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Global Markets Rally on Moderating Global Risk and Positive Fundamentals

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Executive Summary

- **A dramatic reduction in global risk — thanks to the ECB and the Fed — helped fuel January's strong returns…**
- **…and continued robust performance by the "ABCDs" of market fundamentals should help extend the rally.**
- **A tectonic shift in the energy sector bodes well for U.S. energy independence and the equity markets.**

The so-called "January Effect" typically causes equity markets to explode out of the gates only to fizzle out after the second week of the month. January 2012 was different, however, as the equity market delivered four weeks of moderate but relentlessly positive returns on the back of easing global risks. Meanwhile, volatility — as measured by the CBOE Volatility Index (VIX) — broke below 20 for the first time since last May.

Investors on the sidelines barely noticed the explosive performance, nor did a media that nonchalantly labeled it a "stealth rally". There is nothing stealthy about a 4.5% monthly return! The last year that began this well — 1997 — saw the S&P 500 finish up 33%. We think those investors who have been waiting for a "message" from the markets just got it.

Here We Go Again

January 2010 and January 2011 followed similar, dispiriting patterns; each saw markets deliver strong performance that extended a fourth quarter rally, only to be derailed by turmoil in the spring and summer. Despite its parallel trajectory thus far, January 2012 should be able to escape this fate. Why? Because the primary driver of the January's consistently positive returns was a dramatic reduction in global risks, which in conjunction with continued positive fundamentals suggests to us a higher and less volatile market for the rest of 2012. Signs of diminishing risks could be found in both Europe and the U.S.

European Sovereign Risk Abates. In mid-December the European Central Bank (ECB) launched its Long Term Refinancing Operation (LTRO), which we believe will ensure a strong fence against future European market turmoil. The program provides the region's banks with three-year loans at the ECB's rate of 1% while accepting as collateral a wide range of assets, including the poorly rated sovereign debt of troubled euro zone nations. Among the uses for this cheap cash is a carry trade in which banks buy higher-yielding sovereign debt on the open

Risk Assets Were Up Across the Board in January

Index	Wgt	Jan-12	2011	2010	2009	2008	2007	1 Year	3 Years	5 Years	10 Years
Equity											
S&P 500	10%	4.5	2.1	15.1	26.5	(37.0)	5.5	4.2	19.2	0.3	3.5
S&P MidCap 400	10%	6.6	(1.7)	26.6	37.4	(36.2)	8.0	2.7	25.3	3.9	7.8
S&P SmallCap 600	10%	6.6	1.0	26.3	25.6	(31.1)	(0.3)	7.5	25.1	2.8	7.7
U.S. REITs	10%	6.3	4.7	23.5	21.0	(41.5)	(20.2)	7.9	26.6	(6.5)	7.5
EAFE	10%	5.4	(11.7)	8.2	32.5	(43.1)	11.6	(9.2)	13.9	(3.4)	6.2
Emerging Markets	10%	14.2	(22.7)	9.8	93.5	(59.3)	59.1	(8.7)	25.0	4.4	18.7
Average	10%	7.3	(4.7)	18.3	39.4	(41.4)	10.6	0.7	22.5	0.3	8.6
Fixed Income											
Corporate	10%	2.2	8.1	9.0	18.7	(4.9)	4.6	10.3	12.5	7.3	6.5
U.S. Treasury 20+	10%	(0.3)	33.8	9.4	(21.4)	33.7	10.2	37.7	9.7	11.3	9.0
Global Aggregate	10%	1.7	5.6	5.5	6.9	4.8	9.5	7.2	7.8	7.0	7.4
High Yield	10%	3.0	5.0	15.1	58.2	(26.2)	1.9	5.8	23.0	7.9	9.1
Average	10%	1.7	13.2	9.8	15.6	1.9	6.5	15.3	13.2	8.4	8.0
60/40 Porfolio	**10%**	**5.0**	**2.4**	**14.9**	**29.9**	**(24.1)**	**9.0**	**6.6**	**18.8**	**3.5**	**8.3**

Source: MSCI, Standard & Poor's, FactSet market, usually from their home treasuries; not only do banks pocket a tidy 300–400 basis point spread over their borrowing costs, the increased demand for sovereigns puts downward pressure on government yields.

It was a deal banks could not refuse; 523 signed up, borrowing more than €500 billion. The second tranche of this program — planned for February 29 — is expected to attract even greater interest. From a sovereign debt perspective, the impact was immediate and impressive, with Italian and Spanish government bond yields dropping by almost half from their prior levels.

U.S. rates to remain low through late 2014. The Federal Reserve announced that it intends to maintain the target fed funds rates near zero "at least through late 2014". This unexpected announcement was warmly greeted by markets, as it provides a longer window of certainty for funding projects by the private economy, something that has been sorely missing given the political posturing on both sides of the aisle.

Global risk reduction is critical to the market's success — any evidence that risk is receding is immediately priced in, fueling rallies. We anticipate this good and strong policy in Europe and the U.S. will continue, in stark contrast from the extraordinary uncertainty that broke the market's momentum in 2010 and 2011.

Fundamentals Remain Key to the Market's Success

While global risk levels are important, the sustainability of any rally ultimately depends on market fundamentals. If you attribute 2011's flattish performance to a risk-driven decoupling of the market from its underlying fundamentals, as we do, it was entirely foreseeable that a reduction in risk could inspire a "snapback" rally as stock prices moved toward alignment with fundamentals. But with the S&P 500 trading at a price-to-earnings ratio of only 12.9, prices still have far to go to get fully in line with the historical level of 15.0.

Our "ABCDs" of fundamentals have continued to trend positively.

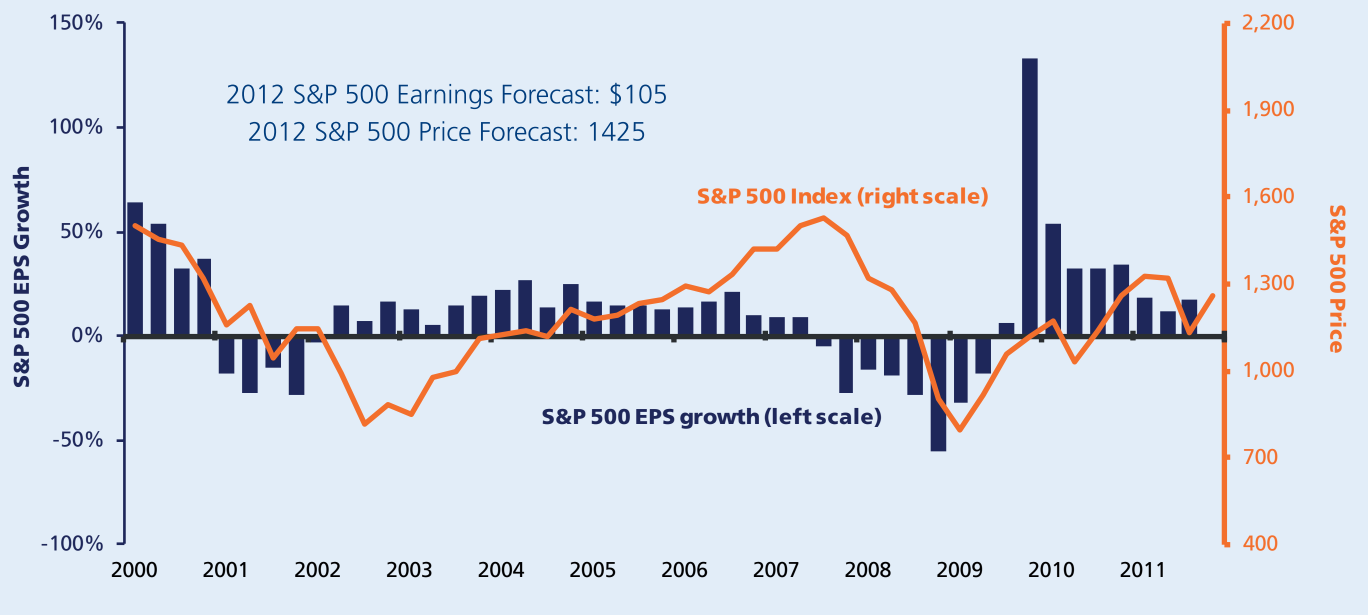
Advancing corporate profits. For each of the past ten quarters, more than 70% of S&P 500 companies have delivered positive earnings surprises. As a result, S&P 500 earnings are on track to beat our expectation of a record $96.50 per share for full-year 2011. Despite some significant misses and incessant hand-wringing in the media, earnings growth for the fourth quarter (with 40% of the S&P 500 having reported results) currently stands at an impressive 5.2% over fourth quarter 2010.

Broadening manufacturing. U.S. manufacturing has reemerged as a powerhouse. The ISM manufacturing index has expanded for 30 consecutive months, while durable goods production surged 8% in 2011 over 2010. The current boom in manufacturing is being driven by global trade in general and demand from emerging markets in particular. U.S. exports surged to an all-time high of $180 billion in September; while they ticked back to $178 billion in November, this still represents 10% year-over-year growth.

Consumer strength underestimated. The much-anticipated December nonfarm payrolls report from the Labor Department showed the addition of 200,000 new jobs, well above consensus expectations of 150,000 but short of the stellar 325,000 new jobs indicated by the ADP employment survey. With the unemployment rate down to 8.5% and the four-week moving average of weekly unemployment claims at its lowest level in three years, consumers have perked up. In fact, retail sales have expanded for seven consecutive months; December's 6.5% year-over-year increase brought monthly sales to their highest level ever, north of $400 billion.

Developing economies are driving global growth. Emerging markets are a key catalyst for U.S. corporate revenue. China reported third quarter GDP growth of 8.9%, disappointing for China but ridiculous by any other country's standards. The World Bank lowered its 2012 forecast

Corporate Profits Continue to Advance



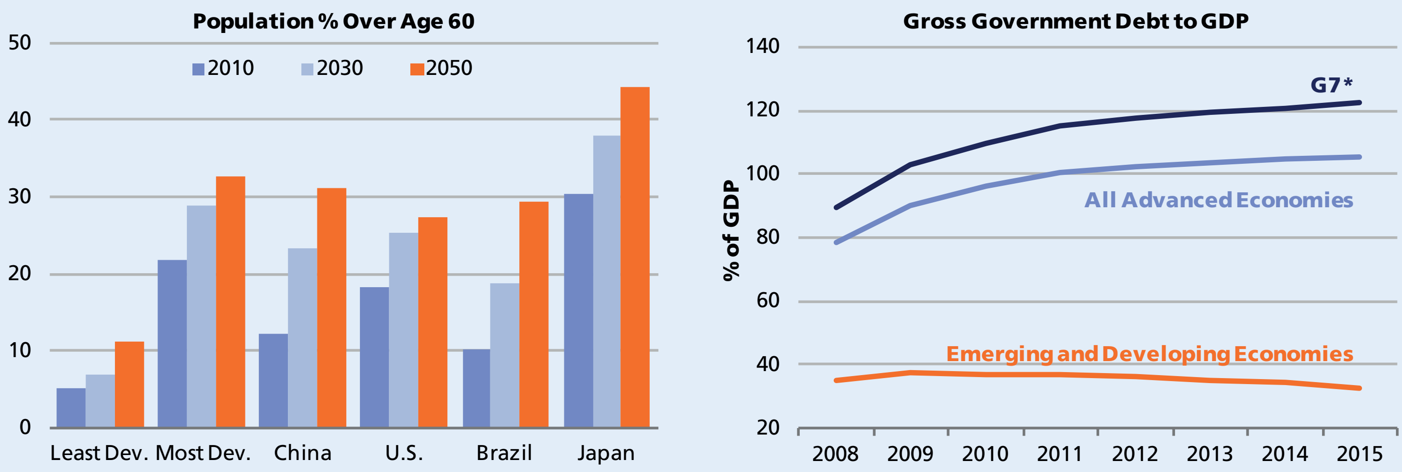
Source: FacSet, Standard & Poor's

for developing market GDP growth from 6.2% to a still-robust 5.4%. Meanwhile, the upheaval in Europe has increased the attractiveness and relative safety of developing markets like Indonesia, which recently was bumped up to investment grade.

Technology Is Driving a Tectonic Shift in the Energy Sector

You'll recall that in our 2012 Outlook we referenced several emerging trends that we expect to have a profound impact on the worldwide economy — drivers we call "tectonic shifts". This month, we'd like to go into more detail about new technologies in the energy sector that have sent natural gas prices plummeting and are shifting the focus of new energy sources squarely on North America.

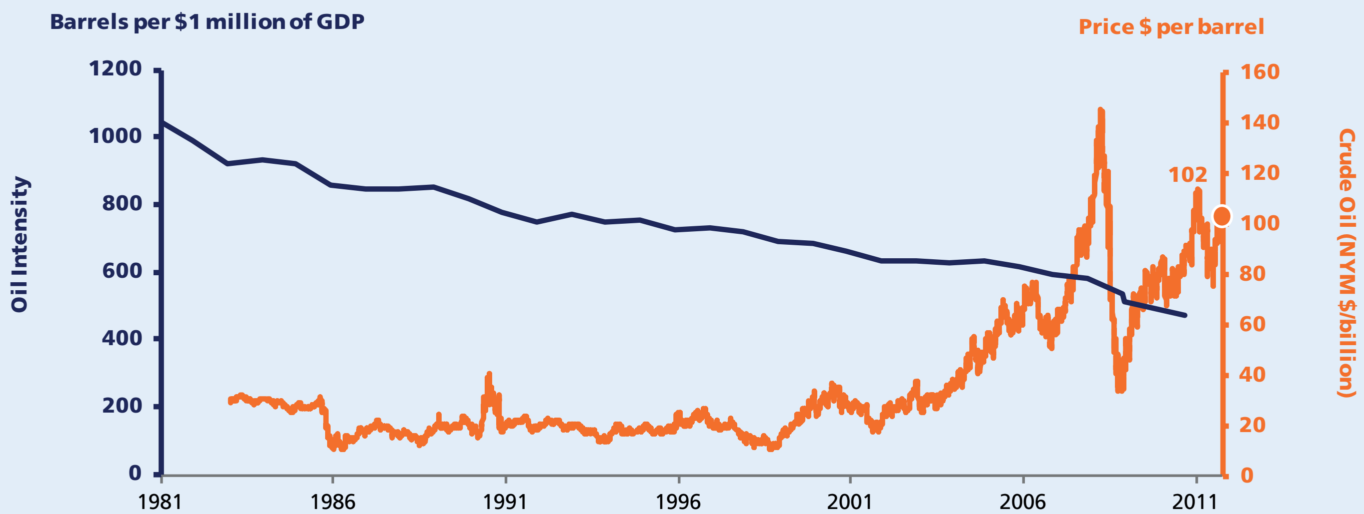
Limited Debt Burdens Have Emerging Economies Well-Positioned for Growth



Source: IMF, CIA World Factbook

**G7 countries are France, Italy, Germany, Japan, U.K., U.S. and Canada*

The Required Amount of Oil per GDP Output — i.e., Oil Intensity — Has Steadily Declined in the U.S



Source: FacSet, Standard & Poor's, U.S. Department of Energy

High-tech "fracking" is already bringing unexpected — and exponentially growing — supply to the market. Fracking is the process of drilling wells horizontally below the surface, allowing a single pathway to reach pockets of oil and natural gas trapped between formations of shale and other rock. Once the bore is complete, high-pressure jets of sand, water and chemicals are pumped into the ground to create fissures through the rock that allow oil to be recovered. Meanwhile, the new technique of "super-fracking" seeks to create deeper, longer cracks that will yield even more oil and gas. Though fracking remains controversial from an environmental standpoint — and super-fracking remains, well, super-controversial — it is indisputable that this technology is spurring a revolution in the energy industry that will contribute to the U.S.'s ability to be energy self-sufficient by 2030.

Though fracking is only a few years old, the pendulum of U.S. oil independence already has begun to swing the other way. Petroleum imports accounted for 60% of domestic consumption in 2005; that figure dropped to 47% in 2011. Sure, the Keystone XL pipeline to bring Canadian oil to Gulf of Mexico refineries was rejected, but when an idea's time has come, no amount of politics can prevent it.

In short, this energy trend in North America is unstoppable. It means much lower oil prices in the future, a massive stimulus for consumers and businesses that we feel is not properly discounted in the market despite a fair amount of media attention. For example, in an article titled "Everything You Know About Peak Oil Is Wrong," *Bloomberg BusinessWeek* wrote that "The World Energy Council reports that global proven recoverable reserves of natural gas liquids and crude oil amounted to 1.2 trillion barrels in 2010. That's enough to last another 38 years at current usage. Add in shale oil, and that's an additional 4.8 trillion barrels, or a century and a half's worth of supply at present usage rates."

Investors vs. Savers: Which is Riskier?

It wasn't just U.S. equities that got off to a strong start; risk was all the rage across markets in January. Emerging market equities (BRICs) staged a stunning 14.2% rally after a brutal 2011, while beleaguered developed markets like Greece also surged, as did high yield bonds. That is precisely why it pays to be broadly, globally diversified: the saver is taking considerable risk by being out of the market during these — entirely predictable — "stealth" rallies.

Yogi Berra was reported to have said, "it's tough to make predictions, especially about the future." But given the Fed's latest announcement, it's easy to predict that savers will earn next to nothing for the foreseeable future. Investors, on the other hand, always have the opportunity to earn market returns. With global risks easing and fundamentals marching forward — not to mention the potential upside embedded in tectonic market shifts such as what we're seeing in energy — even Yogi would find the choice obvious. ■