



Market Perspectives

A Glance At How The World Affects You!

January 17, 2012

Rising Dollar, Squeezing Corporate Profits

By early February the 4th Quarter Earnings Season will come to an end and 2011 can finally be put to bed. If you simply summed the daily price changes over roughly 250 trading days, the market would have changed 250% last year. However, the market finished precisely where it started. One might infer that such volatility simply means a dead year. On the other hand, I am inclined to believe that we ended 2011 with an undecided bull-bear tug-of-war that appears to be intensifying. Before we get ahead of ourselves, let's consider the forces working against a continued rally and why we expect a modest pullback from current levels.

Since early last year, the US dollar trended higher, thus adding pressure to domestic corporate profits. The Euro has fallen from above 1.40 to 1.25 over the last six months. This weakening could imply investors are losing faith in the so-called reform of the Euro Union. Should this decline in the Euro continue, US dollar strength should improve on a trade-weighted basis. In the short run, this reduces the competitiveness of goods that are sold outside the US as foreign trade partners have to cough up more Euros and pounds to offset the gap in competing currencies. Since Europe makes up about 14 percent of overseas sales for S&P 500 companies,



continued dollar strength will begin to hurt profitability of US companies. The opposite effect occurred during the 2nd and 3rd quarters of 2011 when the U.S. dollar hit a low point; making domestic product more competitive and enabling US companies to repatriate their overseas sales and earnings at very favorable rates. In spite of a strengthening dollar, commodity prices are rising which could signal stronger underlying demand and a slight advantage to the bulls.

Whether in a defensive phase or a risk-on phase, the market has been moving higher at a fairly steady rate since late November and without a meaningful downward move since mid-December; investors have been feeling lucky as of late 2011. The American Association of Individual Investors (AAII), last Thursday, showed bullish sentiment at 49.1% while bearish investors registered 17.2%; resulting in a 32% bullish-to-bearish spread. This is the highest bullish-bear spread since January 2011 just before the S&P 500 shed 7%. Has this left the market hugely overbought?

Other measures of bullish behavior are pointing towards the all too familiar "optimism". As the investor sen-

timent indicator reveals, comfort in the market usually happens near the peak of a rally. When too many investors are committed to the markets, euphoric rallies are expected to continue assuming there is enough cash on the sidelines to continue buying. This market continues to look cheap on fundamentals, but revisions to corporate profits and pressure from a strengthening dollar could add to continuing headwinds out of Europe.

However, in our opinion, the markets don't appear significantly overbought. Right around the time Santa was whipping up his rally; volume was thinning and is only now coming back. A few defensive sectors that led all year were under-represented in the final trading weeks as sector rotation began. The advance-decline 10-day moving average is less than 100 points above mid-line on both indices. In the second half of October, when the S&P was racing from 1,100 to 1,285, this 10-day moving average climbed to 400 points above midline. On that basis, this rally has more upside potential. The S&P 500 is enjoying a strong start in 2012. However, if the dollar continues its move higher, the index may not lose momentum but a major threat looms to individual companies that make up the index as global growth estimates continue coming down.

A Recap of Last Week: Equities trended up the first four days of trading with a drop on Friday cutting into the week's gains. The start of the week was boosted by favorable news out of Europe that German Chancellor Angela Merkel and French President Nicolas

Sarkozy were working on a plan for rescuing the euro over the next three months. Also, consumer credit outstanding unexpectedly surged, indicating improved consumer confidence about the economy and personal finances. After close, Alcoa reported a fourth quarter loss on slumping metals prices but did offer an upbeat demand forecast.

Stocks gained Tuesday as bad news out of China was viewed as good news. A drop in China's import growth was seen as leading to monetary easing in that country. Relatively upbeat comments by ratings agency Fitch on Europe also provided lift. Market enthusiasm was tempered by upcoming Italian and Spanish debt auctions later in the week.

Wednesday saw greater movement in a break between U.S. equities and events in Europe. The euro hit a 16 month low after Fitch Ratings warned of dire consequences if the European Central Bank did not take more action to support the currency. While equities were mixed, they were more up than down with a more positive Beige Book on Wednesday afternoon contributing.

Thursday got off to a difficult start as jobless claims rose more than expected and retail sales were softer than projected. But later in the day, global equities rose as government auctions in Spain and Italy went better than expected, helping those countries to finance their debt at lower costs. Bank stocks were key beneficiaries.

At week's close, the big news was a surge in consumer sentiment, helping to partially offset first rumors then confirmation of a Standard & Poor's downgrade for several Eurozone countries. Nonetheless, market reaction was more muted than in recent months.

The Bottom Line: Forward momentum in the US recovery is mostly outweighing renewed worries over Europe's sovereign debt crisis. Investors are placing less weight on foreign issues; a stark contrast compared to recent months. While short-term interest rates in Europe are uniform (they are generally set by the ECB), long-term rates reflect the degrees of sovereign default risk. Greek debt is off the charts, yielding more than 30%. Italian debt yields are above 7%, and Spanish yields have settled above 5%. Meanwhile, German long-term debt yields are close to 2%, in line with U.S. yields. The Chinese yield

curve is inverted and the Indian curve is flat, as local monetary authorities seek to quell inflation. Unfortunately, interest rate changes don't seem to be a likely way out of the European mess. Budget cuts, austerity programs, tax hikes and debt forgiveness are the likely (unpopular) answers.

Though stocks had to fight a lot of uphill battles in the past year, we continue to favor equities over fixed income securities for relative outperformance in 2012 based on earnings trends (currently declining), the historically low level of interest rates, and the eventual downtrend in the

dollar. Stocks appear to be undervalued when compared to bonds and current price to earnings are well below historical levels. With a declining global GDP forecast in the Euro area, Germany and Italy, we anticipate a falling Euro currency. Conversely, the US dollar exchange rate is set to reach new highs in the short term. To reiterate, we expect this recent and continued reversal to add pressure to domestic corporate profits thus sending stock prices lower. Based on S&P 500 EPS revisions, we look for price retracement of 5-10%.

A Look at This Week: In this holiday shortened week, manufacturing, housing and inflation are highlighted. Manufacturing begins with the Empire State report on Tuesday followed by industrial production on Wednesday, and the Philly Fed on Thursday. The PPI and CPI post on Wednesday and Thursday respectively. The NAHB housing market index (Wednesday) and existing home sales (Friday) wrap up the week.

Best Regards,

Phillip L. Clark, RFC
President/CEO

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