Weekly Market Commentary

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"This-ISM, that-ISM"

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Highlights

The ISM index provides an important signal of earnings recovery.

The improving sentiment reflected in the ISM is what we expect to hear from business leaders this earnings season.

The rebound in the ISM index forecasts a profit recovery in the coming quarters. We expect S&P 500 company profits to be positive on a year-over-year basis in the fourth quarter.

The ISM is currently telling us to favor cyclical sectors such as Information Technology, Consumer Discretionary, Materials, and Industrials.

Of course, John Lennon was not referring to the index from the Institute for Supply Management (ISM) when he penned that lyric in Give Peace a Chance, but if he was, his dismissive sentiment of the world's "isms" would be inappropriate for investors today. We are believers in the power of one ISM in particular to define the outlook for earnings and the economy.

The Institute for Supply Management is an association of purchasing and supply management professionals. The ISM surveys its members each month and publishes the results in the form of an index. Purchasing Managers are at the front of the line when it comes to activity in manufacturing, because orders for the supplies to produce products at manufacturing companies are a leading indicator of increased manufacturing. (As trimmed orders are indicative of a slowdown when demand pulls back.)

Although manufacturing makes up only about 40% of S&P 500 company earnings, demand for manufactured goods has proven to be a timely barometer of economic activity of all types. This index is published at the beginning of each month, offering one of the earliest signals of how the economy and outlook for business is faring each month.

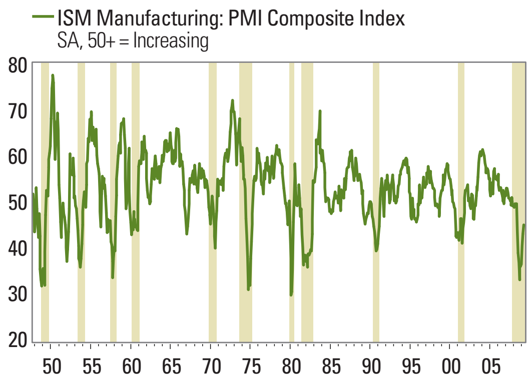
The long history of the ISM shows us how effective it has been in signaling each recession and recovery. Most importantly the ISM has given a consistent signal when the recession is ending. The end of each of the 10 recessions since World War II was marked by a sharp turnaround in the ISM index. During the current recession the ISM index bottomed in December and has since posted a sharp turnaround, rising from a low of 33 to 45. [Chart 1]

The ISM has also been an excellent indicator for profits. Chart 2 shows how closely the ISM index and the year-over-year change in S&P 500 company profits move over time. The rebound in the ISM index forecasts a profit recovery in the coming quarters. We expect S&P 500 company profits to be positive on a year-over-year basis in the fourth quarter.

Market participants typically heed important signals such as the ISM and take action.

As the ISM rebounds from the low point during a recession (usually a reading between 30 and 40) to a reading of about 60, the S&P 500 index typically posts double-digit gains. What sectors perform the best when ISM moves up from the recession low point to about 60? The best performing sectors have been Information Technology, Consumer Discretionary, Materials, and Industrials. The worst performers have been Utilities and

1 ISM Index
Shaded areas market recessions

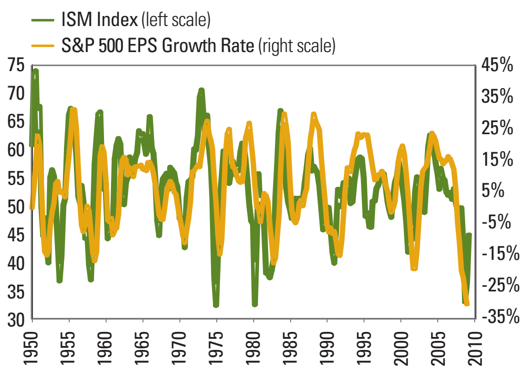


Source: Institute for Supply Management, Haver

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

2 ISM Index Points to a Turnaround in S&P 500 Earnings Growth

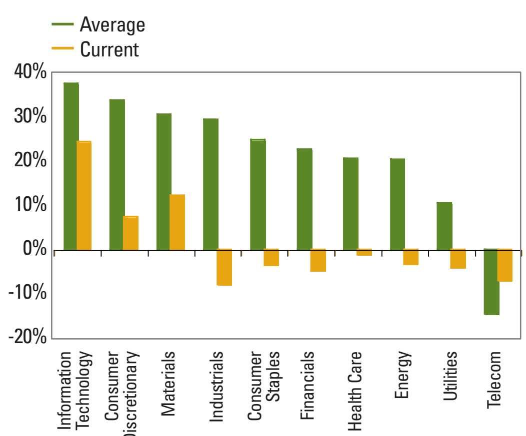
Year-Over-Year Change in Four Quarter Sum of S&P 500 Earnings Per Share and Institute for Supply Management PMI Index



Source: FactSet Research Systems, Thomson Financial, Bloomberg, LPL Financial

3 Average Sector Performance during Rebound in ISM index

Average Sector Performance during Rebound from Recession Low Point for ISM index to about 60 for Every Recession since World War II



Source: LPL Financial, Haver, Bloomberg

Telecommunications Services. During the current recession, the ISM bottomed in December. Since then, a similar pattern of performance can be seen, as illustrated in Chart 3.

In addition to the index, the ISM also releases details of the responses by purchasing managers indicative of the trends in the economy. The latest report contained the following responses:

- "Customer inventory burn is complete and real demand has reappeared." - *Machinery*
- "... a lot of people are requoting old business and using favorable pricing to negotiate with their current suppliers." - *Computer & Electronic Products*
- "Banks are reluctant to lend to businesses, and until this changes the economy will continue to be weak." - *Fabricated Metal Products*
- "Slow June, but firm large orders in July, August and September." - *Food, Beverage & Tobacco Products*
- "Market appears to have bottomed out as aftermarket has picked up slightly over the past month." - *Transportation Equipment*

While not universally positive, the improving sentiment in these responses from purchasing managers are the types of comments we expect to hear from business leaders this earnings season; we will hear from about half of the companies in the S&P 500 over this week and next.