real economic data.

Stocks have either priced in an expectation for a sharp turnaround in economic performance or investor behavior is being driven by factors other than the economy. However, earnings, Europe, and the election are not likely to be the drivers.

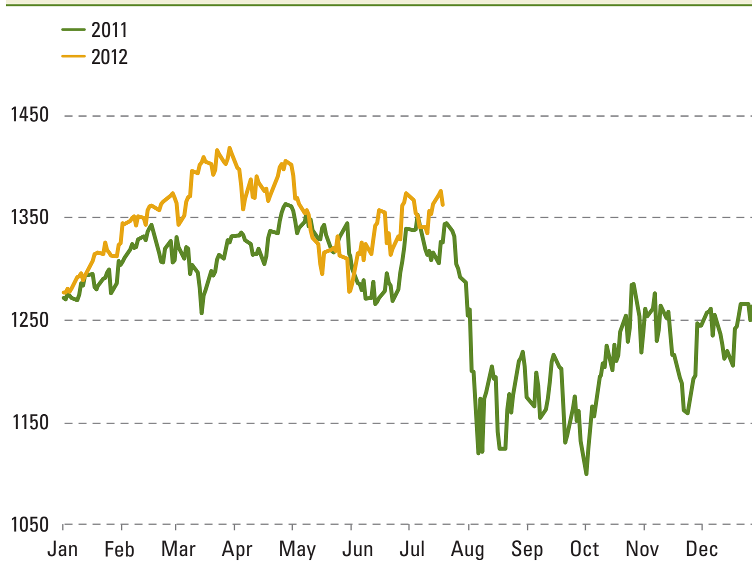
- While stocks have tended to rise during the earnings season, as we pointed out a few weeks ago, the earnings reports thus far in the second quarter 2012 reporting season are not particularly strong on an absolute or on a relative to expectations basis.
- The situation in Europe has not improved as demonstrated by yields on Spanish debt rising over 7% on Friday.
- And election polls on the presidential race in the United States remain close with no clear breakout for either candidate for the markets to react to.

Instead, the reason for the markets' behavior may be the Federal Reserve (Fed). Last week's semi-annual testimony by Ben Bernanke in front of Congress was the catalyst for the gains as stocks turned around on the Fed chairman's comments on Tuesday, July 17 and headed higher for the next couple of days. His downbeat comments on the economy suggested the Fed may announce another stimulus program before the year is over.

The stock market would welcome a third round of stimulus as an inoculation shot against the economic drag of tax increases and spending cuts on tap for next year. The potential for Treasury purchases by the Fed that would likely be part of the stimulus program may also be holding Treasury yields down even as it boosts the stock market.

For the gap between market and economic performance depicted in Figure 1 to close, either upcoming economic data must surprise to the upside or stocks need to drop sharply. It is notable that a gap similar to the current one appeared in July of 2011. Ominously, that gap closed with a sharp drop in the S&P 500, as you can see in Figure 2. ■

2 Will the S&P 500 Follow Last Year's Pattern in August?



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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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.

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.

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