JANUARY 2011: MARKET COMMENTARY

By many measures, stocks appear poised to perform well in 2011. After an excellent fourth quarter that helped 2010 generate very positive numbers, valuations are still running at only 13 times earnings versus a historical average of about 15. European markets are also trading below their averages, although it could be easily argued that the instability of several governments there may slow upward progress.

Cash is starting to flow back into stocks as evidenced by recent strong performance. According to a December 22nd Wall Street Journal article, in November, investors across the globe invested $28 billion into equity funds and withdrew $6 billion from bonds.

Leading market strategists seem to share similar enthusiasm. Bloomberg reports in their tally of 11 leading investment strategists that all of them are bullish for 2011. They project gains for the S&P500 as high as 25% plus with an average of 11%. Barron's panel of supposed experts projected an average guesstimate of 10% returns for 2011.

Other positive signs are further boosting confidence. The Consumer is Returning. November retail sales were 7.7% higher than in November 2009, or 6.3% in real (net of inflation) terms. Near term trends look even better. On a three month annualized basis, November retail sales jumped 12% in real terms while purchases of new and used cars jumped at an annual rate of 27%. Although these increases are unlikely to be maintained, expectations for 2011 still hover at a solid, if not spectacular, 4% growth rate.

Consumer sentiment in December also rose to its highest level since June and was at its third-highest point since the start of 2008 according to a Thomson Reuters/University of Michigan survey.

Wage and salary income continues to increase with October levels coming in 3.4% higher than the previous year. With employment likely to increase and companies feeling a bit more confident, wage and salary increases should continue.

Rising employment is also adding to wage and salary increases. The original consensus expectation for November of an increase of 150,000 jobs should soon become routine. While this increase is still not very strong, the number of new jobs added is high enough to start chipping away at unemployment and will further contribute to a financial recovery.

However, employment will rise gradually. Weak net job creation is only expected to bring unemployment down to around 9% by the end of 2011. The slow jobs increase is partly because of general economic weakness, but also results from significant productivity gains. More than 95% of production lost during the recession has been recovered, but only about 15% of the lost jobs have returned. While this pattern is normal during any recession, permanent productivity gains appear to have hit employment numbers particularly hard during this past cycle.

Inflation also doesn't appear to be much of an issue in the near term. Partly this is related to the slow recovery in labor markets where high unemployment levels haven't left workers much bargaining power. Inflation pressures also remain weak in the commodities markets with moderate economic growth failing to push prices up on basic materials.

Given the growing number of positive trends, it's not surprising that the Optimism Index of the National Federation of Independent Business continues to climb. In 2010, small businesses not only failed to boost the economy, they actually slowed it down. As this tremendously critical contributor to our economy gains confidence, it's likely that small business will provide a boost in 2011. While confidence is likely to be restrained, a switch from negative to positive will have a very welcome effect because this sector is so large.

Taxes also remain unchanged. While the new tax deal feeds a larger problem of the growing federal deficit, the near term impact will be very welcome. The tax deal is partly the reason for the growing confidence of small business since they would have been disproportionately affected by a tax increase. Avoiding a very ill-timed increase across the board and especially on the primary driver of employment, small business, will yield benefits. Longer term issues are certainly cause for concern but are unlikely to affect markets dramatically in the coming year.

Exports are also picking up. Overall government data showed U.S. exports in October rose a robust 3.2 percent while imports declined slightly. Record exports to China and Mexico in October helped push the overall export tally to $158.7 billion, the highest since August 2008. Exports to the European Union and Japan also grew.

The U.S. trade deficit for October totaled $38.7 billion, down from a revised estimate of $44.6 billion for September. The large drop was a surprise as analysts surveyed before the report had expected the deficit to stay nearly the same at $43.60 billion. The smaller-than-expected trade deficit could boost estimates for U.S. fourth-quarter economic growth because it implies a larger share of U.S. demand is being met by domestic production. This is another positive indicator suggesting that the economy is accelerating.

In spite of all these positive trends and strengthening indicators, the recovery will still likely move forward at a steady rather than torrid pace that often follows a recession. On-going housing and employment challenges are the primary issues that will drag down the economy in the near term.

International markets will also continue to cause concern. China recently raised its interest rates for the second time in just over two months as their Central Bank is tightening lending policies to try to tame inflation. Europe also is facing various struggles as different countries deal with questions regarding their fiscal health and viability. However, recently, the Euro has strengthened again against the dollar indicating at least minimal levels of confidence in Europe's near term future.

Much like we projected at the end of 2009, as 2010 draws to a close, we project that this next year will be a smoother and stronger year for the economy and for the stock market. Inevitably, problems will arise and there will be setbacks. However, the widespread positive momentum should continue to lift the economy. As we've said in our last couple newsletters, we believe these factors combine to provide a positive outlook for more risk based assets including stocks. We hope this next year is a very blessed one for you.

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