



Weekly Commentary January 24, 2012

The Markets

Five months ago, it was hard for many investors to imagine that the stock market would be where it is today. Investor sentiment was very low in August after a confluence of negative events, including the U.S. debt downgrade and the escalating European debt crisis, which caused investors to worry that the U.S. economy was going into a double-dip recession. Fortunately, those worst fears did not materialize. Instead, the U.S. economy has proven to be more resilient than many expected last summer.

Looking back, the remarkable reversal in the stock market in October was an important sign that investor sentiment was starting to improve. In November, the stock market pulled back and successfully retested the early October lows, then moved higher again. In December, the stock market broke above its downtrend in another sign that investors were looking at events more favorably. Finally, during the first few weeks of January, the character of the stock market started to improve with the economically-sensitive sectors outperforming the defensive sectors. This market action indicates that investor sentiment was slowly improving during the past few months and investors were more willing to take risk again. During the transition from negative sentiment to positive sentiment, the stock market can be very volatile as we have seen recently. Equally important, volatility is likely to persist because the economic news is still mixed.

It is encouraging to see the markets respond favorably to recent economic news. The gains in the stock market, despite continuing negative news out of Europe and to a lesser extent Asia, means that investors may be thinking that something good will follow all the recent bad news. So what are some other signs to look for over the next few months that would demonstrate that investors are turning more positive and less risk averse?

First, we look for stocks to perform better than bonds this year. Last year, U.S. government bonds outperformed stocks as investors sought perceived safety. The increased demand for government bonds in 2011 pushed bond prices higher, putting a risk-aversion premium in bond prices. If we are correct and investors are more willing to take risk this year, then this premium in the government bond market is likely to decrease. The erosion of the risk-aversion premium in the government bond market could depress U.S. government bond prices and increase bond yields in the months ahead.

Second, if we are correct and investors are more willing to take on more risk this year, then the U.S. government yield curve could widen in 2012 as long-term interest rates increase relative to short-term interest rates. Last year's preference for perceived safety over risk also caused the U.S. government security-yield curve to narrow as long-term interest rates declined relative to short-term interest rates.

If the demand for perceived safe-haven investments diminishes this year and investors are willing to take more risk, then we believe investors should use pull backs in the stock market as buying opportunities. Last year, when investors were increasingly risk averse, investors sold stocks on rallies. This year, if investors are more willing to take risk, investors are more likely to buy stocks on weakness.

Finally, President Obama will deliver his State of the Union address this week, and the Federal Reserve will hold its first policymaking committee meeting of the New Year. Investors will be watching for signs that policymakers are committed to boosting economic growth this year.

In summary, the U.S. economy is more resilient than a lot of investors expected this past summer when many people feared that the economy was going back into recession. Recent market action suggests that investors are more willing to take risk again because U.S. economic news has been relatively good, and the news out of Europe has not been quite as bad as it was several months ago. The stock market is vulnerable to profit-taking after the big price gains over the past three and a half months. The U.S. economy still faces many problems. Global economic growth has slowed down and the European debt problems are not yet resolved. However, we believe the stock market has further upside potential if investors are more willing to take risk this year after weathering many problems this past year.

Index Performance Statistics – January 24

Index	Close	Day Change	Day % Change	% YTD Change	52 Wk % Change
DJIA	12675.75	-33.07	-0.26	3.75	5.83
NASDAQ	2786.64	2.47	0.09	6.97	2.48
S&P 500	1314.65	-1.35	-0.10	4.54	1.82

Source: Bloomberg

*Price return — does not include dividends

Fed: Benchmark Rate Will Stay Low until Late 2014

Federal Reserve officials said their benchmark interest rate will stay low until at least late 2014 and anticipate that unemployment will remain high and inflation “subdued.” “The Committee expects to maintain a highly accommodative stance for monetary policy,” the Federal Open Market Committee said in a statement released in Washington today. “Economic conditions -- including low rates of resource utilization and a subdued outlook for inflation over the medium run -- are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.”

The Fed extended its previous pledge to keep rates low at least until the middle of 2013 as inflation remains tame and more than two years of economic growth have failed to push unemployment below 8.5 percent. Some Fed officials have said further easing might be needed to put more Americans back to work and revive the housing market.

Stocks erased losses and Treasuries extended gains after the statement. The Standard & Poor's 500 Index rose 0.1 percent to 1,315.66 at 12:34 p.m. in New York. The yield on the 10-year Treasury note fell to 1.98 percent from 2.06 percent late yesterday. U.S. central bankers at 2 p.m. today will unveil their latest predictions for economic growth, inflation and unemployment for the next three years. They will also for the first time make public their forecasts for the benchmark lending rate. Chairman Ben S. Bernanke will follow that release with a press conference at 2:15 p.m. in Washington.

Last Week

Wall Street returned from the long weekend to a warm welcome. The market rallied this week as positive news on the global economy helped improve sentiment for stocks. A slowdown in China's growth provided further signs the world's second largest economy was coming in for a soft landing. Concerns over S&P downgrades of European debt ratings proved fleeting after sales of Greek, Spanish, French and European Financial Stability Facility bonds were well received. Reports of a \$500 billion increase to the IMF's lending capacity helped alleviate sovereign debt fears as Greece attempted to strike a deal to lighten its debt burden. Thursday's initial jobless claims fell to a four-year low and capped off a week of generally positive U.S. economic data. This helped to offset a mixed bag of earnings releases. Heading into Friday's trade, the S&P 500 was sitting above 1300 and a 4.5% gain for the month. If you're not convinced the bull is back, the index was up more than 22% from the Oct. 4 intra-day low of 1074.77.

The bond ghouls didn't receive such a warm reception upon returning from the holiday weekend. Signs of economic improvement and successful European bond auctions sent Treasuries lower to push the yield on the 10-year note up to 1.97%. With this week's decline, government paper is off to its worst start since 2003, losing 0.3%, according to Bank America/Merrill Lynch data. Despite bond land's slow start to 2012, risk aversion still looms as the auction of \$15 billion in 10-year TIPS produced a negative yield for the first time. This dynamic should make it interesting to see what the demand is for next week's auctions of \$99 billion in 2-, 5- and 7-year notes.

The commodity pits greeted the positive data with open arms. Crude briefly topped \$102 a barrel before paring back its gain after a disappointing inventory report. In the metal complex, copper rallied to a four-month high amid the optimism for the economic recovery. Gold also caught a bid to hit its highest level in a month. The dollar declined, touching a two-week low against the euro, as successful Spanish and French bond auctions and signs the U.S. is weathering the European storm dampened demand for the currency's safe haven status.

With the market's volatility, things could change quickly for the bull if we receive disappointing news next week. Things kick off on Tuesday night with President Obama taking a trip to Congress to deliver the State of the Union address. While the president is likely to discuss the economy, investors will focus on the Fed's take following the conclusion of the two-day FOMC meeting Wednesday. Included in the statement's release at 12:30 p.m. ET will be the central bank's outlook on its benchmark rate. Chairman Bernanke's press conference at 2:15 p.m. ET will garner attention although not likely to provide much insight. Also on Wednesday, world leaders will descend on Davos, Switzerland to attend the famed economic forum. On the data docket, updates on housing sales, durable goods and leading indicators serve as a precursor to Friday's first look at 4Q GDP. Consensus expectations are that the economy grew at a 3.0% annualized rate in the most recent period.

Earnings season ramps up next week with 123 S&P 500 and 12 Dow components scheduled to post their fourth-quarter profit tallies. Thus far, fourth-quarter results are lagging behind the recent trend. With 9% of S&P 500 companies reporting, 63% have surprised to the upside of analyst expectations, according to Bloomberg data. This compares to the 70% beat rate considered by Wall Street to be positive reporting season. In addition, consensus projections for earnings growth stand at 4.6%, down from 6.4% a month ago. If the market is to keep the January rally going, the market will want to see upside surprises by the next week's reports. The long list of bellwether companies scheduled to post results includes Texas Instruments (TXN \$33.82), Ford (F \$12.61), Johnson & Johnson (JNJ \$65.19), McDonald's (MCD \$101.26), Verizon (VZ \$39.00), Apple (AAPL \$427.63), Caterpillar (CAT \$105.75), Colgate-Palmolive (CL \$89.39), 3M (MMM \$85.80), Starbucks (SBUX \$48.01), Chevron (CVX \$106.93), Procter & Gamble (PG \$66.08), Altria (MO \$28.61) and Dominion (D \$50.30).

Weekly Focus – Think about it

“Worry is the interest paid by those who borrow trouble.”
~ George Washington

Best Regards,

Jim, Aaron & Angela
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- * The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.
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- * Fed: Benchmark Rate: Craig Torres, Bloomberg 1/25/12.
- * Last Week cited from Dean Meehan, Market Analyst, Wells Fargo Advisors 1/20/12.
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