

Weekly Investment Commentary

An Overweight to Stocks Is Still Warranted

March 12, 2012

Three Years and Counting

It has been a consistent market theme for the last several weeks: Stocks have been moving higher, but the pace of gains has been slower than it was at the beginning of the year. Last week, market action was dominated by a sharp sell off early in the week, but that trend was reversed by week's end on the news that some significant progress was made regarding Greece's debt restructuring. For the week, the Dow Jones Industrial Average climbed 0.4% to 12,922, the S&P 500 Index advanced 0.1% to 1,370 and the Nasdaq Composite rose 0.4% to 2,988.

Last week also marked the three-year anniversary of March 9, 2009, the equity market low point during the credit crisis (the S&P 500 bottomed at 666 that day). At that time, investors were in full-fledged panic mode and were convinced that the world was at the onset of a full-scale economic depression. That, of course, did not occur and since that point we have seen an uneven economic recovery and an impressive comeback in stock prices and corporate earnings. US stocks, in fact, have doubled over the last three years. Nevertheless, the credit crisis still looms large in investors' psyches and its shadow may take years to fully recede.

Economy Continues to Improve, but Inflation Remains Muted

The headline economic news from last week was the February payrolls report. As has been the case for several months now, the data was quite strong, showing an increase in 227,000 jobs for the month. Equally important, figures from the prior months were revised upward from their already-impressive levels. The unemployment rate was unchanged at 8.3%.

The employment data, along with other economic readings, suggests that the current economic expansion is becoming increasingly self-sustaining. The trend of accelerating jobs growth is likely to continue, which should help the rest of the economy continue to grow. There are, of course, some significant roadblocks that need to be overcome and the United States remains in a healing mode from the credit crisis. History shows that such healing periods are slow and painful and we do not expect economic growth to exceed 3% in 2012.

In any case, however, improvements in economic growth (along with an increase in oil prices) are causing some to wonder whether we are at the forefront of a renewed era of inflationary pressures. In our view, we are not.



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Higher oil prices are certainly a potentially inflationary force, but other commodities have not advanced enough to drive inflation higher. Overall, global inflation remains on a downward trend and despite some improvements in the global economic landscape over the past couple of years, the world remains subject to fiscal consolidation, ongoing deleveraging and still-high unemployment in most of the developed world—all factors helping to keep a lid on inflation. Certainly, the labor market has been improving in the United States, but those improvements are not being echoed elsewhere, with Japanese labor trends relatively stagnant and European employment levels still falling. The reality is that there is little threat of a cycle of wage and price inflation at this time.

Downside Risks Shouldn't Derail the Bull Market

Since the start of the year, stocks have enjoyed a strong run, but as we have been saying for the last several weeks, markets appear due for some sort of consolidation or corrective action. Is it time, then, to take some profits and reduce exposure to stocks?

There are several downside risks that investors should be mindful of. Regarding the European debt crisis, although some progress was made last week, Europe's woes are far from over. While the European Central Bank's decision to expand its balance sheet and the passage of the Greek bailout package have helped to buy some considerable time, there is still much to be done and, in our opinion, Greece will likely eventually have to leave the eurozone. There are also some risks in the US political situation. The election season brings with it no small amount of uncertainty and there are a number of important fiscal decisions (including tax policy, healthcare spending and the debt ceiling) that are being deferred until after the November elections.

On balance, we believe the macro environment remains equity-friendly and we would argue that it still makes sense to retain overweight positions in stocks. The economic expansion should continue, inflation remains muted and central banks around the world are hyper-focused on maintaining easy monetary policy. Add to this backdrop the fact that stock valuations remain attractive, and the case for sticking with stocks gains strength.

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