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Markets Soar as Global Monetary Stimulus Inspires Confidence

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Investors cheered the Federal Reserve's bottomless punch bowl with the best January market returns in years. Not only is the Fed purchasing $85 billion of mortgages and Treasuries each month, it recently spiked the mix with an old-fashioned twist — the outright printing of money, indefinitely (or at least until the unemployment rate drops to 6.5%). As if to lock in the Fed's support, the unemployment rate increased in the latest Bureau of Labor Statistics report — due to obfuscated benchmark revisions — despite the addition of a respectable 274,000 jobs (including upward revisions to prior months). Only in government statistics could a headline number get worse on better underlying results.

While "don't fight the Fed" has long proven a useful investment mantra, fundamentals ultimately drive the markets. Are things as good in this regard as the markets would seem to suggest? Before you answer this question, consider a few more:

- Why has Europe been in recession for four consecutive quarters?
- Why has Japan been in recession for three consecutive quarters?
- Why did the preliminary report of fourth quarter 2012 GDP in the U.S. tip negative? Will it be revised up?
- Why did U.S. corporate profit growth go negative in third quarter 2012?
- Why are so many U.S. corporate bellwethers announcing negative fourth quarter 2012 results?
- Why has the Fed been so aggressive with its monetary stimulus?
- What will be the impact of a $1.2 trillion of spending cuts — i.e., the sequester — scheduled for March?
- What is the true cost of the changes to one-sixth of the U.S. economy brought on by the Affordable Care Act?

Executive Summary

- **"Don't fight the Fed" holds true in January, as equity markets surged in the face of persistent fundamental questions.**
- **Tail risk in Europe has eased considerably, though economic growth remains elusive.**
- **With fourth quarter earnings trending positive, corporate America is likely to sidestep a profits recession.**
- **Cash is a dangerous asset class, delivering negative real returns in our low-interest-rate environment.**

Investors Piled Into Equities to Start the Year

Index	Wgt	Jan-13	2012	2011	2010	2009	2008	1 Year	3 Years	5 Years	10 Years
Equity											
S&P 500	10%	5.2	16.0	2.1	15.1	26.5	(37.0)	16.8	14.1	4.0	7.9
S&P MidCap 400	10%	7.2	17.9	(1.7)	26.6	37.4	(36.2)	18.6	17.6	8.0	11.6
S&P SmallCap 600	10%	5.8	16.3	1.0	26.3	25.6	(31.1)	15.5	17.6	7.4	11.5
Global REITs	10%	3.5	29.8	(8.1)	20.0	41.3	(48.9)	24.1	16.3	2.4	9.7
EAFE	10%	5.3	17.9	(11.7)	8.2	32.5	(43.1)	17.8	7.4	(0.3)	9.7
Emerging Markets	10%	4.2	14.9	(22.7)	9.8	93.5	(59.3)	4.8	3.2	(1.1)	20.7
Average		5.2	18.8	(6.9)	17.7	42.8	(42.6)	16.3	12.7	3.4	11.9
Fixed Income											
Corporate	10%	(0.9)	9.8	8.1	9.0	18.7	(4.9)	6.5	8.1	7.5	6.2
U.S. Treasury 20+	10%	(3.9)	3.4	33.8	9.4	(21.4)	33.7	(0.4)	12.3	8.4	7.5
Global Aggregate	10%	(0.9)	4.3	5.6	5.5	6.9	4.8	1.7	4.7	4.7	5.8
High Yield	10%	1.3	15.8	5.0	15.1	58.2	(26.2)	13.9	11.9	10.9	10.4
Average		(1.1)	8.3	13.2	9.8	15.6	1.9	5.4	9.3	7.9	7.5
Overall Average		**2.7**	**14.6**	**1.1**	**14.5**	**31.9**	**(24.8)**	**11.9**	**11.3**	**5.2**	**10.1**

Source: ING Global Perspectives, FactSet

No "Lost Decade"

These are just a few of our immediate concerns. The markets, though, have been relentless in their volatility-free march upward and onward; at one point in January, the S&P 500 Index advanced for ten straight days. The index ended the month up 5.2%, its best January since 1997. This was only good enough for fourth place in the asset-class derby, however, as mid caps, small caps and even the Dow Jones Industrial Average posted better returns.

Another explanation for the extraordinary market performance is that the tail risk in Europe — the probability of an Armageddon event around the European debt crisis — has abated thanks to strong action and leadership from the European Central Bank. While we thought the European debt crisis was overblown to begin with, the distinct lack of economic growth in Europe is concerning. The German economy appears to be bouncing back from its fourth quarter contraction, but what about the 17 other countries that comprise the currency bloc? Debt forgiveness and free money from the central bank will not work if these economies continue to sputter.

With that, let's turn to the fundamentals, the "ABCDs" that drive the markets.

Advancing corporate profits. With 68% of the S&P 500 having reported fourth quarter results, the earnings growth rate is 5%. So far, so good it seems. Earnings quality, however, is less impressive; top-line sales growth is 3%, indicating that much of the earnings expansion is via cost-cutting as opposed to organic sales growth. Regardless, positive growth in the fourth quarter — however it is come by — would avoid a profits recession (that is, two consecutive quarters of contraction in earnings). Corporate profits trends tend to persist for long periods; negative growth in the third quarter inspired our defensive posture, which we will re-evaluate once fourth quarter earnings season is complete.

Broadening manufacturing. Manufacturing has once again flexed its muscles and has clearly returned to expansion — the latest ISM reading came in at 53.7%. Inexpensive natural gas, global wage-equilibrium trends and the economic advantages of producing products close to where they are sold will continue to fan the flames of the U.S. manufacturing renaissance.

Consumer as the game changer. Consumers took to the stores in December, spending their way to an all-time-high retail sales figure. But what portion of this surge was fueled by special dividends and income showered on investors prior to year-end on fears of a radically new tax structure in 2013? January consumption numbers will most likely reflect a reversal. So while consumers are benefitting from a long-awaited housing revival, the end of the payroll tax holiday will likely dampen their enthusiasm.

Developing economies. The developing countries are undeniably a huge catalyst for U.S. corporate growth, but they don't want just goods and services from us. Before U.S. companies can open a coffee shop on every corner, many of these countries need massive upgrades to their infrastructure. Electricity, running water, roads, bridges, hospitals — all are required. So the growth opportunities here are not limited to companies peddling finished goods but are available to firms across the economic spectrum.

Meanwhile, the "tectonic shifts" we have been promoting in these pages continue to gather momentum. The energy wave keeps rolling, with reports of the development of more environmentally friendly fracking chemicals. Clearly fracking is not going away any time soon, but energy is not the only economic shift that will impact global growth. Advancements in technology, frontier-market surges and the expansion of new trade routes will all contribute to a shift in the global economic landscape.

Positive Fourth Quarter Earnings Growth Would Sidestep a Profits Recession

Sector	Reported		Earnings Growth			Earnings Surprise		
	Actual	Total	Percent	Positive	Negative	Percent	Positive	Negative
Financials	68	81	24%	42	21	7%	41	19
Materials	24	30	19%	16	6	9%	14	7
Utilities	10	33	15%	7	3	3%	4	4
Energy	26	43	13%	12	11	7%	20	6
Consumer Staples	21	41	10%	18	3	4%	16	4
Consumer Discretionary	44	81	4%	29	15	3%	30	11
Information Technology	52	70	2%	32	23	4%	44	6
Health Care	41	52	(2%)	24	17	3%	26	8
Telecommunication Services	4	8	(12%)	0	3	(8%)	1	3
Industrials	49	61	(18%)	25	23	(13%)	31	12
S&P 500	**343**	**500**	**5%**	**205**	**125**	**3%**	**227**	**80**

Source: Bloomberg, Standard & Poor's, FactSet

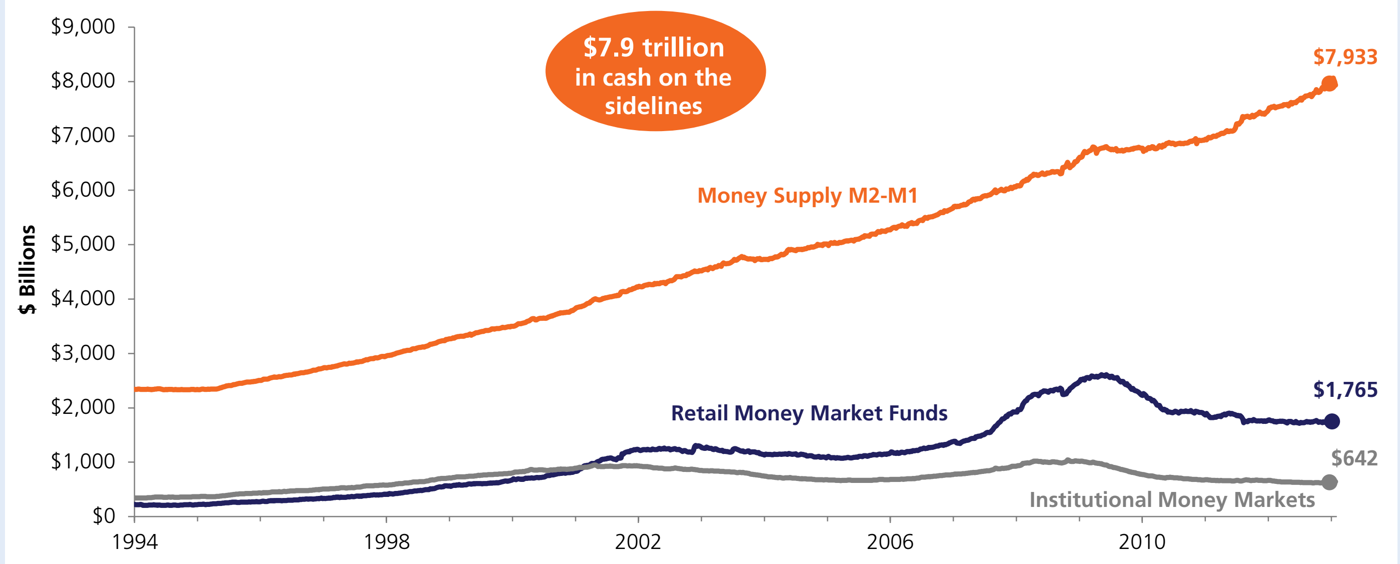
Rally Highlights the Folly of Gaming Diversification

Rising asset prices, for both the securities markets and housing, have one important remedial impact: attracting back into risk assets a portion of the $7.9 trillion presently locked up in unproductive cash. At least the nouveau bulls are increasing the animal spirits that global economies — including the U.S. — really need. Despite weakening fundamentals, we believe investors need to be broadly and globally diversified across risky assets, albeit defensively at this point.

Cash is a dangerous asset class — especially with the Fed's determination to keep rates at or near zero for the next couple of years — and this attempt at gaming diversification has resulted in negative real returns. Sidelined investors — more aptly described as "savers" — have succumbed to the false but widely publicized notion of the "lost decade" of investing, a construct that did not exist for the well-diversified investor.

Cash is a bearish and an excessively harsh response to a world that always experiences uncertainties. There are more opportunities globally than ever before, and the real economy is being bolstered by tectonic shifts. While it is prudent to protect capital against probable bouts of volatility, parking hard-earned assets in cash is an enormous mistake. Perhaps the jolt of January confidence we have just witnessed will lure more groundhog savers out of their holes. ■

Massive Cash Holdings Highlight the Folly of Gaming Diversification



Note: M2 minus M1 includes all savings deposits and retail money market funds and excludes currency, coins and checking account balances.

Source: FactSet

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