



Weekly Market Commentary



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Black Friday Caps a Dark Week for Investors

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Highlights

It was a black Friday for investors as the holiday week closed with the S&P 500 turning in its worst performance during the week of Thanksgiving since 1932.

Fear gripped the market that the risk of a default by a major European government that would trigger a financial crisis was rising.

It is likely to take years to resolve the debt problems in Europe; however as with the lingering U.S. subprime mortgage debt and housing problems, merely stabilizing the problem may allow markets and the economy to heal from the damage.

As progress in managing risks and efforts toward fiscal sustainability meets with setbacks and disruptions, expect continued market volatility—but not all of it to the downside as in the past seven trading days.

It was a black Friday for investors as the holiday week closed with the S&P 500 turning in its worst performance during the week of Thanksgiving since 1932. Despite strong retail sales indications and solid readings on U.S. economic growth, worsening sentiment on the European debt problems—combined with a failure of the super committee in the United States to agree on deficit cuts—pulled the S&P 500 down 4.7% adding to the cumulative decline of 7.9% in just the past seven trading days.

U.S. economic data was solid again last week with claims for unemployment benefits falling further below the 400,000 level, home sales rising over 13% year-over-year, and a 12% year-over-year rise in orders for durable goods excluding the volatile transportation (airplane) orders in October. This week's ISM reading on Thursday and the employment report on Friday will be closely watched. Fourth quarter gross domestic product (GDP) is on pace to top the third quarter's growth rate.

In addition, retail sales during Thanksgiving weekend climbed 16% as more shoppers hit the stores and spent more money, according to the National Retail Federation, wildly exceeding consensus estimates. Retail sales matter to the stock market mainly because they reflect the health and sentiment of the consumer and investor [Chart 1], but also because they contribute to growth of the economy and corporate profits.

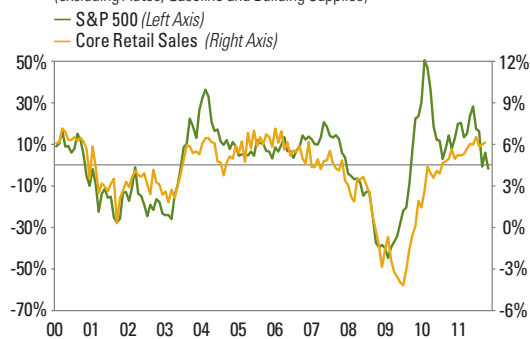
The market knew going into last week it was a long shot that the super committee would produce a deal for the \$1 trillion-plus in deficit reduction with which they had been tasked. However, some disappointment over the failure that may have affected markets was that it dimmed the prospects for getting those items passed that have greater near-term consequences for the economy and markets. The real deal Congress must pass before year end is some combination of these expiring programs:

- Payroll tax cuts
- Unemployment benefits extension
- The 100% depreciation of new capital spending for businesses
- The annual physician Medicare fix and the AMT fix

Although these extensions are by no means off the table and it is still likely some of these pass in an end-of-year session, the odds that Congress cannot reach any agreement have risen.

1 Solid Consumer Demand Typically Comes Along with Solid Investor Demand

Year-Over-Year Change in S&P 500 and Core Retail Sales (excluding Autos, Gasoline and Building Supplies)



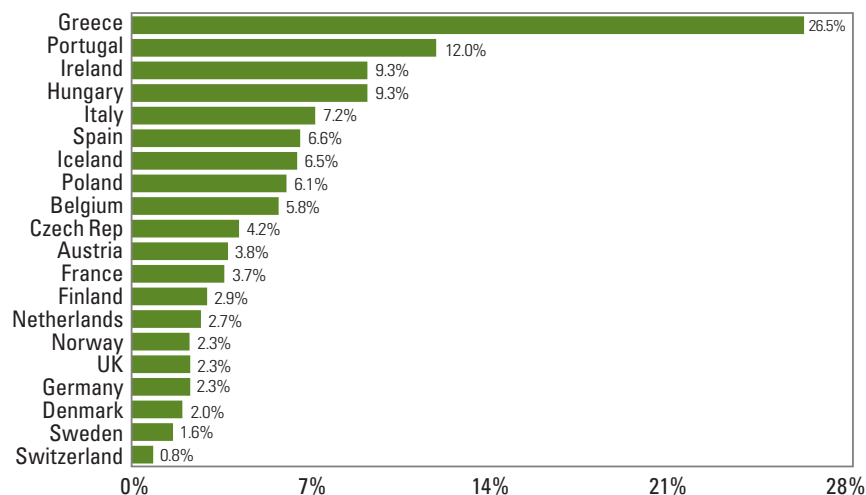
Source: LPL Financial, U.S. Census Bureau 11/27/11

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

The main driver of last week's market action was the fear among some market participants that the risk was rising of a default by a major European government that would, in turn, trigger the collapse of financial institutions and a crisis throughout Europe and beyond. This potential path echoes the chain reaction that followed the bankruptcy of Lehman Brothers in September 2008 that led to a global financial crisis.

In late October 2011, European policymakers crafted a ground-breaking agreement that addressed recapitalizing the banking system, created an orderly default by Greece, and provided financial buffers against losses on future bond issuance among eurozone members. All of these steps are in an effort to reverse the tide of money that has flowed out of the European sovereign bond market and pushed up borrowing costs. These actions averted a 2008-like financial crisis. However, concerns remain about the outlook for economic growth in Europe and the ability of some countries to meet budget targets. As hurdles to implementation of the debt plan are materializing, bond yields of some European nations have risen to levels that make progress on balancing budgets very difficult. There are eight European countries with yields over 6% [Chart 2]. Last week, Italy saw its 10-year borrowing cost rise above the 7% threshold that forced Greece, Ireland, and Portugal to seek bailouts in 2010.

2 European 10-Year Bond Yields



Source: LPL Financial, Bloomberg 11/27/11

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There are many technical factors driving yields higher, including European bank asset sales as these institutions raise required capital. However, fundamental factors lie at the heart of the rise, particularly for the eight European nations with yields over 6%.

- The troubles of Greece, Portugal and Ireland are no secret. These three nations were granted bailouts in 2010 that continue to provide ongoing support. The worst off is Greece, which, despite a landmark debt deal, still faces years of economic decline. The best off is Ireland which has



proven itself as the bailout country most loyally implementing austerity and markets are responding. Irish yields have fallen from 13.8% to 9.3% over the past four months and the economy has produced solid economic growth. Fortunately, the bond markets of these nations are relatively small and banks have largely insulated themselves from the impact of a default.

- Hungary is part of the European Union and received IMF funding, but does not use the euro and cannot until 2020 at the earliest.
- Italy has implemented spending cuts and is running a primary surplus, meaning that the borrowing is to cover their debt costs and not to fund new spending. Italy's budget deficit is less than 5% of its GDP, lower than France's 7% and close to Germany's 4%. However, Italy has over 2 trillion euros in debt totaling about 120% of GDP. In an effort to lower debt, Italy has cut government workers, raised revenue with closing some tax breaks, and sold some government assets. With the recent change in power in the Italian government, more cuts are on the way.
- In some ways, Spain is better positioned than other European countries. It has shown a greater tolerance for cutting spending and last week's election generated a strong majority for the incoming ruling party which has emphasized further fiscal reform. Fortunately, Spain's debt-to-GDP is only half that of Italy. On the negative side, its budget deficit is twice Italy's and its banking sector is perhaps the most damaged in Europe, other than Greece.
- While Iceland does not use the euro and is not even a member of the European Union, Iceland suffered a banking collapse in 2008 and required support from the IMF. Iceland has made some progress. Notably, Iceland had its credit rating outlook raised last week by Standard and Poor's and bond yields have declined to 7% from about 13% at the peak in 2008.
- While a bond yield of 6.1% may seem high, Poland's borrowing costs are in line with the average of the past 10 years and well below recent peaks and therefore likely to remain manageable.

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As many European countries (eight), have yields below 3% as above 6%. Although these countries do not share the same fiscal position, they are not immune to the economic impact of contagion in the region. The troubles with Greece, Italy, and Spain lie at the heart of the problem for all of Europe. The long-term success of rescue efforts is dependent upon European nations taking additional steps to adhere to their plans for achieving financial stability and deficit reduction. It is no coincidence all of these three countries have seen a change to their governments in 2011 to those willing to take more aggressive actions.

Lack of enforcement of budget rules is a big part of what drove Europe to the current state. Going forward, the European policymakers want to ensure important steps are taken before extending additional support to halt the slide in the markets. While it will take years to resolve the debt problems in Europe, with the lingering subprime mortgage debt and housing problems in the United States, merely stabilizing the problem can allow markets and the



economy to heal from the damage. We expect the passage of the difficult, but necessary, reforms among the troubled nations, during the coming weeks and months.

As progress in managing risks and efforts toward fiscal sustainability meet with setbacks and disruptions, expect continued market volatility—but not all of it to the downside as in the past seven trading days. Hopefully, as we leave black Friday and the month of November behind the market has a brighter start to December.

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