



MONTHLY MARKET COMMENTARY

INNOVEST January 2012

The Economy

The U.S.

January represented a surprisingly strong start to the New Year for the U.S. economy, though questions remain as to how long the good news may last. For the month, several key economic reports met economists' expectations, and some exceeded those expectations. While it is too soon to declare the U.S. economy back on very healthy footing, it is time to recognize the slow progress that has been made.

There was some fear at the end of 2011 that the recession in Europe would subsequently drag down economic growth in the U.S. It appears that the opposite is actually happening: the U.S. economy has remained relatively stronger and is serving as a powerful counterweight to Europe. The result is that global growth estimates for 2012 remain intact because of strength from the U.S.

Among the most important data in January were the ISM manufacturing and non-manufacturing surveys and the January jobs report. In January the ISM manufacturing index rose 1% to 54.5%, largely in-line with estimates. This is the 30th consecutive month of expansion in the manufacturing sector. Of note, new orders registered a 57.6 reading, an encouraging sign that was nearly 3% higher than December. The ISM non-manufacturing survey registered a 56.8, marking the 25th consecutive month of expansion. The January jobs report was encouraging. The BLS estimated a 243,000 job boost for the month, well ahead of expectations, and the unemployment rate dropped to 8.3% from 8.5%.

Still, pessimists can find plenty of data to support their viewpoint. Though the unemployment rate has dropped, so too have the number of people looking for jobs. According to Moody's, the unemployment rate today would be closer to 11.3% if the labor force had grown at a "normal" rate since the end of 2007. Housing prices continue to decline nationally, highlighted by yet another drop in the twenty city S&P Case Shiller Index. Once a huge addition to jobs and growth for the U.S. economy, the housing industry is unlikely to be healthy and normally functioning for a few more years.

The World

Things appear to be getting better in Europe, although the situation remains volatile. European leaders agreed on a fiscal pact at the end of January that was created to shore up confidence in European sovereign debt. The agreement will require European Union countries to balance their budgets and will impose stricter penalties on those that fail to do so. The European Stability Mechanism, a permanent €500 million rescue fund for troubled members of the Eurozone, will likely launch this summer. This is a full year sooner than expected and an encouraging development.

Greece continues to hog headlines and create anxiety for investors. The latest negotiations involve Greece's coalition

government being forced to accept greater austerity measures in exchange for a new €131 billion bailout. Few doubt that Greece will eventually experience some form of default on its sovereign debt. Importantly, the default will likely be structured so as to avoid a "credit event" and trigger credit default swaps. The question is whether the default will be orderly or disorderly. A well executed and orderly bankruptcy would calm debt markets in Europe and around the world, while a chaotic default is the nightmare of nearly every finance minister in Europe.

China has gained attention in recent months as its economy has slowed. Inflationary pressures and a bubble in infrastructure and housing in major Chinese cities have led to concerns that the Chinese economy could be in trouble. The IMF currently estimates 8.2% GDP growth for the country in 2012, a still-blistering pace of growth. The Chinese government has been hard at work to engineer a soft landing for its economy. It appears to be working, at least so far. In January, China's factory sector expanded ever so slightly with a PMI reading of 50.5, beating market expectations and easing fears of a hard landing for their economy.

The IMF issued a report recently highlighting what would happen to China if Europe suffers an escalation of its own debt crisis. A bad European crisis could cut China's GDP growth in half this year, the report estimates. China remains vulnerable to global economic trends despite its transition to a more domestic-based consumption model.

Israel and Iran continue their saber rattling. Israel has repeatedly stated that a nuclear Iran is an unacceptable outcome. According to a recent report in the Washington Post, U.S. Secretary of Defense Leon Panetta indicated that an Israeli strike on Iran may occur in May, June or July. Conflict in the Middle East would likely lead to greater volatility across financial markets and especially higher oil prices.

The Market

Nearly all asset classes appreciated in January. Correlations remain high between asset classes, as investors have either had a "risk on" or "risk off" approach to investing capital. January was a "risk on" month for the financial markets. Stocks, both domestic and foreign, enjoyed a positive month. Bonds across the entire spectrum of credit quality rallied, as well as commodities and REITs.

The U.S. stock market had its best start to the year in 25 years. For the month, the S&P 500 was up 4.48%. Increasingly positive economic data were behind the rally in U.S. equities. Small and mid cap stocks rallied even more. The Russell 2000 Index witnessed a 7.07% gain for the month.

Global equities were up in January. For the month, the MSCI EAFE Index posted 5.33% return. Equity markets rallied in Europe as credit conditions eased; falling sovereign debt yields in countries like Italy and Spain reflected an improving outlook. Emerging markets registered huge gains in January. The MSCI Emerging Markets Index was up 11.34% for the month.



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Bonds, from Treasuries to high yield, registered gains in January. The Barclays U.S. Aggregate Index was up 0.88% for the month. Corporate bonds gained 2.21%, reflecting a tightening of spreads. High yield bonds were up 3.04%. The Fed has remained committed to an extremely accommodative monetary policy, highlighted by still incredibly low U.S. Treasury yields. In January short-term U.S. Treasuries rallied 0.12%.

The Dow Jones UBS Commodity Index was up 2.47% in January. Industrial metals, precious metals and agriculture rallied significantly in the month, balancing out a decline in energy. New technology in the natural gas space, mostly due to fracking, has created excess supply in the market. Natural gas prices were down 17% in January.

Outlook

The investment outlook is surprisingly decent, particularly given the dark headlines out of Europe over the past six months. Stocks are cheap on an absolute and relative basis, and the U.S. economy is poised for continued growth. There are signs of easing around the world.

Economist Brian Wesbury makes an interesting point about the current state of the economy. Real GDP growth has accelerated and private sector jobs have expanded for twenty three consecutive months. Many skeptics remain on the investment sidelines for fear of a fading recovery. But this recovery is real. The “duck test” for the economic recovery is useful here: if it looks like a duck, walks like a duck and quacks like a duck—it’s a duck. It’s a recovery.

President Obama must be breathing a sigh of relief. Fairly or not, Presidents typically receive the lion share of blame (or credit) for the ups and downs of the economy. Much to the chagrin of his Republican challengers, the U.S. economy is picking up this election year. Expect much of the Presidential race to be focused on the strength of the economy.

It is difficult to say what effect political events will have on the financial markets. In the second quarter of 2011 we experienced revolutions in Tunisia and Egypt, along with an earthquake and tsunami in Japan. Yet the markets moved higher in the second quarter, seemingly immune to the world’s increased instability.

Exogenous shocks to the global economy can happen at any time and may temper our enthusiasm. A disorderly default of Greek sovereign debt or a sustained skirmish between Iran and Israel would certainly be harmful.

Bond yields remain at near record lows. Expect them to likely stay at these levels for some time, as the Fed will continue to be aggressive with monetary policy. An unemployment rate above 8% indicates a lot of slack in the economy and hedges out a good deal of inflation risk. Another round of quantitative easing is being discussed. While yields will inevitably rise in the long term, it is tough to say when.

Clint Eastwood performed in a memorable commercial during this year’s Super Bowl. Entitled “Halftime in America,” the Chrysler ad addressed the recession and the recent turnaround of Detroit’s auto industry. Said Eastwood: “This country can’t be knocked out with one punch. We get right back up again, and when we do the world is going to hear the roar of our engines. Yeah, it’s halftime in America, and our second half is about to begin.” We hope the words of the commercial are not merely aspirational, but a true predictor of the U.S., and global, economic recovery.