



Weekly Market Commentary

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Fiscal Fights for the Foreseeable Future

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

While the current deal making in Washington may alleviate the problem of having “run out of debt capacity”, the government will soon “run out of money” if another deal is not reached by the end of next month to avoid a shutdown.

This serves as a reminder that the markets are going to have to deal with ongoing fiscal fights for the foreseeable future.

Nevertheless, stocks may post a modest relief rally on the debt ceiling agreement averting sharp spending cuts and a potential default. The backdrop for the market outside of Washington has been improving with further evidence coming to light last week.

Last week’s decline of about 4% in the S&P 500 marked the biggest weekly loss in more than a year and was driven primarily by the debt ceiling impasse. Now that the parties in Washington have crafted a deal to raise the debt ceiling by \$2.1 trillion in exchange for \$2.4 trillion in spending cuts over the next 10 years a modest relief rally may ensue in the stock market.

However, the deal does not go far enough to put the United States on a path to fiscal sustainability nor does it decisively remove the threat of a downgrade to the nation’s AAA credit rating. The spending cuts to narrow the deficit will be phased in slowly with little effect until 2013, after the next election, resulting in minimal impact on the economy in the near-term.

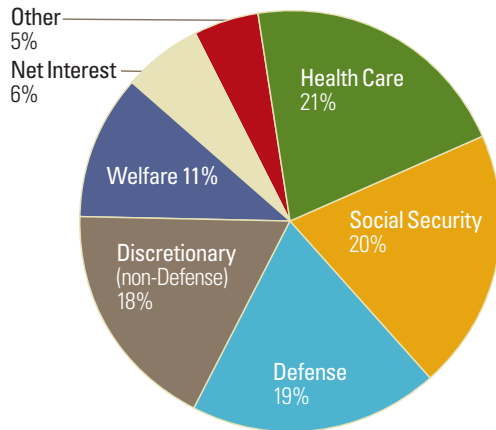
We say a modest rally because stocks are still up 4% this year after having pulled back only mildly and because the market is likely to continue to be held captive by Washington for the rest of 2011. The budget agreement that averted a government shutdown earlier this year, and presaged the current battle in Washington, only funded the government for the 2011 fiscal year which ends September 30. While the current deal making in Washington may alleviate the problem of having “run out of debt capacity,” the government will soon “run out of money” if another deal is not reached by the end of next month to avoid a shutdown. This means another market volatility-inducing budget battle is on tap for early this fall. And the vote by Congress on finding the second \$1.5 trillion round of spending cuts and boost to the debt ceiling is set for December 23, 2011.

In fact, the latest battle over the national debt reflects only a small portion of the nation’s total liabilities and interest cost accounts for only about 6% of government spending. The bigger problem is in the mandatory spending, or entitlement portion of the budget, where much bigger liabilities such as Medicare, Medicaid and Social Security account for nearly half of all spending and seven times what is spent on servicing the nation’s debt. The nation is still not on a path to fiscal sustainability. This serves as a reminder that the markets are going to have to deal with ongoing fiscal fights for the foreseeable future.

Nevertheless, stocks may post a modest relief rally in the coming weeks on a debt ceiling agreement which avoided sharp spending cuts and a potential default. Stocks would likely be higher if it were not for the concern over the



1 2011 Federal Government Spending by Type



Source: LPL Financial, Congressional Budget Office (January 2011 baseline)

impasse in Washington. The backdrop for the stock market outside of Washington has been improving with further evidence coming to light last week:

- Strong earnings (despite weak second quarter economic growth in the United States) and guidance for the rest of the year were reported,
- Retail sales were reported up about 5% year-over-year for the third week in a row,
- Initial filings of claims for unemployment benefits fell below the 400,000 level and have been improving steadily in recent weeks.

The improving environment may inspire investors to re-engage the markets and reduce defensive positions as the debt ceiling concerns lift. Consider reducing defensive positions in favor of the following areas:

- Stocks in the economically sensitive Technology and Consumer Discretionary sectors,
- Mid-Cap Growth stocks benefitting from a firming economic soft spot in the U.S., rebounding business confidence, and the acceleration in merger and acquisitions.
- Japanese stocks benefitting from a rebound in the world's third largest economy.
- High Yield bonds as investors increasingly seek yield, rather than safety, in bonds.

The flip side of the stock market rally is that safe havens such as precious metals and even government bonds may surrender some of their gains achieved in the last week or so as gold soared to new highs. However, it is unlikely to be clear sailing for the rest of the year as volatility is here to stay.



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

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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.

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