



Weekly Market Commentary



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The Pink Swan

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Highlights

A “black swan” event—a rare, unexpected event that has a major impact—is most often referred to as something with negative consequences. Investors have sharply discounted the odds of a positive surprise, or “pink swan” event.

While investors fret over black swans, there are a number of potential pink swans that could take place and grab investors’ attention in the weeks ahead.

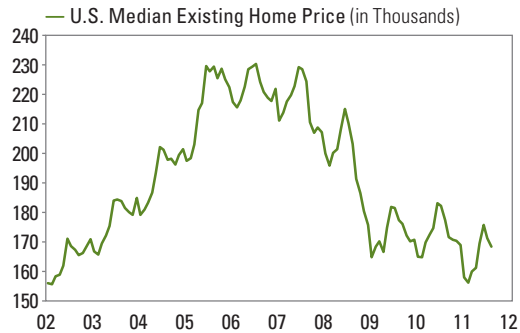
While they may be hard to see at the moment, there are potential pink swans that could result in stronger-than-expected growth over the longer term: a clear path to U.S. fiscal sustainability could emerge in the next few years; China’s consumers could begin to become a powerful force and drive global demand growth; and new technologies could greatly improve resource productivity.

A “black swan” event—a rare, unexpected event that has a major impact—is most often referred to as something with negative consequences. The near-record low investor confidence readings and double-digit decline in the stock market during the third quarter reflect concern that the odds have sharply increased that a black swan event may take place. It is easy to cite a few of them: a European financial crisis; a U.S. recession; a fiscal debacle in Washington. However, investors have just as sharply discounted the odds of a positive surprise, or “pink swan” event. Given the pessimistic tone of investors, the pink swan may have the bigger potential market impact.

Last week the U.S. economic data came in better than expected and progress was made on the European debt problem with Germany’s ratification of the expansion of the European Financial Stability Facility. However, this provided little relief to investors as stocks were basically unchanged on the week and remained near the low end of the 1100 to 1200 range the S&P 500 Index has been stuck in for the past two months. While investors fret over black swans, there are a number of potential pink swans that could take place and grab investors’ attention in the weeks ahead:

- The employment report is released this week and could surprise to the upside. Recent economic data has been better than expected, with the index of leading indicators rising for the fourth consecutive month and initial claims for unemployment benefits falling below 400,000 last week for the first time since April. These indicators may surprise investors braced for weak data.
- Next week the third quarter earnings reporting season gets underway. Corporations were able to post double-digit earnings per share gains in the first and second quarters despite U.S. gross domestic product (GDP) growth that averaged less than 1%. Third-quarter GDP may have been more than twice the first half average, supporting continued solid earnings growth despite low expectations by investors priced into stock valuations.
- Further signs may emerge in the coming weeks that Germany is supporting the euro zone as evidenced by the wide margin of passage on the German vote for the expansion of the European Financial Stability Facility (EFSF). Based on the success in Germany of the EFSF vote, the European Commission may introduce a proposal for so-called eurobonds

1 Median Home Prices Have Been Relatively Unchanged Since the Drop in 2009



Source: LPL Financial, National Association of Realtors data 10/02/11

S&P 500 Double-Digit Quarterly Losses Usually Followed By Solid Gains

Quarter of S&P 500 Double-Digit Decline	Magnitude of S&P 500 Double-Digit Decline	S&P 500 Performance in the Following Quarter
2Q 1962	-21.3%	2.8%
2Q 1970	-18.9%	15.8%
4Q 1973	-10.0%	-3.7%
3Q 1974	-26.1%	7.9%
3Q 1975	-11.9%	7.5%
3Q 1981	-11.5%	5.5%
4Q 1987	-23.2%	4.8%
3Q 1990	-14.5%	7.9%
3Q 1998	-10.3%	20.9%
1Q 2001	-12.1%	5.5%
3Q 2001	-15.0%	10.3%
2Q 2002	-13.7%	-17.6%
3Q 2002	-17.6%	7.9%
4Q 2008	-22.6%	-11.7%
1Q 2009	-11.7%	15.2%
2Q 2010	-11.9%	10.7%
3Q 2011	-14.3%	
Average		5.6%
Average ex-losses		9.4%

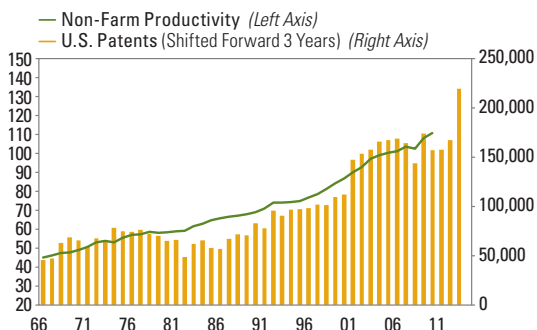
Source: LPL Financial, Bloomberg data 10/02/11

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

to the parliament. The potential for the adoption of a long-term solution to the European debt problems would be a confidence boost where it is needed most.

- China may surprise by cutting rates. After hiking rates and restraining growth and inflation pressures over the past couple of years, China has recently declared victory over its inflation problem and could return to a more pro-growth policy after economic growth slowed from about 12% to 9% in the past year and a half. This would be a surprise positive for the markets—particularly commodities.
- The Federal Reserve's last effort to help the economy, the so-called Operation Twist, could spur home buying as it creates the lowest mortgage rates in history. Already low rates helped to lift existing home sales 18% over the past year and new home sales are up 6%. A rise in home prices, with median home prices basically unchanged since the free-fall ended in early 2009 [Chart 1], would be a welcome surprise.
- It is possible that the "super committee" tasked with finding the minimum of \$1.5 trillion in deficit reduction by the end of this year as part of the debt ceiling legislation passed in August may succeed and recommend real fiscal reform. The bar is low. Many political pundits expect the group to fail by only finding a fraction of the intended deficit reduction, resulting in an automatic sequester to discretionary spending, the outcome largely reflected by markets.
- Over the past 50 years, when stocks post a double-digit decline in a quarter they typically rebound 6% during the following quarter. Out of the 16 times the S&P 500 has registered a double-digit loss during a quarter, 13 of those times—or over 80% of the time—the following quarter posted a gain and those gains averaged 9%. It is worth noting that the month of October is historically the month that typically ends stock market slides as the market begins to reverse declines.
- Looking beyond the next several weeks or months, we continue to expect a below average growth environment in the years ahead. However, while they may be hard to see at the moment, there are potential pink swans that could result in stronger-than-expected growth.
- A clear path to U.S. fiscal sustainability could emerge in the next few years. The current political gridlock may give way to action after the 2012 elections as rising interest costs force broad fiscal reforms.
- China's consumers could begin to become a powerful force and drive global demand growth rather than just the growth in the global supply of goods. Employment and incomes are rising sharply in China. While domestic consumer spending currently only accounts for about one-third of China's GDP it is rising quickly. The United States is the world's largest manufacturer. U.S. companies would benefit from solid growth in Chinese consumer spending.

2 Rise in Patent Grants May Boost Productivity



Source: LPL Financial, Bureau of Labor Statistics, U.S. Patent Office data 10/02/11

- New technologies could greatly improve resource productivity. There is a correlation between patent grants and productivity a few years later [Chart 2]. The United States is currently saddled with a backlog on new patent requests; however, this logjam is beginning to break. If recent efforts at patent reform are combined with an increased emphasis on providing protection to new ideas we could see an explosion of efforts driving innovation and creating new products.

With consumer, business, and investor confidence readings near historic lows it is hard for negative black swan events to surprise an unprepared marketplace. Alternatively, with so few expecting positive developments it is more likely that a pink swan event is the true outlier with the most potential market impact.

IMPORTANT DISCLOSURES

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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.

Debt-to-GDP is a measure of a country's federal debt in relation to its gross domestic product (GDP). By comparing what a country owes and what it produces, the debt-to-GDP ratio indicates the country's ability to pay back its debt. The ratio is a coverage ratio on a national level.

Correlation is a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

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.

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