



Market Perspectives

A Glance At How The World Affects You!

January 30, 2012

Economic Data Giving Mixed Signals

Nearly a year ago, it appeared the Fed had fired its last bullet to prop up the ailing economy; QE2 came to a close. Today, Fed officials maintain that more ammunition is available and will be used as needed. The latest shot came last week as Fed Chairman Ben Bernanke repeated his December 2011 statement with one small exception; rates will now stay at or near zero through late 2014 as opposed to 2013. Until unemployment improves, low rates could be the only impetus to boost investment and consumer spending. In addition to low rates, Operation Twist (the successor to QE2) remains intact. In summary, the Fed calls our economy “moderate”. Meanwhile, the latest earnings reports are mixed while the dearth of notable news out of Europe has led to an overbought market.

During the first few weeks of this month, news out of Europe remained muted as economic indicators were improving here in the U.S.. Investors grew less concerned about the sovereign debt issues and pushed the broad markets higher. That theme is unwinding as liquidity infusions from the European Central Bank and negotiations with Greece on debt forgiveness continue. The latest infusion for Greece comes with caveats; one of which includes a European budget “overseer” to monitor the country’s finances. Greek officials are vehemently repudiating the idea of a supervisor. But Greece, while not to be ignored, is essentially inconsequential in the Euro Group. The real challenge for regulators and financiers will be to keep Italy – the world’s third largest debtor – from taking the same path. Italy’s economy is near recession and their new president has implemented a tough budget that could impede



growth in the near future. Germany’s Angela Merkel is also focused on “fiscal compact”. Whether Greece defaults (a likely scenario) or not, the best we can hope for is a plan to provide backing of Italy and maintaining an intact Euro Union.

Back at home, fourth quarter GDP gained strength but the results were a bit bumpy. A solid 2.8% looks impressive, compared to the previous three quarters, but the details brought disappointment. The report is the first 4Q reading on the economy and will be revised in coming months as more data is reported. On a year ago basis, the economy has improved in many ways but the latest data is mixed. Although, the economy’s growth trajectory is increasing, economists were looking for the latest figures to be above 3%. The most important component of GDP, personal consumption, grew 2.0% in the fourth quarter versus 1.7% in the third quarter. That’s good. Durable goods and Technology spending were lower. Exports were steady, but imports increased, detracting from GDP growth. Government spending was sharply lower. The report provides further evidence that the U.S. economy is recovering, albeit slowly, and should be able to avoid a double-dip recession. Modest improvement in consumer spending is encouraging but more is needed; after all, the consumer makes up 70% of GDP. On the surface, things are looking better but

the economy is operating far from an optimum level.

The latest GDP report shows improvement in consumer spending. However, revolving consumer credit is on the rise during a time when income growth has declined. The Federal Reserve reports revolving consumer credit (credit-card debt) grew at a 5.5% annual rate in November 2011, the fastest growth since before the recession. In my observation, sustained periods of growing credit-card debt is usually associated with periods of rising consumer confidence; the consumer confidence index in December posted a solid 9.3 point rise to 64.5 for the best reading in eight months. While surveys of consumer confidence rebounded last fall, they remain well below normal levels. Looking at growth in revolving credit against growth in disposable personal income, there has been a pretty strong correlation between these two metrics in recent years. Nonetheless, the recent spike in credit-card debt actually coincides with a recent decline in income growth rates. To me, this calls the sustainability of the recent card balance growth into question. This should send a lucid message to Washington; jobs are the most important element in the recovery, not adding debt to consumer balance sheets.

The economy improved overall in the fourth quarter but results were not as favorable as hoped. The modest improvement in consumer spending is encouraging but more is needed. The Fed’s notion appears to have been correct; low rates will be needed for some time to boost investment and spending.

A Recap of Last Week: Equities were mixed but mostly up this past week. Trading started tentatively Monday with indexes generally flat to down marginally as many stayed on the sidelines ahead of the Fed's policy decision on Wednesday. Some support came from news that officials from Germany and France indicated that progress was being made between Greece and bondholders. Also, European finance ministers agreed on a deal on the European Stability Mechanism to be signed on January 30.

Stocks were mixed Tuesday as the International Monetary Fund downgraded its forecast for the global economy. In corporate news, McDonald's reported an 11 percent increase in profit for the fourth quarter, but lowered guidance due to a decline in the euro which cuts into repatriated profits. McDonald's gets about 60 percent of its revenue from outside the U.S.

At mid-week, the Fed lifted stocks significantly with its announcement that policy rates likely would remain exceptionally low through late 2014—extending the extended period language from last meetings' mid-2013. Also adding to market momentum was blowout earnings from Apple released after close Tuesday.

Stocks swung notably Thursday. A strong durables orders report, combined with jobless claims data that were only moderately higher than expected, initially boosted equities. But later in the day, a negative report on new home sales weighed on markets. Home builders and banks were notable recipients of the downdraft. In contrast, Caterpillar far exceeded expectations on increased global demand for construction machinery and mining equipment. 3M also beat projections.

At week's end, the Commerce Department's advance estimate improved from the third quarter but fell short of expectations. Detail on final sales was particularly disappointing and weighed on blue chips. Small caps, however, appeared to continue to benefit from the Fed's announcement Wednesday of further continuation of low rates. Techs rose on rumors that Facebook may issue an IP as early as this coming week. Also, Ford reported its best annual earnings since 1998. But much of the profit was due to tax credits from past losses on its balance sheet. Excluding that credit, Ford's earnings fell short of analysts' forecasts.

The Bottom Line: The recovery improved in the fourth quarter but the bigger question remains; are we gaining momentum? The mix of GDP results came in below the expected 3.1%. Consumer spending grew but most of the strength in the latest economic data came from temporary inventory restocking which suggests a sluggish slow-growth year. Simultaneously, domestic companies have struggled to meet lower revised earnings expectations. As of this writing, only 57% of reporting companies have beaten their estimates. The strength of the recovery is more uncertain in both directions after this past week's data and the Fed is erring on the side of caution, thus keeping monetary policy very loose. New home sales

fell short following three consecutive gains and pending home sales dipped in December but the recent trend still points to improvement, albeit slow. The biggest cynic of the recovery is the consumer if measured by sentiment (spending has been better than sentiment). I have said in several writings that actions speak louder than words. However, the consumer appears to be gradually conceding that our economy is improving. Even so, the mood of the consumer needs to improve further if first quarter is to keep pace with the 3% expectation for GDP.

With no more than one trading day left in January, the broad market can be confident of a winning month. The bulls have maintained control year to

date. From our view, stocks have raced ahead as though nothing could stand in their way. Key technical indicators confirmed overbought conditions about mid-month. Consequently, we increased our cash positions one week ago today. We expect the Europe crisis to continue as EU leaders work to avoid a deleterious outcome. Based on mixed signals in the latest GDP report and continuing headwinds from Europe, we still feel the market needs to collect some profits and find a spot to consolidate; for the S&P 500, we are watching key levels in the 1300 range. As fundamental and technical data improve, our cash will be reinvested.

A Look at This Week: The economic calendar is jam packed with the highlights on the consumer bookending the week with personal income on Monday and the January employment situation on Friday. Rounding out the consumer updates are confidence (Tuesday), ADP employment and motor vehicle sales (Wednesday). Construction sector updates post with Case-Shiller home price index (Tuesday) and construction outlays (Wednesday). Manufacturing news includes ISM (Wednesday) and factory orders (Friday) with ISM non-manufacturing also at week's close.

Best Regards,
Phillip L. Clark, RFC
President/CEO

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