



Weekly Market Commentary



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Back to 1997

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Highlights

A sudden policy vacuum in the past few days after so much action in the prior two months was jarring to market participants and pulled the S&P 500 back to levels first reached in 1997. Not only did we learn that Paulson will not ask for the rest of TARP money and that no purchases of distressed assets with TARP money are going to take place, but it also appears that a fiscal stimulus package is unlikely to pass during the lame duck session of Congress. The jarring changes to the execution of the plan have made it seem ad hoc and vulnerable to being politicized, undermining its credibility.

The potential near-term catalysts that may establish support for the markets include: another temporary ban on short selling for Financials that may be implemented, members of the Obama transition team interceding at the Treasury to take action with the TARP funds, the Federal Reserve renewing purchases of mortgage backed securities and undertaking guarantees of more Financials.

Eventual stabilization in the economic data combined with falling inflation already well underway should help to lift market valuation. The S&P 500 analyst consensus price-to-earnings ratio on 2009 earnings is below 10, and the dividend yield has risen to 4% from current levels not seen since the early 1980s.

Last week the S&P 500 broke down out of the range of about 850 to 1000 that it had been in since October 10. This range appeared to be part of a classic bottoming process with a volume surge followed by multiple retests of a range on declining volume. The slide to new lows last week—at one point taking the S&P 500 back to levels first reached in 1997—was not on a volume surge like the October 10 one. Instead, trading volume was relatively moderate, indicating many market participants had already capitulated during the selling climax on October 10. Last week's new low was likely the result of a lack of buyers while some forced selling by hedge funds and institutions lingers. This fading selling pressure, along with the 75% peak-to-trough decline in the S&P 500 Financials sector nearing the 81% peak-to-trough decline of the S&P 500 Information Technology sector during the bear market of 2000-2002, suggests the additional downside may be limited. [\[Chart 1\]](#)

What took place that resulted in the renewed downtrend? On Monday, Treasury Secretary Paulson announced that he did not plan to seek authorization to release the second \$350 billion in TARP funds. He said he wanted to “preserve the firepower, the flexibility we have now and those that come after us will have.” What Paulson calls flexible, market participants consider vague and uncertain. This announcement comes just a few days after dropping the TARP's original concept—to buy troubled assets in an auction. The TARP was conceived to stabilize financial markets and restore investor confidence. But the jarring changes to the execution of the plan have made it seem ad hoc and vulnerable to being politicized, undermining the credibility of the plan. Instead, by not having a clear focus and execution, the TARP is left vulnerable to raids by powerful constituencies like the auto industry.

The sudden policy vacuum of the past few days after so much action in the prior two months was jarring to market participants. Not only did we learn that Paulson will not ask for the rest of TARP money and that no purchases of distressed assets with TARP money are going to take place, but it also appears that a fiscal stimulus package is unlikely to pass during the lame duck session of Congress. With the key element of policy support—critical to the bottoming process of prior recessions and bear markets—suddenly withdrawn, stocks have followed the path of least resistance: downward. Also, other key indicators of the financial crisis where we have been observing improvement stalled or reversed recent progress. LIBOR rates have stopped falling, Commercial Paper issuance has slowed over the past week (after the burst that followed the initiation of the Federal Reserve program), and credit default swap spread indexes have now started to widen again.

In addition, credit conditions may tighten between now and yearend. Every year, banks cut back on lending to boost their capital ratios as the year-end



1 S&P 500 Index Touches Levels First Reached in 1997



Source: LPL Financial Research, Bloomberg

regulatory deadline nears. Without the two firms that provided 30 to 40% of the year-end funding in 2007, Bear Stearns and Lehman Brothers, the capital crunch could be greater than usual. This credit tightening may push LIBOR higher and partially reverse the recent declines that were welcomed by the markets. While this seasonal pattern is well known, there is recent added pressure coming from the pullback in expected TARP execution. Previously, it seemed that the remaining investment firms, Goldman Sachs and Morgan Stanley, would be able to liquidate some distressed assets by yearend. The tighter credit terms extended by these prime brokers to leveraged hedge funds may result in more forced sales of securities prior to year-end.

What could halt the market's slide? Potential near-term catalysts that may establish support for the markets are:

- Another temporary ban on short selling may be implemented for Financials, which are down about 40% in November.
- Timothy Geithner, Lawrence Summers, Paul Volker, and others on the Obama transition team could intercede at the Treasury to implement the remaining \$50 billion of the first \$350 billion of authorized TARP funds right away and seek authorization of the other \$350 billion.
- The Federal Reserve might renew purchases of mortgage backed securities and undertake guarantees of more Financials.

What could reverse the market's slide? The catalyst for the market to begin to reverse the recent losses may be stabilization in the economic data—not improvement in key readings on the economy which could take a couple of quarters, but merely not worsening monthly numbers on employment, manufacturing, and retail sales. That stabilization could be at least a month away based not only on our outlook for the economy, but also on the Fed's revised outlook released last week. Eventual stabilization in the economic data combined with falling inflation already well underway should help to lift market valuation—the S&P 500 analyst consensus price-to-earnings ratio on 2009 earnings is below 10, and the dividend yield has risen to 4%—from current levels not previously seen since the early 1980s.

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