



# Weekly Market Commentary



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## Thriving in Volatile Times

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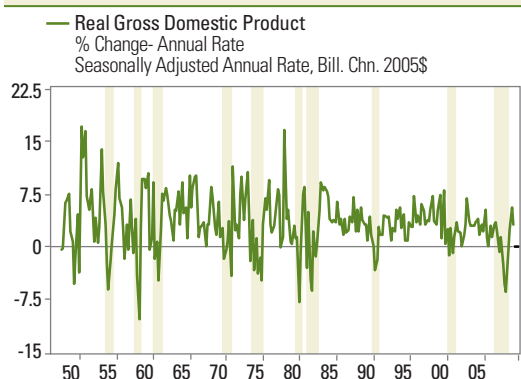
### Highlights

Volatility in the markets may be higher not just in the near-term cyclical environment but on a long-term secular basis, as well.

Over the past 30 years, long-term growth drivers that are now absent helped to lengthen and moderate the business cycle, including steady declines in interest rates, tax rates, and inflation. A potent driver of economic volatility in the years ahead may be the swings in fiscal and monetary policy.

Investors must be well prepared to manage volatility and use it to their advantage in the years to come, since waiting it out is not an option. We believe thriving in volatile markets requires incorporating volatility themes into your portfolio, including: a focus on yield, utilizing volatility-thriving investments, and a tactical rebalancing approach.

### 1 Economic Cycles Smoothed Out and Lengthened in the 1980s-00s *Real Gross Domestic Product with Recessions Shaded*



Source: Bureau of Economic Analysis/Haver 6/01/10

Elevated volatility has been an enduring characteristic of the markets in recent years. Friday's sharp pullback of about -2.9% in the S&P 500 after a 7% run up in the prior nine days was a reminder that volatility remains high even on a daily basis. This is due, in part, to the current stage of the economic cycle notorious for highly volatile markets. But there are longer-term forces at work likely to keep volatility above average, as well.

The economic recovery in the United States that likely began a year ago is ending. The United States economy is now expanding to new highs, not just recovering:

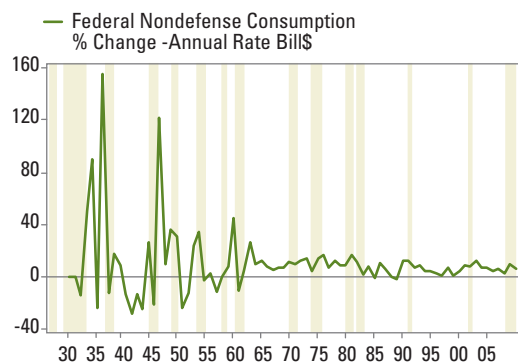
- Nominal GDP, the broadest measure of economic activity, has already recovered all the ground it lost during 2007-09 and is now back above its prior peak.
- Consumer spending has also rebounded to new all-time highs.
- During the second quarter earnings season now underway, a number of companies have reported sales or profits that are at new all-time highs, including chip maker Intel.
- Leading indicators of economic activity have begun to roll over as the strong growth momentum that is characteristic of a recovery starts to fade.

Historically, what ultimately follows the economic recovery has typically been a successful transition to a multi-year period of economic growth. However, about a year after the recovery begins an uneven pattern in the economic data and market performance emerges that we call a "soft spot". The soft spot tends to last for several quarters as the monetary and fiscal policy drivers of the rebound fade and private sector driven growth slowly picks up. In prior commentaries, we showed how each of the past ten recessions encountered a soft spot about one year after it began that led to increased market volatility.

During the current stage of the economic cycle, heightened economic volatility leading to above-average market volatility is common. However, volatility in the markets may be higher not just in the near-term cyclical environment but on a long-term secular basis, as well. Investors must be well prepared to manage volatility and use it to their advantage in the years to come, since waiting it out is not an option.

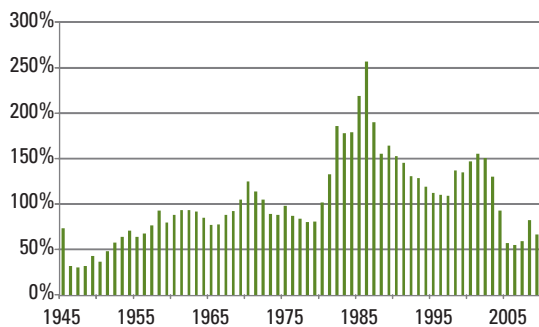


## 2 Growth Rate of Federal Government Spending *Federal Non-defense Consumption Expenditures Annualized Growth Rate*



Source: Bureau of Economic Analysis/Haver 6/01/10  
Shaded areas represent recessions.

## 3 Depreciation as a Percent of Corporate Profits *Capital Consumption Allowance Divided by Corporate Profits After Tax*



Source: LPL Financial, Bureau of Economic Analysis 07/16/10

## Greater Economic Volatility

In recent decades, economic cycles (the period from one recession to the next) have smoothed out and lengthened to average about 7-10 years, changing drivers may lead to shorter and more volatile economic cycles in the future. In the 1980s, 1990s, and 2000s, powerful, long-term secular growth drivers helped to lengthen the economic cycle. These included steady declines in interest rates, tax rates, and inflation while the overall level of debt (leverage) was steadily rising. The absence of these factors going forward may heighten economic volatility. An even more potent driver of economic volatility in the years ahead may be the swings in fiscal and monetary policy.

Government has become a bigger driver of the economy with the recovery over the past year having been fueled more by actions on Capitol Hill (and at the Federal Reserve also in Washington) rather than by capitalism. The last time government spending made up as large of a percentage of GDP as it does today it was 1945. As the government deleveraged in the following years, the economic cycles were short and sharp. Expansions lasted only 3-5 years, on average. The period from 1945-60 was an environment where big swings in fiscal policy (changes in government spending and tax revenue) were the main driver of the high economic volatility.

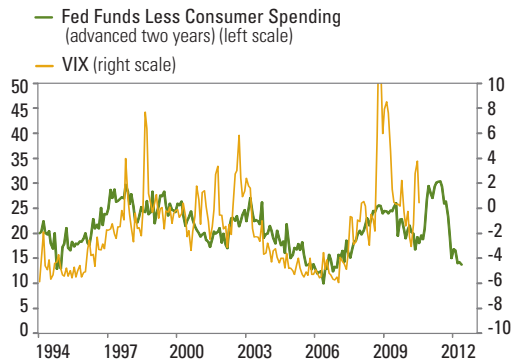
One of the reasons the economic cycles are shorter during periods when the government makes up a large portion of the economy and spending and revenue highly variable is that the long-term planning environment for businesses gets less certain. The uncertain outlook for the business environment related to which taxes will be raised or cut and what spending will be appropriated or terminated in the near-term keeps business leaders from making the long-term capital allocation commitments that drive expansions. From 1945-60, business spending was well below levels needed to support stable growth. The lack of sufficient investment can easily be seen in that depreciation (the amount of corporate spending on productive assets consumed each year) averaged only around 50% of corporate after tax profits and did not get back near 100% until 1960 where it stayed until the early 1980s. In the 1980s, 1990s, and early 2000s the pace of depreciation exceeded after tax profits reflecting the use of leverage to support a high level of corporate spending growth. As the driver of the economic cycle shifted from government to business, the average economic cycle lengthened.

A year ago, governments around the world were spending as fast as they could to end the global recession. Now, governments are raising taxes and cutting spending to rein in soaring deficits. The boom and bust cycles in government spending and tax revenue are likely to contribute to 3-5 year policy-driven cycles for the economy and markets rather than the 7-10 year economic cycles that had become the norm.

Expanding this policy-driven cycle in the United States to the rest of the globe, we can see reinforcing evidence of a global policy cycle. The past few years gave birth to the first globally synchronized business cycle in history as every country entered into recession and then expansion at the same time due to the effects of the global financial crisis. In a synchronized manner



#### 4 Volatility May Stay High *VIX and Federal Funds Rate Less Personal Consumption Expenditures Year-over-Year (advanced two years)*



Source: LPL Financial, Bloomberg

countries around the globe cut interest rates and increased spending at the same time and are now beginning to contemplate raising interest rates and cutting back on spending in concert. The global diversification of the past, when different countries were at different stages of the business cycle, may be giving way to an era where every country is in sync. This may further exacerbate the swings in economic and market volatility to a global scale.

### Volatility for the Long-Term

What the changing drivers of the economy mean for investors is not the end of growth (although growth may be slower over the long-term), but of an environment of heightened economic and market volatility.

The argument we present may seem theoretical and heavily dependent upon historical data. However, our view is currently supported by reliable forward-looking indicators.

The Federal funds rate less the pace of consumer spending provides a gauge of how much stimulus is being provided by the Fed less the pace of growth already taking place. As you can see in [chart 4](#), when we advance the Fed funds less consumer spending measure by two years, to account for the lag time in Fed policy, it forecasts very accurately where the VIX, or S&P 500 volatility index, is headed. The VIX reflects market volatility. In essence, the higher the level of the VIX the greater the implied volatility for the stock market. Since, markets have become more closely linked volatility for one market likely means volatility for all.

This tells us that we can expect higher-than-average volatility not just in the coming quarters, but over the years to come. We can expect the VIX to remain in a range of 15-30 in the coming years — suggesting much higher-than-average market volatility. This is in contrast to the start of the last business cycle in the mid-2000s as the economy transitioned from recovery to sustainable growth when the VIX steadily fell from 20 to 10 and volatility fell to well below average levels.

### How to Thrive in Volatile Times

We believe thriving in volatile markets requires incorporating volatility themes into your portfolio, including: a focus on yield, utilizing volatility-thriving investments, and a tactical rebalancing approach.

- A higher yield may benefit portfolios by providing a consistent income component that is received regardless of volatile price movements. There are several ways to help benefit from a focus on yield, including High-Yield Bonds, Real Estate Investment Trusts (REITs), Emerging Market Bonds, and Dividend Paying Stocks.
- Higher correlations among asset classes and shorter economic cycles mean alternative investment strategies play a bigger role in portfolio construction. Alternative styles such as Global Macro strategies benefit from heightened volatility helping to, not only potentially improve returns, but also help reduce portfolio risk.



- A volatile market that produces multiple rallies and pullbacks, but remains largely range-bound, creates many opportunities to enhance performance through tactically re-balancing portfolios by taking profits when markets are at the top of the range and seeking attractive opportunities at the low end of the range.

Tighten your seatbelts. It may take a long time before economic and market volatility eases again.

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#### IMPORTANT DISCLOSURES

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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.

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.

The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. While this is not necessarily predictive, it does measure the current degree of fear present in the stock market.

High-Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Stock investing may involve risk including loss of principal.

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

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

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

Global Macro strategy is a hedge fund strategy that bases its holdings--such as long and short positions in various equity, fixed income, currency, and futures markets--primarily on overall economic and political views of various countries (macroeconomic principles).

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