



Weekly Market Commentary

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What Is Priced In?

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

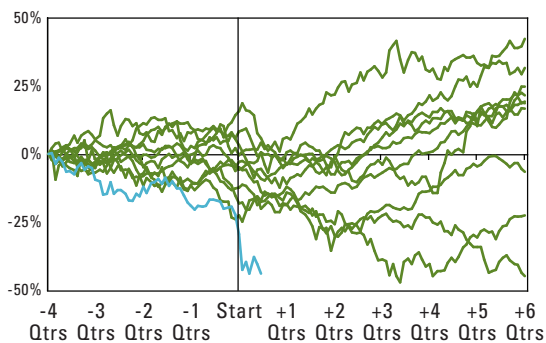
By comparing the current episode with the wide range of stock market performance leading up to, during, and following each recession since WWII, we can see that the market has not only priced in a recession, but has posted the worst performance entering a recession in over 60 years.

The relative performance of early and late cyclical stocks suggests market participants have priced in an expectation for inflation to head sharply lower.

While market volatility is likely to continue, history suggests additional significant downside is unlikely and that the stage is set for an eventual recovery led by early cyclical sectors as the pace of inflation slows.

1 Stocks Post Worst Performance Entering a Recession in Over 60 Years

S&P 500 Index from Four Quarters Before to Six Quarters After Start of Each of the Ten Recessions Since WWII



Source: Bloomberg, LPL Financial

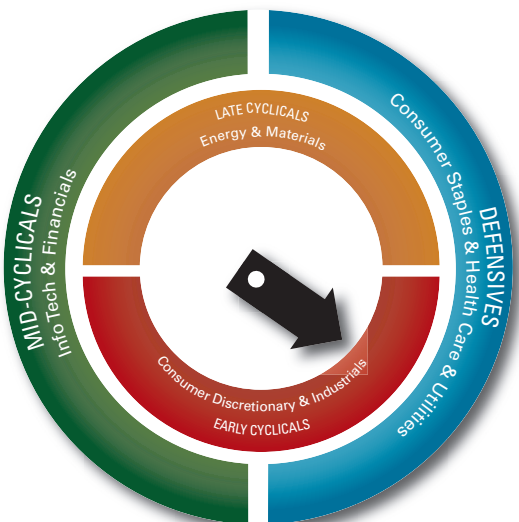
Last week's activity illustrated once again that the S&P 500 remains in the range of about 840 to 1000 where it has been for over a month, as signs of healing in the credit markets were offset by the incoming tide of weak economic data. It has been reported that investors are pricing in a recession resulting from the financial crisis, begging the questions: To what extent has the market priced in a recession? And if it has, how severe does the market expect the recession to be? What inflation outlook is priced into the stock market?

It is widely known that the stock market usually bottoms and then posts powerful gains well before the end of a recession. The chart shows that the worst performance for stocks has generally been in the year leading up to the recession, with the stock market generally starting to recover once the recession was underway. By comparing the current episode of recession (which we believe began with the mid-September seizure of the credit markets) with the wide range of stock market performance leading up to, during, and following each of the ten recessions since WWII, we can see that the market has not only priced in a recession, but has posted the worst performance entering a recession in over 60 years.

The stage of the business cycle impacts the relative performance of sectors of the stock market. In general, the ten sectors of the stock market can be grouped by the stage of the business cycle during which they tend to outperform. As economic and earnings growth accelerates at the start of a business cycle, early cyclical sectors, Consumer Discretionary and Industrials, lead the market higher while inflation is falling and growth is reaccelerating. These sectors gradually pass the leadership on to mid-cycle sectors Information Technology and Financials as the business cycle matures. Eventually growth approaches the peak of the cycle when inflation pressures begin to emerge, and late cyclical sectors Energy and Materials are often the leaders. Finally, as the economy begins to slow and pull into recession, defensive sectors like Utilities, Consumer Staples, and Health Care tend to be the best performers as the market falls. We did not assign the Telecommunications Services sector to a business cycle group, since the sector has transformed dramatically over the past 10 years. Just two stocks make up over 90% of the market capitalization of the sector, effectively tying performance in the sector to the stock-specific factors affecting those two companies.



2 The Business Cycle: What Time is it?



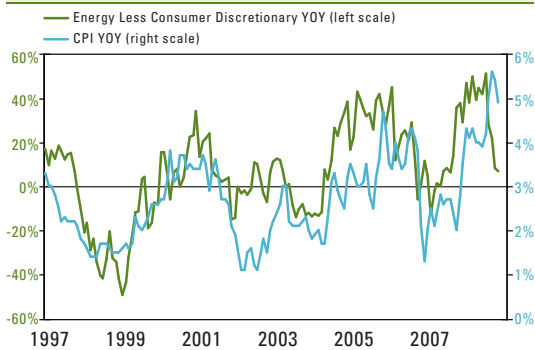
Source: LPL Financial Research

We believe we are currently in the stage of the business cycle where growth is still slowing but has not yet reached its trough. While the potential exists for a rise in inflation stemming from the unprecedented policy actions to address the financial crisis, the stock market has priced in an expectation for inflation to slow sharply in the coming months. While the business cycle has not yet reached the trough, performance has started to shift from late cyclical to early cyclical. Over the past 10 years, inflation and the relative performance of early and late cyclical stocks have tracked very closely. Historically, when early cyclical stocks are lagging, inflation has been on the rise, and when early cyclical stocks begin to outpace late cyclical stocks, inflation has been falling. The relative performance of early and late cyclical stocks at this time suggests market participants expect inflation to head sharply lower.

Market participants have braced for a deep recession with the decline matching the full magnitude of the 1973-74 recession that was the longest and deepest since WWII. Given the uncertainty regarding the duration and magnitude of the current recession, the market is in a transitional period resulting in high levels of volatility. While market volatility is likely to continue, history suggests additional significant downside is unlikely and that the stage is set for an eventual recovery led by early cyclical sectors as the pace of inflation slows.

3 Early Cyclical Stocks Outperform Late Cyclical Stocks When Inflation is Expected to Fall

Year-Over-Year Performance of S&P 500 Energy Sector Less Consumer Discretionary Sector and the Year-Over-Year Change in the Consumer Price Index



Source: Bloomberg, LPL Financial

IMPORTANT DISCLOSURES

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

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

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