



Weekly Commentary January 3, 2012

The Markets

Two weeks ago, the U.S. stock market rallied and appeared to be breaking above a five-month downward trend in the S&P 500. Last week, the stock market pulled back and retested that breakout. As a result, the market is poised to rally further and could move back up to the highs of last spring.

The economic fundamentals actually look better than the stock market at this time. Historically, the stock market generally moves in anticipation of the economy. This is especially true when the economy is strong and investors are optimistic. But when the economy is growing only modestly, and investors are worried about many problems, the market does not always lead the economy. In fact, during periods of uncertainty as we have seen recently, investors often wait for the economy to prove itself before pushing the market higher.

We seem to be in one of those “show-me” markets now. Recent economic news indicates that the U.S. economy is more resilient than many investors thought it would be last summer when a confluence of negative factors shook investor confidence. Investor confidence has recovered somewhat during the past three months; but investors still do not appear optimistic and willing to assume that the economy will get stronger in the future. Nonetheless, we believe the U.S. economy has been gradually improving.

The U.S. economic fundamentals, including low interest rates, declining gasoline prices, increasing corporate profits and fewer job cuts, are better than they were early last year when the stock market was higher than it is now. Unfortunately, investors are still worried about the European debt crisis and the slowdown in the global economy. Therefore, the recovery in the stock market has been slow to unfold. The S&P 500 declined several times during the past few months. But each time the stock market recovered from a higher level. This succession of higher lows is a positive sign that stock market sentiment is shifting from negative to positive. However, the recovery in the stock market seems to have a defensive character, suggesting investors are still cautious. For example, defensive stocks have been outperforming the economically-sensitive cyclical stocks during the past month. If investors were optimistic, the opposite would probably be true.

On the positive side, the recovery in the stock market has coincided with a decline in gold prices. Last summer, when investors were fearful, stocks prices were falling and gold prices were rising. The current recovery in the stock market along with the decline in the gold market during the past three months suggests that investors are less fearful. Fears could be subsiding because investors are focusing more on the resilient U.S. economy rather than the lingering problems in Europe.

In summary, investor sentiment appears to be improving but investors still seem to be cautious. Current economic fundamentals suggest the U.S. economy is likely to avoid recession and continue to grow in the year ahead, provided there are no major negative shocks like a spike in oil prices or major bank failures in Europe. If the U.S. economy remains resilient and investors become less risk averse, we believe the stock market is likely to do better than the bond market in the year ahead.

Index Performance Statistics – January 3

Index	Close	Day Change	Day % Change	% YTD Change	52 Wk % Change
DJIA	12397.38	179.82	1.47	1.47	6.04
NASDAQ	2648.72	43.57	1.67	1.67	-1.21
S&P 500	1277.06	19.46	1.55	1.55	0.54

Source: Bloomberg

*Price return — does not include dividends

Fed Shows Rate Forecasts, Boosts Transparency

Federal Reserve Chairman Ben S. Bernanke is betting that announcing Federal Reserve officials' own forecasts for borrowing costs will make monetary policy more effective while also supporting the two-year expansion. A decision to reveal forecasts for the federal funds rate starting this month represents the biggest step toward openness since Bernanke took office in 2006 promising greater transparency, according to Michael Feroli, chief U.S. economist at JPMorgan Chase & Co. and a former Fed board economist. The central bank didn't even start announcing changes in interest rates until 1994.

"This is a complete 180-degree shift from the old mysterious-institution approach," said Ethan Harris, co-head of global economic research at Bank of America Merrill Lynch in New York. "There's been a steady move toward opening up the central bank to outside scrutiny and trying to explain to the public the logic of what they're doing."

The first forecasts will be announced after the Jan. 24-25 meeting of the Federal Open Market Committee, according to minutes of the Dec. 13 gathering released yesterday. That may boost economic growth by delaying expectations for an increase in the benchmark rate, which has been kept close to zero since December 2008, according to Feroli. At the same time, publishing a range of forecasts risks sowing confusion by showing disagreement among policy makers, Harris said. "It's a bit awkward -- you're going to reveal to the public how much uncertainty the Fed itself has about where it's going," Harris said.

Last Week

The 2011 race between the bulls and bears came to down the wire. Stocks stumbled out of the blocks as the European Central Bank came under fire for its ballooning balance sheet. Uncertainty over Italy's bond auctions caused investors to tread lightly. However, the bulls were able to regain their stride after receiving encouraging words on the economy from better-than-expected reports on consumer confidence and pending home sales. Heading into the home stretch, the bears held a slight lead over the bulls with the S&P 500 down 0.2% for the week heading into Friday's session. However, the bulls closed the gap enough to regain the lead for the year with the index up 0.4% going into the final trading day of 2011. With a 6.1% gain for the year, the Dow remained on pace to garner its third consecutive annual gain. Bringing up the rear is the Nasdaq, which was down 1.5% in 2011.

Action over in bond land saw Treasuries gain ground as investors remained cautious about Europe heading into 2012. As a result, the yield on the 10-year note fell to 1.90% and the 30-year bond yield declined to 2.90%. The flight-to-safety bid has benefited holders of government paper as Treasuries returned 9.6% in 2011, according Bank of America/Merrill Lynch data. Over in the commodity pits, crude oil rallied on a mixture of positive economic data and rising tensions in the Middle East. The week was not so good for gold. The yellow metal continued to slide as a rising dollar dampened demand for precious metals. Despite falling 18.4% from its Aug. 22 closing high of 1891.90 an ounce, it remains on pace to record its 11th consecutive annual gain.

Investors may want to use the long holiday weekend to rest up because 2012 hits the ground running with a full schedule of economic data. The New Year kicks off with reports on ISM manufacturing and construction spending. Thursday's ADP and weekly initial claims could set the tone heading into Friday's important employment data. Wall Street is expecting nonfarm payrolls to show an increase of 150,000 jobs and an uptick in the unemployment rate to 8.7% for December. Accompanying the data will be communiqué from the Fed as it releases the December FOMC meeting minutes on Tuesday as well as speeches by central bankers Rosengren, Duke, Raskin and Bullard. In addition to the data, investors' attention will likely turn towards the upcoming fourth-quarter earnings season. Current analyst projections for the S&P 500 index are for earnings to grow 6.2% and revenues to rise 6.6% from the same period a year ago, according to Bloomberg. Scheduled profit tallies by Mosaic (MOS \$50.28), Monsanto (MON \$70.45), Constellation Brands (STZ \$20.68) and Family Dollar (FDO \$57.79) could foreshadow what to expect when the season kicks off with Alcoa reporting after the close on Jan. 9.

Weekly Focus – Think about it

“Drive-in banks were established so most of the cars today could see their real owners.”
~ E. Joseph Cossman

Best Regards,

Jim, Aaron & Angela
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- * The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.
- * 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.
- * Bloomberg is the source for any reference to the performance of an index between two specific periods.
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- * Past performance does not guarantee future results.
- * The Markets prepared by Gary Thayer, Chief Macro Strategist, Wells Fargo 1/3/12.
- * Fed Shows Rate Forecasts: Caroline Salas & Craig Torres, Bloomberg 1/3/12.
- * Last Week cited from Dean Meehan, Market Analyst, Wells Fargo Advisors 12/30/11.
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