

Weekly Investment Commentary

Markets Continue Their Winning Ways

February 6, 2012

(Another) Strong Week For Stocks

The winning ways for stocks continued last week, thanks to some additional progress on the European debt crisis and a surprisingly strong January labor market report for the United States. For the week, the Dow Jones Industrial Average gained 1.6% to 12,862, the S&P 500 Index climbed 2.2% to 1,344 and the Nasdaq Composite advanced 3.2% to 2,905. With these gains, US stocks are within striking distance of the cyclical peak reached last April, although global stocks are still about 10% below last year's high point.

The Economy Appears to Be on a Self-Sustaining Path

Last week's employment report was significantly stronger than expected. Payrolls rose by 243,000 last month and the unemployment level fell to 8.3%, its lowest level in almost three years. Equally important, the report showed large upward revisions to November's and December's data and the numbers regarding income and hours worked were also pointing in the right direction.

There are some pessimists that would point out that some areas of the economy are still weak. Household income levels are still relatively low and the housing market remains a significant source of weakness, with foreclosure levels still quite high. Additionally, as we discussed last week, the positive fourth-quarter gross domestic product report was based at least in part on inventory increases, which is hardly sustainable.

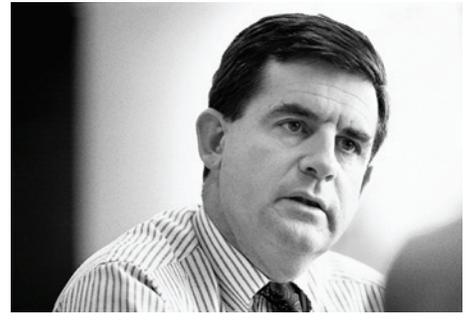
In any case, however, it appears to us that the economy may finally be entering into a self-sustaining expansion. Jobs growth is helping to generate increases in spending levels, which, in turn, is helping to support further gains in jobs. Should these trends continue, they would go a long way toward helping the economy continue to enjoy momentum.

Downside Risks Cannot Be Discounted

Since the start of the year, the economic and market news has clearly trended in the right direction, so it's worth asking what some of the negatives might be. Chief among them is ongoing fears of the European debt crisis spiraling out of control. The Greek debt restructuring talks are becoming more complicated, and while it appears that markets are prepared for some sort of eventual debt default, investors are still expecting any default to at least be somewhat orderly. Should we see a chaotic default (in which Greece simply walks away from its obligations, for instance) that would serve as a significant disruption to the positive trends we have seen.

Additionally, in the United States there is still a risk that we will not see an extension of the payroll tax cut and unemployment benefits that are due to expire at the end of February. If they are not extended, that would act as a near-term drag on spending levels.

We would also add that there is the always-present risk of some sort of unforeseen geopolitical turmoil emerging that could act as a drag on the economy and could drive risk assets down.



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Stocks Remain Poised For Outperformance

Certainly, these risks cannot be ignored. However, as we said at the beginning of the year, what we are really looking for is an environment that is not worse than what is expected. In other words, we do not need to see risks vanish or tremendous upside surprises for equities to perform well — merely having an “OK” backdrop should be good enough for stocks.

Notwithstanding the strong performance of the last month, we believe markets are still pricing in a more negative economic backdrop than what we are predicting. Investor confidence remains low and many are still sitting on large amounts of cash. It is important to remember that stock prices have not completely recovered from the significant drawdown that occurred in the summer of 2011, suggesting that markets have further room to run.

We are not expecting to see uninterrupted smooth sailing from here, but we do believe that the trends for stocks are pointing in the right direction.

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