Market Perspectives

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Investors Growing Complacent, Economy Remains Fickle

When investors start getting "too comfortable" with the market's tone, defense is often the best strategy. Since turning the corner into 2012, momentum for stocks has continued; most indexes have climbed effortlessly to unrealistic levels. That's not to say that stocks are overvalued using current valuations and compared to bonds. Rather, it appears that investors have become complacent. The huge market move following the recent January payrolls report (the S&P 500 shot to 1344) was followed by two lackluster days at the end of last week. So where will the market get sustenance to move higher? I will attempt to clarify what has become a very inconsistent environment.

The recent January jobs gain is encouraging as it further strengthened the five month trend in nonfarm payrolls. The average is now equal to about 183,000. The household survey, which better captures small-company hiring, has been much stronger. Yet we are cognizant that many of the restraining forces in the economy, including government hiring, housing values and consumer sentiment are persistently challenging and continue to weigh on the market. As jobless claims are declining, GDP is rising; the 2012 forecast is 3% give or take and that can only be construed as a positive. But rising GDP is not congruent with declining interest rates which the Fed has pledged to keep low through 2014. Therefore, we think that interest rates are declining not because the economy is deteriorating (nor is it surging) but because our government has declared an ultra-low rate for several years.

The final earnings reports for the last quarter of 2011 continue to trickle in, wrapping up what was the most erratic EPS reporting period among 2011's four quarters. We continue to see lots of upside surprises but guidance for 2012 is much more conservative. The other side of the coin is numerous earnings misses. In fact, the highest number of misses in any quarter since the recovery began late in 2009. Markets have rallied on what looks like "not as bad as it could be" news. In some regards, the stock market survived a mercurial 2011 and managed to post a positive year. On the other hand, risk-on investors have been gaining stronger comfort in stocks and thus created the latest sector rotation; moving leading defensive sectors to the background. As the risk-on theme grows, much of the sidelined cash has been pouring into stock and driving prices higher; not just domestically but around the world.

The international trade deficit worsened but this might be a net positive as it potentially signals demand. Supporting that notion, consumer credit continues to rise and suggests that's consumers are feeling better about the economy and their job security. An aging auto fleet is adding to this data point as auto loans have increased. Regardless of these positive signals, consumer sentiment has taken a step back in the last week. What is not so discernable is whether the increase in credit spending is based on confidence or empty savings accounts.

In spite of this propitious run in the stock market, last week ended with two lackluster days. What on earth happened? Not Greece again! It makes no sense that Greece could be importuning markets again considering that much of the recent advance in stocks came on the heels of a "to heck with Europe" attitude. As long as things remained quiet across the pond, domestic investors grew comfortable with a "out of sight, out of mind" mentality. Now, all of sudden, the market is focused on whether Greece has finally come to terms with austerity measures that would qualify for much needed rescue funds from international agencies. The "hope trade" that Greece will resolve its debt crisis has reached reality once more. Another futile attempt by the Greeks fell short on Thursday in spite of the earlier announcement of a final deal. Over the weekend, an agreement was signed, again. We will not "hope" that they can live by their own volition.

The economy has clearly shown some resiliency and economic data suggests continuing recovery and growth. Regardless, it is reasonable to conclude that while things appear good on the surface, conflicting data is suggesting that we take a closer look. Rather than trying to make sense out of so many metrics, I think the most likely culprit to the recent underwhelming market performance is complacency. The American Association of Individual Investors measure of bullishness remains above 50% and the VIX is in the 20% range; since October 2011, it has declined 54%. Too many investors are assuming stocks will continue their precipitous climb; sideline cash is lower than previous levels and that could restrain a continuing advance. In our opinion, a more likely scenario is profit taking as European headwinds and domestic politics persist; it is likely that the S&P 500 settles around 1300.

A Recap of Last Week: After what appeared, at first, to be a net positive week, stocks ended in the red after the collapse of a deal to resolve the Greek debt crisis. At week's start, stocks were lower on lingering uncertainty over whether Greece would accept the terms of a bailout to avoid default on sovereign debt. Another deadline came and went in Athens over the weekend as political leaders failed to respond to bailout terms from the European Union and International Monetary Fund. Most indexes rose Tuesday as talks between Greece and its creditors on a loan deal appeared to be nearing conclusion Tuesday, though political leaders postponed a meeting until Wednesday. Yum! Brands Inc., owner of the KFC and Taco Bell fast-food chains, also added lift to stocks as company earnings surged 30 percent. Equities again rose at mid-week as a Greek debt deal appeared to be closer to finalization.

Stocks were mixed Thursday but mostly up. Greek officials finally agreed to an austerity plan that was believed to meet international agency requirements to secure rescue funds. Initial jobless claims in the U.S. unexpectedly dropped and supported equity gains. Also, the Obama administration, individual states, and major banks (under scrutiny for so-called robo-signings of foreclosure documents) finalized a foreclosure deal. Some homeowners will see their loan balances reduced or will get refinancing. Importantly, banks will now be able to proceed with foreclosure sales and help the housing market to heal. Agreeing to the settlement were Bank of America, JPMorgan Chase, Citigroup, Wells Fargo, and Ally Financial. Negotiations continue with other major mortgage servicers to join the settlement. Somewhat weighing on stocks, however, was news from China that its inflation rate had picked up; dashing hopes that China would loosen monetary policy. However, progress on Greek debt turned out to not be finalized as earlier believed.

Thursday night, international agencies rejected Greece's austerity plan as inadequate, pushing equity futures down sharply. Stocks followed through and ended the last trading day down with an unexpected dip in consumer sentiment also weighing on stocks. Also, Standard & Poor's downgraded 34 Italian banks, adding to the down drift. European and Greek officials were expected to continue discussions over the weekend but few expected final resolution before market open the upcoming week.

The Bottom Line: John D. Rockefeller famously sold all his stocks before the 1929 collapse when his shoeshine boy gave him a "tip" on U.S. Steel; the moral is that when everybody knows, then nobody knows. In our opinion, this is not the time to exit the markets but we are strongly advocating a defensive posture following a four month rally. Prior to a full-on rally, investors were highly focused on Europe's debt crisis; more accurately, the likely default in Greece. That protracted anxiety eventually ended and the risk-on trade has dominated ever since. Last week, investors changed their minds and decided that Greece does matter after all. The new deal that Greece signed yesterday (199 to 74 vote) will be discussed Wednesday at an emergency meeting of Eurogroup Finance Ministers in Brussels. The reception of this new austerity plan is far from certain; there is rising speculation that the new measures will fall short of the group's requirements. The latest news out of Greece is a necessary step in resolving the EU debt problem. However, the ultimate outcome is anyone's guess. Domestically, the economy appears to be gaining traction. The international trade deficit worsened but this time it might be for the right reason – expected demand on the part of consumers. Other risks include bickering in Congress, eventual electing of a new president; a newcomer or the incumbent, Iran threatening the closure of the Straits of Hormuz, and civil unrest in the Eurozone.

Right now, too many domestic investors are assuming that stocks will race higher; they are confident in this market and continue to reallocate sidelined cash. Nevertheless, last week's market action and overbought technical indicators continue to solidify the argument for defensive action. Therefore, we recently raised additional cash (10%) to be used for opportunities should the market consolidate.

A Look At This Week: Investors will be looking for a rebound when Tuesday's retail sales data are released. Empire State and industrial production (Tuesday) are followed by the Philadelphia Fed survey on Thursday for an exam of manufacturing's health. Housing starts and producer prices also add to Thursday's plethora of new information. The CPI wraps up the data week on Friday. At mid-week, as always, the Fed's FOMC minutes will be parsed closely.

Best Regards,

Phillip L. Clark, RFC

President/CEO