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Weekly Investment Commentary

Modest Economic and Jobs Growth Should Continue in the Months Ahead

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A Mixed Week for Stocks

The multi-week rally in equities took a breather last week as markets produced mixed results. Thanks in large part to a strong earnings release from Apple Inc., growth areas of the market outperformed value areas. For the week, the Dow Jones Industrial Average dropped 0.5% to 12,660, the S&P 500 Index was up marginally to 1,316 and the Nasdaq Composite climbed 1.1% to 2,816.

Economic Data Continues to Skew Positively

The economic highlight of last week was the release of the preliminary fourth-quarter US gross domestic product (GDP) report, showing that GDP grew by 2.8% in the last quarter of 2011. This pace represents the fastest growth since the second quarter of 2010, but the details within the report were somewhat mixed. On the positive side, the data showed that private consumption and private fixed investment were both up. In contrast, the data also showed that the largest positive contributor to growth came as a result of inventory accumulation, which tends to be quite cyclical. On balance, we believe the report paints a picture of modest, if unspectacular, growth in the United States.

At the end of this week, we will see the release of January's employment report. Initial unemployment claims have been falling in recent weeks, suggesting that jobs data is improving and we do expect to see better employment figures in the months to come. Our expectation is that jobs growth is likely to average around 150,000 per month, adding up to 1.8 million new jobs for all of 2012. That should be enough to continue to bring the unemployment rate down, but we are not expecting it to fall below 8.0% by the end of 2012.

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Taking a step back, it does seem clear that the economy has improved since the lull in growth in the middle of 2011 that was caused by the natural disasters in Japan, higher energy prices and the consternation over the debt ceiling debate. Looking ahead, we are calling for economic growth in the neighborhood of between 2.0% and 2.5% in 2012.

Politics and the Fed: No Changes for Now

President Obama delivered his State of the Union address last week and, not surprisingly, the majority of his comments focused on economic issues, particularly regarding the manufacturing sector and broader tax policy. In terms of infrastructure spending, the President proposed a significant spending increase by using half of the savings that will be achieved by the winding down of the wars in Iraq and Afghanistan. Regarding tax policy, the most significant change he advocated was for individuals with over $1 million in income to pay a minimum effective tax rate of 30%. The speech was quite charged politically (not surprising for an election year), and in our view few of the policies the President advocated have any chance of passing in advance of the November elections.

The Federal Reserve also met last week and, in their new era of openness, announced that the central bank would maintain a highly accommodative monetary stance for the foreseeable future. In particular, the Fed indicated that it plans to keep rates at their current near-zero level through at least late 2014, a longer timeframe than it had previously indicated. The Fed also left room for the possibility of additional quantitative easing, but as expected, nothing definitive was announced.

We think it is likely that modest levels of economic growth should continue, which should help pave the way for risk asset outperformance.

The Background for Stocks Remains Constructive

From a technical perspective, the market backdrop continues to be a strong one. All of the major indices are trading at above their 200-day moving averages and the advance/decline lines are trending quite strong. Additionally, mutual fund flows are starting to move in a positive direction for stocks with some evidence suggesting that investors are starting to get back into the markets (although the amount of cash on the sidelines remains extremely high).

Although economic and market data is looking better than it did several months ago, it is important to remember that significant downside risks remain. The European debt crisis still has the potential to spiral out of control and investors need to keep an eye on potentially rising oil and gasoline prices. Additionally, should Congress fail to extend the payroll tax cut beyond February, we could see a consumer spending pullback.

On balance, however, we believe the positives outweigh the negatives. Central banks remain highly committed to promoting better economic growth and while we are not expecting to see a clear resolution for the European debt crisis, we do expect it to remain reasonably well contained. Given this backdrop, we think it is likely that modest levels of economic growth should continue, which should help pave the way for risk asset outperformance.

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