CAPITAL MARKETS PERSPECTIVES

Weekly Market Review

Week ended **February 12th**

Dr. Jerry Webman is Chief Economist for OppenheimerFunds, Inc. In this capacity, Dr. Webman provides strategic viewpoints on the overall financial and economic markets to investment management and the financial advisor and investor communities.

For over 20 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, financial advisor and portfolio manager.

Dr. Webman holds a B.A. in political science, with honors, from the University of Chicago where he graduated Phi Beta Kappa, and a Ph.D. in political science from Yale University. He is also a Chartered Financial Analyst.

Equities Gain as Debt Concerns Momentarily Subside

By Dr. Jerry Webman, Ph., CFA
Chief Economist, OppenheimerFunds, Inc.

World stock markets rose last week as fears over Greece's deficit problems and their contagion began to subside.

The week's economic headlines pointed to a growing trend toward fiscal tightening—both voluntary and involuntary—in many corners of the globe. Essentially, governments are either deciding or being forced to retrench from the expansive policies of the last two years.

We've already seen Ireland institute austerity measures to cope with its mounting debt, and we're likely to see Greece obliged to take even more dramatic fiscal action in return for some type of assistance from larger Euro zone partners like Germany. Belt-tightening across the continent may be necessary, but could weigh on European economic activity. Any resultant euro weakness may have a silver lining, however, potentially supporting European exports; Germany recently fell behind China as the largest exporter in the world.

Conversely a weaker Euro could slow the U.S. recovery. Europe accounts for approximately 29% of American exports but only 8% of S&P 500 revenues and less than 5% of U.S. banks' total assets. The biggest tail risk to the U.S. is contagion spreading from the European system in the form of broader risk aversion and a sharp decline in global liquidity.

Meanwhile, China's central bank sought to rein in lending by raising reserve requirements for commercial banks, the second such move in five weeks. Chinese banks nonetheless actually lent more in January than in the prior three months combined. The Chinese government hopes to subdue debt-fueled inflation pressures by upping commercial banks' reserve requirement ratio, which limits how much the banks have left over to lend to customers.

Closer to home, Federal Reserve Chairman Ben Bernanke took an additional step toward an "exit strategy" by telling Congress that the Fed might begin raising the discount rate (the interest rate it charges financial institutions for direct loans) "at some point." By leaving the timing of policy action vague, Bernanke signaled that the Fed is actively planning an exit strategy but is seeking to avoid surprising the markets with any sudden tightening moves.

President Obama, for his part, is increasingly turning his attention to the ballooning deficit. Though a number of the policies he's mooted could prove helpful, they may wind up being largely symbolic in the short term, given the deficit's sheer size. Always unsure what they want, market participants seem to worry both about the waning of fiscal stimulus after mid-year and the cost of maintaining that stimulus even now.

Signs of continued U.S. recovery

Reports on jobs, retail sales and business inventories offered further evidence that a "virtuous cycle" of economic factors continues to support a gradual U.S. recovery.

Initial claims for unemployment benefits technically fell by 43,000 to 440,000 in the week ended February 6, but the Department of Labor attributed the drop to its clearing an administrative backlog from the holiday season. In any case, the broader trend of fewer jobless claims remains intact.

As mass layoffs have subsided and the economy returned to growth, consumers have started returning to stores. **Retail sales** rose 0.5% in January, marking the third gain in four months. December's sales figures also revised slightly higher, as well.

Business inventories fell 0.2% in December, the latest month of data available. While manufacturing and wholesale inventories were lower, retail inventories were roughly flat.

Higher sales and falling inventories offer encouragement that production could rise, ultimately stimulating job creation and increased consumer spending—a perpetuation of the virtuous cycle.

Positive revenue and earnings surprises support expansion

Indeed, the corporate financial results we've seen so far for last quarter have generally offered some big upside surprises—not only to earnings, but also to revenue. We were concerned that companies were posting earnings increases solely on efficiency gains and favorable year-over-year comparisons, but higher revenues indicate a real improvement in business conditions. They also offer companies an opportunity for expansion. With productivity near record highs, companies will eventually need to build capacity—including hiring new employees—to match demand. Rising sales give them the opportunity to do so.

JGK-1-2-16-10 February 16, 2010