

Weekly Investment Commentary

Stocks Advance Despite Softening Earnings Data

January 23, 2012

Equity Market Rally Continues

Risk assets advanced yet again last week as 2012 has gotten off to a strong start for the markets. Last week, investors looked past some mixed earnings results and focused on improvements in economic data, helping stocks to notch some solid gains. For the week, the Dow Jones Industrial Average climbed 2.4% to 12,720, the S&P 500 Index rose 2.0% to 1,315 and the Nasdaq Composite gained 2.8% to 2,786.

The improvements in equity markets in the early weeks of 2012 are particularly notable given that stock market gains have been global in nature. In fact, the past three weeks mark the first time since 2007 that markets in the United States, Europe and China have all advanced at the beginning of a year. Despite the gains, however, it is important to point out that mutual fund flows are still showing that investors are moving out of equities, indicating that risk aversion remains high.

Economic Data Remains Solid

One of the key recent economic data releases showed that US jobless claims fell by 50,000 last week to 352,000. That drop represents the largest weekly decline since 2005 and suggests that the January payrolls report could be a strong one. Our estimate is that when that data is released in a couple of weeks, it will show that around 150,000 new jobs will have been created.

As we have been saying for some time, improvement in the employment market is a critical factor in helping to create positive “feedback loops” for the economy, and it does appear to us that jobs data is continuing to slowly get better.

In other economic news, this Wednesday’s Federal Open Market Committee (FOMC) meeting will mark the beginning of a new era for the Federal Reserve. In addition to the FOMC statement that the Fed typically releases at these meetings, the central bank will also begin to release forecasts for the benchmark Fed Funds rate and will provide guidance about the timing of the first rate hike. This represents a significant change as part of the Fed’s desire to become more transparent about its decision making.

Earnings Growth Looks to Moderate

It is still quite early in the fourth quarter 2011 earnings season, but results to date have been mixed and are weaker than they have been in recent quarters. About 15% of companies have reported, with just over half delivering better-than-expected results. At this point, it looks like overall earnings will exceed estimates by somewhere around 1% to 2%, the lowest rate we have seen in some time.

At present, analysts are downgrading their 2012 earnings forecasts. The current bottom-up consensus estimates are that earnings will grow by around 12% in 2012. Our guess is that growth will come in at around half that rate.



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What Will it Take for the Rally to Continue?

The recent bounce in stocks and other risk assets can be attributed to a combination of some improved US economic data, a lack of significant new negatives in the euro debt crisis and further evidence of a soft economic landing in China. For the rally to continue, we believe at least two developments need to occur. The first is that we need to see policymakers in the euro area continue to stabilize conditions. The second is that we need to see global economic data continue to improve enough to support corporate earnings growth.

Regarding the first, it does appear that the European Central Bank is working diligently to address the weakness in the European banking system, which was the source of much concern in 2011. While we still expect to see a recession in Europe and while some of the less competitive European countries will likely face fiscal and debt challenges for years to come, we do believe that contagion risks can be contained if global economic growth continues (and we believe it will, at a subpar pace).

At some point, it is inevitable that markets will take a break from the pace they have been on since the year began, but our outlook for stocks remains a positive one. Despite the likely moderation in earnings growth, stocks remain attractively valued, and we would reiterate our forecast that equities should outperform cash and Treasuries in 2012.

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