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Weekly Investment Commentary

The "Risk On" Trade Remains the Right Call

February 13, 2012

Market Rally Fades on Debt Concerns

Although markets got a boost early last week as some decent economic news and a pervading "risk on" sentiment pushed prices higher, momentum faded later in the week as renewed concerns about the European debt crisis emerged. For the week, stocks were down slightly, with the Dow Jones Industrial Average falling 0.5% to 12,801, the S&P 500 Index declining 0.2% to 1,342 and the Nasdaq Composite losing 0.1% to 2,903.

Economic Outlook Remains a "Muddle Through" One

One of the main factors underlying improved economic conditions has been a continued trend of better-than-expected jobs market data. Unemployment claims have fallen steadily since the fall, and monthly jobs growth and unemployment data have been surprisingly strong of late. The housing market remains weak, but that sector of the economy does appear to be in a long-term bottoming process. While we are not expecting to see any significant near-term upside in housing, housing-related headwinds in gross domestic product do appear to be fading.

On balance, we retain our generally positive view toward the US economy, but we do not expect the recent almost-uninterrupted trend of positive data to continue. There is little prospect for economic acceleration beyond what we have seen lately, which suggests that economic risks are skewed to the downside compared to where we are today. Over the course of the year, we expect the US economy to remain firmly in "muddle through" mode.

Regarding corporate earnings, we are now well past the halfway mark for the fourth-quarter reporting season. While results have been generally good, the degree of positive surprises is down from that of previous quarters. By the time reporting season draws to a close, overall results should be somewhat ahead of expectations.

European Debt Woes Resurface

The week ended with a relatively sour note on the European debt crisis when the European Union (led by Germany) rejected the proposed austerity plan for Greece, stating that they believe it does not do enough to reduce Greek debt levels and leaves deficits too high. As such, it appears that Greece will have to propose further spending cuts and/or tax increases in order to move the process forward.

Over the past couple of years, the debt crisis has followed a familiar script in which policymakers appear to await some sort of "market riot" before they begin to ease policy and to pledge further budget cuts. Unfortunately, however, the efforts to cut budgets have resulted in weaker growth rather than stronger growth, and therefore we have seen scant improvement in Europe's fiscal situation. Policymakers are in a bind. On the one hand, fiscal austerity measures are largely self-defeating in the short term since they act as a drag on growth, but on the other hand, if policymakers fail to enact cuts now, it is hard to imagine they will be doing so in the future.

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The world has placed a lot of faith on central banks and their ability to inject the liquidity needed to help solve debt problems. Indeed, we do believe the European Central Bank needs to further expand its balance sheet as part of the overall effort to bring the crisis under control. These issues cannot be solved by central bank action alone, however, and elected officials need to continue to push forward with their rescue packages. In any case, Europe's debt problems will not be fading any time soon, suggesting that financial markets will continue to trade in a somewhat "risk on/risk off" pattern.

Our view is that the "risk on" trade is the right one in the long term given that the world's major economies are healing and that debt problems are slowly improving.

Our Market View Remains Positive, but a Consolidation Is Likely

Notwithstanding last week's modest setback, risk assets have enjoyed a strong run over the past couple of months as reduced fears from the European Union financial problems and a better economic climate in the United States have driven investors back into stocks and other risk asset classes.

Our view is that the "risk on" trade is the right one in the long term given that the world's major economies are healing and that debt problems are slowly improving. It is important to remember that these processes will not occur in a straight line and we will see setbacks along the way. The rise in risk asset prices, however, has been in a more-or-less straight line, with US stocks rising close to 25% over the past four months. As a result, at some point we will almost certainly see at least a pause in the upward move as markets experience some sort of consolidation or corrective action.

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