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The Upshot

All the market insight and data you need to jumpstart your week

Resist a Kneejerk Reaction to Credit Downgrades

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Standard & Poor's delivered a one-two punch to the euro zone late last week that could put downward pressure on stocks, but investors should be wary of letting a few jabs keep them out of the ring.

On Friday, the ratings agency announced that it had downgraded the credit ratings of nine euro zone governments, most notably France, which lost its AAA rating. S&P lowered its rating for countries such as Italy, Spain and Portugal by two notches. The move puts Italy's bonds in the BBB+ category, which is the lowest rating bonds can be assigned and still be considered investment grade.

However, S&P affirmed its rating on seven other euro zone countries including Germany. which maintained a AAA rating. S&P's outlooks on all but two of the 16 sovereign euro zone nations are negative. Arguably, these downgrades had already been priced into the market, given that these sovereigns had been placed on credit watch in early December. France's finance minister Francois Baron explained that it wasn't much of a surprise.

Weak in the Knees

S&P was explicit in providing the rationale for the downgrade decision: weakening economic growth prospects, tightening credit conditions across the euro zone, an increase in risk premiums for an expanding number of governments and a simultaneous deleveraging by both governments and households. In addition to these economic and financial factors, S&P cited "an open and prolonged dispute among European policymakers over the proper approach to address challenges." (U.S. Congress, please take note). S&P further posited, "Today's rating actions are primarily driven by our assessment that the policy initiatives that have been taken by European policymakers in recent weeks may be insufficient to fully address ongoing systemic stresses in the euro zone."

Given that sentiment, it was no surprise that on Monday, S&P downgraded its credit rating on the European Financial Stability Facility, Europe's rescue fund, from AAA to AA+. While the two other major ratings firms, Moody's and Fitch, still rate the EFSF at AAA, there is potentially more downside from S&P. In fact, S&P warned that it could downgrade the credit facility even further if member states' creditworthiness is further eroded.

Index returns for the week ended January 13, 2012

Broad Market Returns	Total Return Wk (%)	Total Return MTD (%)	Total Return QTD (%)	Total Return YTD (%)
DJ Industrial Average	0.50	1.76	1.76	1.76
S&P 500	0.90	2.58	2.58	2.58
BarCap U.S. Agg Bond	0.55	0.41	0.41	0.41
DJ UBS Commodity	-1.43	-0.12	-0.12	-0.12
FTSE NAREIT All REITs	1.44	1.34	1.34	1.34
NASDAQ Composite	1.37	4.07	4.07	4.07
Equity Returns	**Total Return Wk (%)**	**Total Return MTD (%)**	**Total Return QTD (%)**	**Total Return YTD (%)**
Russell 1000	1.03	2.75	2.75	2.75
Russell Mid Cap	1.61	3.14	3.14	3.14
Russell 2000	1.95	3.17	3.17	3.17
MSCI EM	2.80	4.02	4.02	4.02
MSCI EAFE	0.62	0.21	0.21	0.21
MSCI Europe	0.11	-0.74	-0.74	-0.74
MSCI Pacific	1.54	1.85	1.85	1.85
MSCI Pacific Ex Japan	2.68	3.73	3.73	3.73
MSCI Japan	0.84	0.70	0.70	0.70
MSCI China	4.75	5.16	5.16	5.16
Bond Market Returns	**Total Return Wk (%)**	**Total Return MTD (%)**	**Total Return QTD (%)**	**Total Return YTD (%)**
BarCap US Agg Bond	0.55	0.41	0.41	0.41
BofAML US HY Master II	0.31	1.08	1.08	1.08
BofAML All Convertible All Qualities	1.36	2.99	2.99	2.99
JPM GBI Global Ex U.S.	0.58	-0.94	-0.94	-0.94
JPM EMBI Global	-0.33	-0.53	-0.53	-0.53
BarCap Long Term U.S. Treasury	1.85	-0.03	-0.03	-0.03
BarCap US Treasury 1–3 Yr	0.08	0.06	0.06	0.06
Equity Style Returns	**Total Return Wk (%)**	**Total Return MTD (%)**	**Total Return QTD (%)**	**Total Return YTD (%)**
Russell 1000 Value	1.24	2.98	2.98	2.98
Russell 1000 Growth	0.82	2.51	2.51	2.51
Russell Mid Cap Value	1.54	2.86	2.86	2.86
Russell Mid Cap Growth	1.67	3.43	3.43	3.43
Russell 2000 Value	1.70	3.09	3.09	3.09
Russell 2000 Growth	2.19	3.25	3.25	3.25
Russell Micro Cap	2.52	3.84	3.84	3.84
Russell Micro Cap Growth	3.34	4.71	4.71	4.71
Russell Micro Cap Value	1.96	3.23	3.23	3.23

That's certainly a lot of bad news for one week. And that's not all. Much has been made of the disappointing December retail sales number, which rose 0.1% versus expectations of a 0.3% gain. Further, investors continue to worry about earnings season, with companies such as Citigroup and JP Morgan Chase falling short of expectations.

Still, positive economic data have been overlooked including the Federal Reserve Beige Book—an anecdotal report on economic activity—which showed some improvement in nearly all 12 Federal Reserve districts from late November to the end of December, with retail spending showing improvement across all districts. Elsewhere, consumer credit rose $20.4 billion, far exceeding expectations. The majority of the increase came from the $14.8 billion growth in non-revolving credit, which could be considered "personal cap ex" as it constitutes significant capital expenditures that could be viewed as financing long-term investments for a better future, including federal and student loans and car loans.

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Prize Fight

It is only a few weeks into the year and yet it looks as though 2012 is shaping up to be quite similar to 2011: a tug-of-war between positive and negative data, which results in volatility and investor eschewal of equities. In fact, 2011 may be remembered as the year when stocks were flat (up about 2% if you factor in dividends) but investors still retreated. In 2011, we saw almost $99 billion in net outflows for U.S. equity funds, according to Morningstar. These outflows were not much smaller than the exodus we saw in 2008, during the Great Recession, when investors fled U.S. equities to the tune of $121 billion in outflows. But that's far more understandable, given that stocks dropped about 37% in 2008.

The U.S. stock market has taken quite a few heavy-handed punches over the last year but has managed to maintain its balance. Investors, on the other hand, are so focused on negative data points and downside volatility that they are completely ignoring their long-term financial goals. It's akin to driving cross-country while staring into one's side-view mirror. Long-term investors looking to manage market risk need to consider the inherent risk of having a short-term view, one that overemphasizes scary headlines and downside volatility.

View the online version—including the chart of the week:

The S&P 500 has rebounded significantly in the wake of credit downgrades to U.S. and Spain suggesting that France's downgrade may be a non-event.

A more prudent tack to take would be to focus on their greatest risk: not meeting their long-term financial goals. Achieving them requires significant exposure to equities and equity-like securities. Let's be sure to keep our eyes fixed on the long-term prize.

Market Movers

This week's economic calendar

Monday

U.S. Holiday—Martin Luther King Jr. Day

Tuesday

Empire State Manufacturing Survey
Previous: 8.19/Consensus: 10.50

Wednesday

Producer Price Index (month/month change)
Previous: 0.3%/Consensus: 0.0%

Industrial Production (month/month change)
Previous: -0.2%/Consensus: 0.5%

Thursday

Initial Jobless Claims:
Previous: 399,000/Consensus: 383,000

Consumer Price Index (month/month change)
Previous: 0.0%/Consensus: 0.1%

Friday

Existing Home Sales
Previous: 4.22 million/Consensus: 4.65 million