

# Compass Points

Bringing you our latest tactical investing ideas



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## Jeffrey Buchbinder, CFA

Assistant Vice President  
LPL Financial

### Overview

This bi-weekly update provides an in-depth look at the latest tactical investment thoughts from LPL Financial Research as presented in the Portfolio Compass. This publication is designed to cover a broad investment landscape and present ideas to assist when considering portfolio strategy and to customize investment solutions.

## Data and Debt Woes

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
Stocks				●	○ → ●	●	
Alternatives				●	● ← ○	●	
Energy	●	●	●	●	○ → ●	●	

● Negative ● Neutral ● Positive

As of 11/09/11

Please refer to the Portfolio Compass publication for complete details.

### Compass Changes

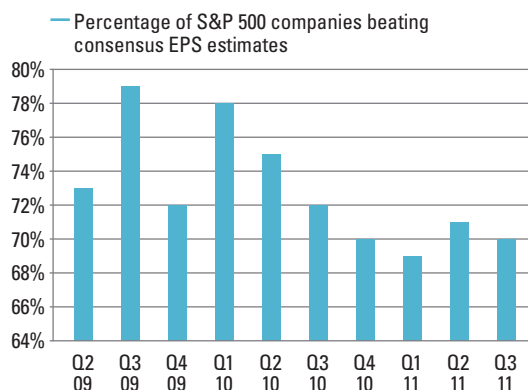
- Upgraded Stocks
- Downgraded Alternatives (direct Commodities)
- Upgraded Energy Sector

### Investment Takeaways

- Our more positive view of Equities reflects our continued belief that investors are pricing in overly pessimistic prospects for financial crisis, economic growth and profits. Europe has taken positive steps to contain the sovereign debt crisis, but substantial challenges remain including implementation of the expansion of the European rescue fund, rising Italian bond yields and political uncertainty in the Euro zone.
- Our lowered view of Alternatives reflects our preference for Commodities Equities over direct Commodities investments following the recent stock market pullback and run-up in crude oil prices.
- Economic data releases in the United States over the last two weeks were mixed and, like the earnings data, suggest slow economic growth, but no recession. Fewer jobs than forecast were added in October but upward revisions to prior months and a slight decline in the unemployment rate to 9.0% made for a balanced payrolls report.
- Earnings season has contradicted fears that Europe's debt woes would drag the United States into recession. With nearly 90% of S&P 500



## 1 Another strong earnings season relative to expectations



Source: LPL Financial, Thomson Reuters 11/07/11

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

companies having reported, an impressive 70% have beaten Wall Street's EPS targets [Chart 1].

- The Federal Reserve (Fed) reduced its growth outlook accompanying its November 2nd FOMC policy statement, but remains more optimistic than Wall Street, while leaving the door open for additional stimulus.
- Intermediate-term Treasury yields declined to near record low levels since our last publication on uncertainty over the European debt situation. Meanwhile, High-yield bond performance slowed since our last publication on risk aversion over Italy. We continue to find high-yield bonds attractive.

## Economy

- Economic data in the United States over the past two weeks was mixed, and continue to point to slow growth but not recession. Since our last publication, notable reports included stronger-than-expected third quarter gross domestic product (GDP) growth of 2.5% (annualized), driven by strong business spending, but a weaker-than-forecast Institute for Supply Management (ISM) manufacturing survey and payrolls data. Weekly jobless claims dipped below 400,000 for just the third time since early April. Claims data remain indicative of a weak labor market, and likely need to fall closer to 350,000 before a meaningful decline in the unemployment rate is realized. We expect the economy to expand at a 2.0% to 2.5% annualized rate during the fourth quarter of 2011.
- The Fed reduced its growth outlook in revising its quarterly forecast for growth, inflation and unemployment, but remains more optimistic than Wall Street. Additional monetary stimulus could come if the economy and jobs track closer to the market's expectations than the Fed's.

## Equity and Commodities Asset Classes

- We have taken a slightly more constructive view of Equities in recent weeks. We continue to believe investors are pricing in overly pessimistic prospects for financial crisis, economic growth and profits. U.S. economic data pointing to modest growth and not recession, strong third quarter earnings results, still attractive stock valuations and some positive steps taken in Europe toward containing the sovereign debt crisis have led us to a move to a neutral Equities view. Substantial challenges remain, including implementation of the framework agreed to in the latest Greek rescue package, rising Italian bond yields, a lack of leadership in Italy and Greece (as this publication was going to print) and the risk that the "Super Committee" fails to reach an agreement on the required \$1.2 trillion budget cuts ahead of the November 23rd deadline set by the debt ceiling agreement in August.
- The stock market, as measured by the S&P 500 Index, has entered a new trading range between 1220 and 1275. A sustained break above 1275 would be a bullish signal, while a potential break below the 50-day simple moving average just below 1200 is a key downside support level to watch. As this publication was going to print, the S&P 500 is down roughly 1% on the year.



- Our lowered view of the Commodities asset classes reflects our preference for Commodities Equities over direct Commodities investments following the recent stock market pullback and run-up in West Texas Intermediate (WTI) crude oil to our short-term price objective in the mid \$90s.

## Equity Sectors

- Earnings season has contradicted fears that Europe's debt woes would drag the United States into recession and provided support for positioning toward more economically sensitive sectors. With nearly 90 percent of S&P 500 companies having reported, an impressive 70% of companies have beaten Wall Street's EPS targets while more than 60% exceeded revenue forecasts. The top and bottom lines are on track for year-over-year increases of 11% and 17%, respectively, 2% and 5% better than analysts' estimates coming into reporting season, thanks in large part to strong growth in Emerging Market countries and surprisingly resilient profit margins. Guidance from corporate leaders has clearly pointed toward continued profit growth, not the recession that the market had been pricing in entering reporting season. These results and outlooks clearly point to continued earnings and revenue growth through year end and into 2012.
- We have upgraded the Energy sector, following recent changes in portfolios away from direct Commodities investments and toward Commodities Equities. With WTI crude oil having reached our near-term target range in the mid \$90s, we expect better return potential for stocks of energy producers than in a direct investment in crude oil. Energy has led the rally from the October 3rd S&P 500 low.
- Our bias remains that the cyclical sectors—Industrials, Materials, Energy, Consumer Discretionary and Technology—may benefit more than the defensive sectors from an economy that continues to grow, even if modestly. We find valuations on these sectors compelling as investors continue to price in what we believe are overly pessimistic prospects for financial crisis, as well as economic and profit growth.

## Fixed Income

- Intermediate-term Treasury yields declined to near record low levels since our last publication, benefitting from uncertainty over the European debt situation. As expected, the Federal Open Market Committee (FOMC) at last week's meeting reiterated its commitment to keep short-term rates on hold until mid-2013. Chicago Fed President Dudley surprised some market participants by dissenting on the vote, preferring to add additional monetary accommodation. Other Fed Governors in recent weeks have spoken out in favor of quantitative easing (QE3), including restarting mortgage-backed securities (MBS) purchases. Given that the Fed's quarterly forecast of growth, inflation and employment was revised weaker, the central bank stands ready to provide additional stimulus. Still, we view another round of QE as unlikely with core inflation hovering at 2.0%, the high end of the Fed's stated comfort zone.



- High-yield bond performance slowed since our last publication as the spread tightening that occurred during October stalled on risk aversion over Italy. Earnings results continue to show stable to improving credit metrics and contradict overly pessimistic default outcomes priced into current valuations. The yield advantage to Treasuries of around 7.5% implies a default rate of around 8–9%, well above the trailing 12-month default rate of 1.8%. We continue to find high-yield bonds attractive.

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#### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

Stock investing may involve risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

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

**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.

**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.

**Energy Sector:** Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

**Technology Software & Services Sector:** Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

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.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of



prepayment risk, and interest rate risk.

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.

The ISM index is 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.

Default rate is the rate in which debt holder's default on the amount of money that they owe. It is often used by credit card companies when setting interest rates, but also refers to the rate at which corporations default on their loans. Default rates tend to rise during economic downturns, since investors and businesses see a decline in income and sales while still required to pay off the same amount of debt.

An earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

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