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Weekly Investment Commentary

Market Drawdown Presents Buying Opportunities

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Another Downturn for Stocks

Once again, risk assets struggled last week with most investors blaming the downturn on re-ignition of concerns over the European debt crisis brought about by a disappointing debt auction in Spain. For the week, the Dow Jones Industrial Average fell 1.6% to 12,849, the S&P 500 Index declined 2.0% to 1,370 and the Nasdaq Composite dropped 2.3% to 3,011.

Does History Repeat? Or Just Rhyme?

Last year around this time, stocks were coming off an impressive first quarter, but were headed for trouble. Higher oil prices, the earthquake in Japan and the brouhaha over the US debt ceiling all conspired to cause a sharp turnaround in risk assets. So far this year, stocks have been following a somewhat similar pattern as early strength for equities appears to be fading somewhat. So, it is worth asking the question: Will 2012 look like 2011?

There are some aspects of the financial and economic backdrop that do look similar between the two years. In addition to the flare ups in Europe regarding debt problems, we are currently in the midst of a period of rising energy prices. Gasoline prices in particular are getting close to last year's peaks. We are also seeing some renewed weakness in the economic data—the pace of jobs growth slowed in March and consumer confidence levels have been looking softer. Should gasoline prices continue to rise, it would be reasonable to fear that the spillover effect onto the rest of the economy would worsen.

We believe it would be a mistake, however, to look too closely to 2011 as a model for what might happen this year. For starters, current expectations for both the economy and the markets are worse than they were at this point last year. In early 2011, investors were pricing in a better economic environment than what would ultimately come to pass. In contrast, at this point we believe that markets are already priced for relatively modest levels of growth, suggesting that there is less room for downside disappointments. Additionally, the fundamental strength of the economy is better now than it was one year ago. Notwithstanding last month's data, the labor market is stronger than it was, housing appears to be bottoming and US credit conditions have been improving. Finally, it is important to remember that the recovery and market

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strength last year were, to some extent, derailed by the natural disasters in Japan and by S&P's credit downgrade of the United States. While external shocks are always a risk, we can hope that these sorts of factors will not be repeated.

Reasons for Optimism

Given the relative differences between the economy in 2011 and what it looks like today, we believe the US economy will be more resilient than it was last year, providing some support for US equities.

In addition to the economic backdrop, we would also look to corporate earnings as a source of strength. Although we are forecasting that the pace of earnings growth will be slower this year than it has been in the recent past, so far the data has shown that corporate earnings have been doing just fine. Expectations for the first quarter have been set relatively low, but so far over 80% of the companies that have reported have surpassed expectations, which is a good sign. (In comparison, in the previous several quarters around 60% to 70% of companies beat expectations.)

We believe that stocks should see a resumption of gains after the current period of weakness, which could create buying opportunities for investors.

Putting all of this together, we would argue that we are unlikely to see the sort of sharp and severe pullback in stock prices that we witnessed in 2011. We do, however, expect to see higher levels of volatility in the months ahead compared to what we experienced in the first quarter and we would not be surprised to see the current pullback take the markets down to around the 1,350 or 1,300 level for the S&P 500. Such a pullback would represent a normal correction occurring in the midst of a bull market. Furthermore, we also believe that stocks should see a resumption of gains after the current period of weakness, which could create buying opportunities for investors.

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