Market Update • March 4, 2011

Worldwide Turmoil, $100 Oil but Markets Positive in February

Douglas Coté, CFA

Senior Market Strategist

Who would have thought that "tweets" would promote viable democratic movements from Egypt to the shores of Tripoli? The markets reeled, and oil gushed to $100 in response to the unrest. Meanwhile, in the U.S., the impending crisis in federal and state debt, deficits and taxes took center stage, with Wisconsin in the spotlight.

One thing about when an idea's time has come, it simply overwhelms resistance. We are seeing it in the Middle East and North Africa, where the people have had enough of oppressive autocratic regimes, and we are witnessing it in the U.S., too, where the people are fed up with out-of-control spending by all levels of government. While the goals of these movements differ, the results will be the same: The voice of the people will be heard.

So for three whole days the markets were hammered, then reversed course sharply, leaving February solidly in positive territory for the month. Let me say it again, in case you did not know, everything including the kitchen sink was thrown at this market, but its forward momentum could not be derailed, with mid-cap stocks leading the way and the energy sector dominating returns across all equities. Not even the added threat of a U.S. government shutdown could stop this bull market. Now, the bears may contend that QE2 with $600 billion of stimulus has driven the market since September, yet $4 trillion of currency trades every day, two-thirds of which is the U.S. dollar. QE2 is a drop in an ocean. So what is driving this market and why is it — OMG! — plowing through risks like a teenager driving while texting?

U.S. REITs and Mid-Cap Stocks Surged Ahead Year-to-Date

Index	Feb-11	YTD	2010	2009	2008	2007	2006	1 year	3 years	5 years	10 years
Equity											
S&P 500	3.4	5.9	15.1	26.5	(37.0)	5.5	15.8	22.6	1.3	2.9	2.6
S&P 400 MidCap	4.5	6.5	24.9	35.0	(37.3)	6.7	9.0	30.9	5.9	4.6	6.9
S&P 600 SmallCap	4.3	4.4	25.0	23.8	(32.0)	(1.2)	14.1	29.7	5.0	2.9	7.3
U.S. REITs	4.3	7.6	23.5	21.0	(41.5)	(20.2)	30.2	33.7	(1.0)	(2.2)	8.5
EAFE	3.3	5.8	8.2	32.5	(43.1)	11.6	26.9	20.5	(2.5)	2.9	5.3
BRIC	1.0	(2.3)	9.8	93.5	(59.3)	59.1	56.6	13.9	(3.4)	11.6	17.3
Average	3.5	4.6	17.7	38.7	(41.7)	10.2	25.4	25.2	0.9	3.8	8.0
Fixed Income											
Corporate	0.8	1.0	9.0	18.7	(4.9)	4.6	4.3	7.9	7.3	6.2	6.3
U.S. Treasury 20+	1.5	(1.7)	9.4	(21.4)	33.7	10.2	0.9	4.7	4.2	4.7	6.1
Global Aggregate	0.6	0.8	5.5	6.9	4.8	9.5	6.6	5.8	4.7	6.6	6.7
High Yield	1.3	3.5	15.1	58.2	(26.2)	1.9	11.8	17.5	12.5	9.2	8.3
Average	1.0	0.9	9.8	15.6	1.9	6.5	5.9	9.0	7.2	6.7	6.9
60/40 Portfolio	**2.5**	**3.2**	**14.5**	**29.5**	**-24.3**	**8.8**	**17.6**	**18.7**	**3.4**	**4.9**	**7.5**

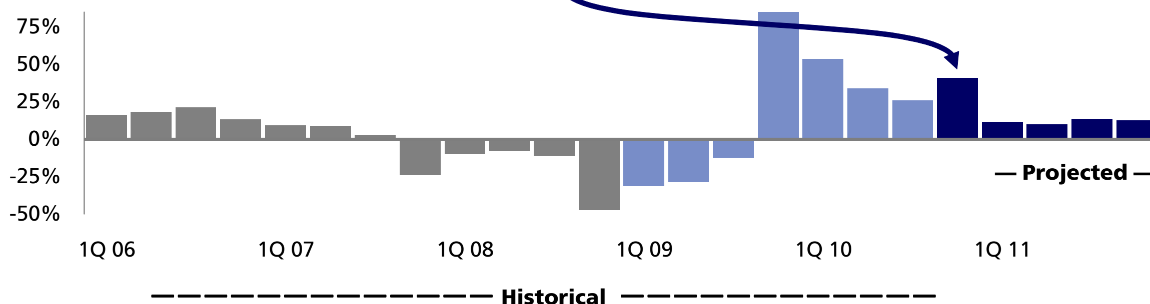
Source: MSCI, Standard & Poor's, FactSet

In short, fundamentals are driving this market. Below, we address the **ABCs** — and we'll throw in **D** as a bonus — of the rally.

A is for "accelerating corporate earnings". Corporate earnings are the most important driver of the equity markets. Positive and accelerating earnings drive the market up — period. With more than 90% of the S&P 500 having reported fourth quarter results, the earnings growth rate is hovering around 30% year-over-year, and we are on target to achieve the highest level of annual corporate earnings since 2006. Top-line sales growth has come in close to 10% on average, showing that this market has legs. For 2010, GM reported its first annual profit since 2004. Consumer discretionary rivals Home Depot and Lowe's posted earnings growth over 40%. An above-average company like Apple delivered 70%-plus growth in both earnings and sales, while an exceptional company like Caterpillar recorded 62% growth in sales and 265% growth in earnings.

Earnings Growth for S&P 500 Companies Is Hovering Around 30% Year-Over-Year

Sector	Reported			Earnings Growth			Earnings Surprise		
	Actual	/	Total	Percent	Positive	Negative	Percent	Positive	Negative
Consumer Discretionary	56	/	79	12.7%	43	11	1.1%	43	12
Consumer Staples	35	/	41	0.2%	20	15	1.5%	17	11
Energy	32	/	41	45.0%	22	7	10.2%	25	7
Financials	76	/	81	432.7%	45	17	(7.9%)	48	26
Health Care	46	/	52	7.8%	36	10	5.6%	38	3
Industrials	51	/	59	24.5%	42	8	8.5%	37	11
Information Technology	69	/	75	24.3%	56	10	9.5%	55	9
Materials	28	/	30	50.7%	20	5	12.2%	19	6
Telecommunication	6	/	9	8.9%	3	2	1.0%	2	4
Utilities	20	/	33	-2.0%	8	11	0.5%	8	11
S&P 500	419	/	500	33.4%	295	96	4.3%	292	100



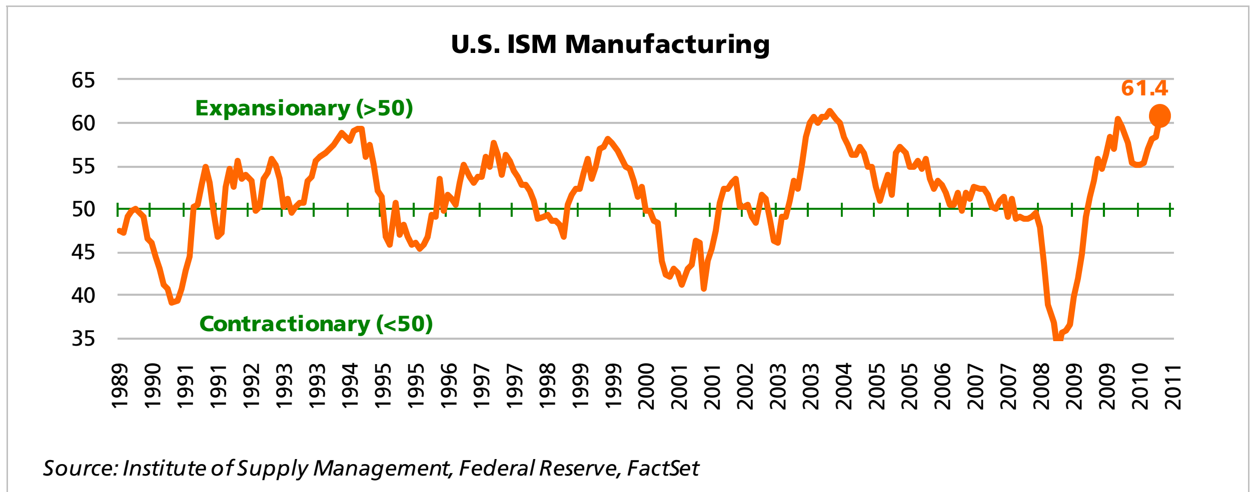
Note: Earnings Growth is the percentage change in the cumulative share weighted EPS Earnings from that of a year ago. Surprise Percent is the share weighted average of the ratio of actual company earnings vs. the consensus estimate.

Source: Bloomberg, Standard & Poor's, FactSet

B is for "boom-level manufacturing". The ISM manufacturing index blew away all expectations in January, reaching a whopping 60.8, its highest level since 2004; while readings over 50 are considered expansionary, readings over 60 are considered boom levels. In tandem, durable goods orders rose for the first time since September, increasing 2.7%.

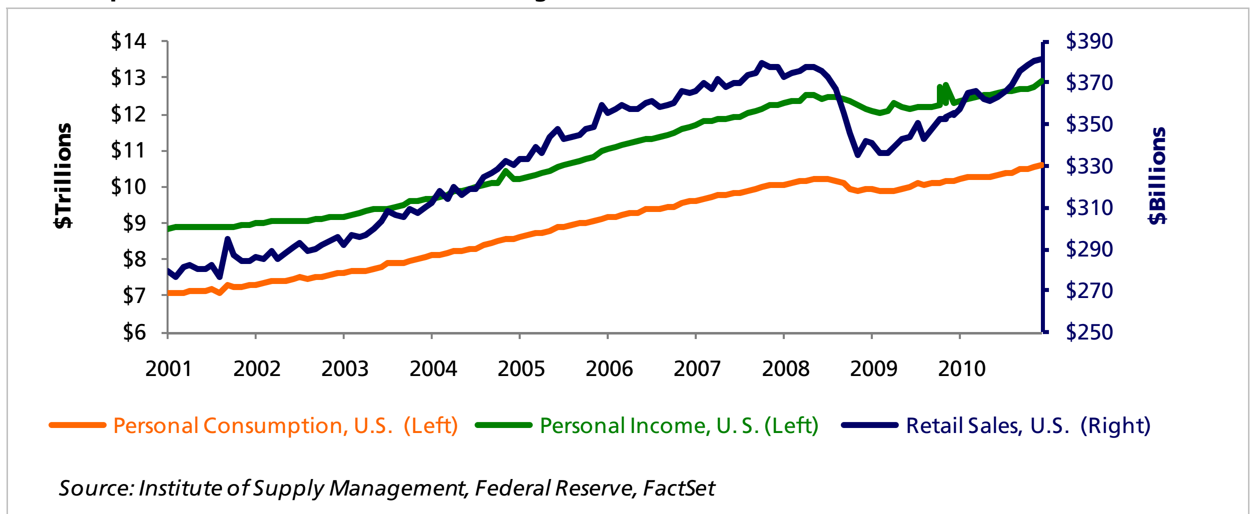
C is for "consumer". The consumer accounts for 70% of U.S. GDP, and the influence of this 2011 game changer continues unabated. Consumer confidence jumped above 70 from the prior month's 64.8 reading. Retail sales for February were slightly disappointing on a relative basis; a mere 0.3% month-over-month increase couldn't help but pale in comparison to the robust holiday season just completed. If we look at absolute levels, however, February was actually the strongest month ever. Although the unemployment rate is still high at 9%, initial jobless claims recently dropped below the 400,000 mark to reach their lowest level in 2.5 years, a very positive signal for the job market, consumers and the market.

Manufacturing Reached a Seven-Year High



Source: Institute of Supply Management, Federal Reserve, FactSet

Consumption, Income and Retail Sales Rose, Again



Source: Institute of Supply Management, Federal Reserve, FactSet

D is for "developing global economies". If you were thinking "deflation", you were way off. That was so 2010 — and, in reality, was anyone other than Ben Bernanke seriously warning of that scenario? In 2011, it's inflation that's a cause for concern, in the developing economies and elsewhere in the world. Surging commodity demand and rising labor costs are increasingly making an impact. However, while inflation is worrisome, let's not forget that some overheated economies are contributing positively to overall global trade and are lining the coffers of U.S. corporations. China, the king of the export hill, experienced a more than 50% year-over-year increase in imports — yes, imports — last month. China imported almost $1.4 trillion worth of goods in 2010, and the U.S. is one of China's top five import suppliers.

The market fundamentals are powerful and accelerating forces. But risks abound. Despite the situation in the Middle East, by far the most urgent and dangerous risk to the economy and markets is our own debt and deficits. Pay close attention when Federal Reserve Chairman Bernanke says, "We have no expectation or intention to get involved in state and local debt...the Fed has no authority to buy state or local debt." His warning that the Fed cannot or will not bail out states and municipalities is not comforting and implies that the problem may be worse than reported. But rest assured, leadership on debt is MIA in the new federal budget, which spends $300 billion every month while borrowing $120 billion. Fiscal responsibility may be voluntary or involuntary, but the markets will likely punish violators with higher prices for their debt. Just look at Illinois, the state with the lowest credit rating in the union, paying junk bond prices to attract buyers — i.e., hedge funds — to finance its debt.

It is gratifying to see a market so buffed with fundamentals that it can shrug off geopolitical risks. The wildcard is U.S. politicians at all levels. Do they step up to the plate, or do they capitulate? We think the market will enforce the right action, and economic growth will accelerate. ■

Nothing contained herein should be construed as (i) an offer to sell or solicitation of an offer to buy any security or (ii) a recommendation as to the advisability of investing in, purchasing or selling any security. Any opinions expressed herein reflect our judgment and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels, (4) increasing levels of loan defaults, (5) changes in laws and regulations and (6) changes in the policies of governments and/or regulatory authorities.