FVCM

U.S. Market Report

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REVIEW & OUTLOOK

The year 2011 was a disappointment. In contrast, 2012 has the potential to surprise to the upside. Stocks in the U.S., as measured by the S&P 500 Index, both started and ended the year at 1,257.6 (see Table 1 below). The fact that the market was exactly flat for the year, however, doesn't tell the full story of extreme volatility and punishing moves in stocks that failed to meet investor's short term expectations. Last year's weakness and volatility can be attributed to a high level of uncertainty and concern that the world economy was heading for another meltdown of the sort we saw in 2008 and 2009. Cyclically sensitive stocks followed the disappointing economic growth downward despite their already low valuations. But, whereas 2011 came in below expectations, data for 2012 is now trending above expectations and those inexpensive cyclical stocks could bounce back sharply.

At the start of 2011, the consensus was that U.S. real GDP growth would approximate 3.5% for the year. **Real GDP growth for all of 2011 is now expected to have been only about 1.8% (annualized).** We thought the originally estimated 3.5% figure could be conservative but we were wrong. Going into the past year conditions appeared good thanks to massive injections of liquidity by the Federal Reserve as well as the natural tendency for the U.S. economy to experience accelerating growth coming out of a recession. Unfortunately, there were a number of factors that derailed the rosy expectations: There were a series of natural disasters and weather related events in the U.S. that negatively impacted production; the earthquake and tsunami that struck Japan in March had global repercussions as Japanese suppliers for numerous industries were unable to meet demands by U.S. corporations; 2011 was the year that the European sovereign debt crisis reached a critical point were serious people began to actually talk about the viability of the Euro; and, lastly, the political machine in Washington DC became completely dysfunctional and progress on sharply reducing the U.S. budget deficit ground to a halt. With all these headlines, businesses and individuals decided to sit on their big piles of cash rather than spend more. Unfortunately, we didn't anticipate events playing out this way but, in hindsight, it is clear that consumers and investors had good reason to sit tight and not assume more risk. Consequently, real GDP growth for all of 2011 is now expected to have been only about 1.8% (annualized). Growth of about 1.8% is a long way from the original expectations of something approaching 4% growth. However we don't think growth will stay at these low levels and rather will be at least 2.5% for 2012 and corporate earnings should continue to experience good growth.

Corporate earnings growth--estimated at 11.7%-- was quite good despite the disappointing general economic conditions. The corporations in the S&P 500 now earn the majority of their profits from exports and foreign operations. Strength in foreign operations enabled many large U.S. multinational corporations to continue to grow sales at a good pace of nearly 10%. Furthermore, profit margins remain at high levels and appear to have even expanded further. Growth in labor productivity over the past three years has been a remarkably high 2% annualized rate as manufacturers have increased production mostly with a smaller work force. Furthermore, because of the high level of unemployment, the bargaining power of labor is weak and wage growth has been anemic. Not a good situation for labor but a good result for corporate profits.

The S&P 500 started and ended the year at the same level as earnings increased an estimated 11.7% but the P/E ratio contracted 10.4% from 14.5 to 13.0 (see Table 1). Essentially, the volatility and the move away from risky assets meant that investors were only willing to hold stocks if earnings were discounted by 10% more (vis-à-vis a lower P/E) than a year before. This is really quite remarkable because with inflation in the 1% to 2% range, a normal P/E on operating earnings would typically be more like 15, which is about the P/E we use for our 2012 forecast. To a large degree, it now really comes down to a matter of confidence.

Table 1

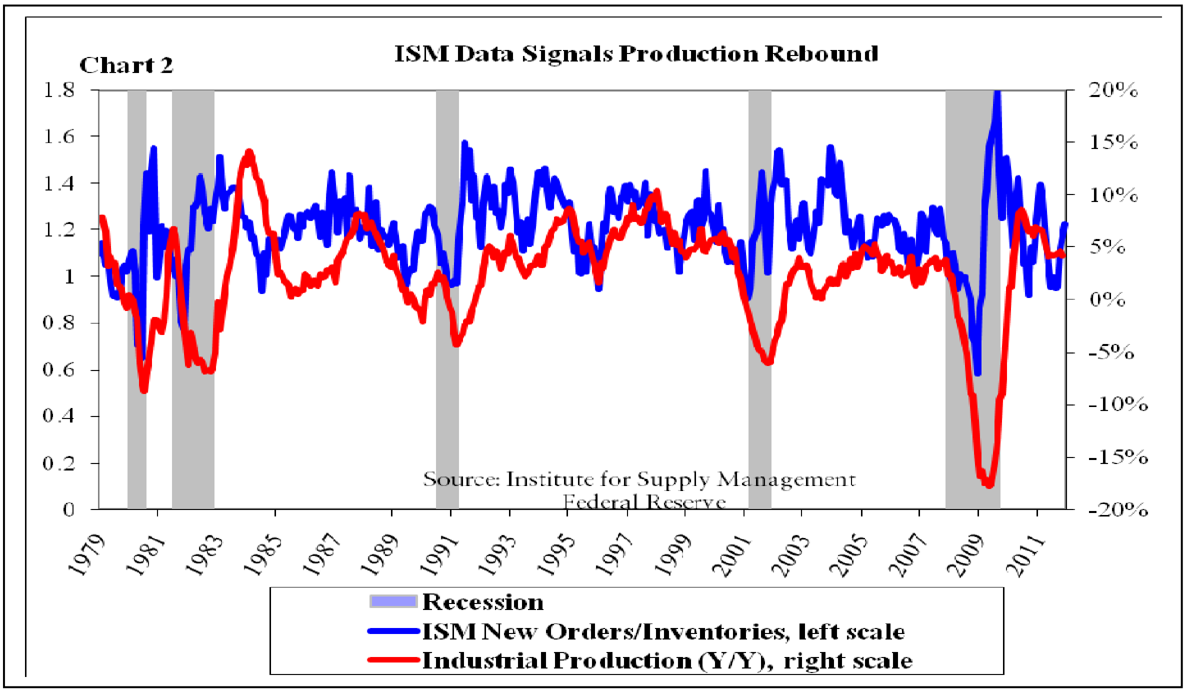
	S&P 500 Closing Price	Operating Earnings	P/E Ratio	Nominal GDP Growth	Real GDP Growth	Deflator (inflation)
2010	1,257.60	86.73	14.5	4.2%	3.0%	1.1%
2011	1,257.64	96.84	13.0	3.9%	1.8%	2.1%
% Chg. Y/Y	0.0%	11.7%	-10.4%			
2012 (e)	1,500.00	103.00	14.6	4.0%	2.5%	1.5%
% Chg. Y/Y	19.3%	6.4%	12.1%			

Sources: FVCM; Standard & Poor's Corp., Federal Reserve, Thomson Baseline.

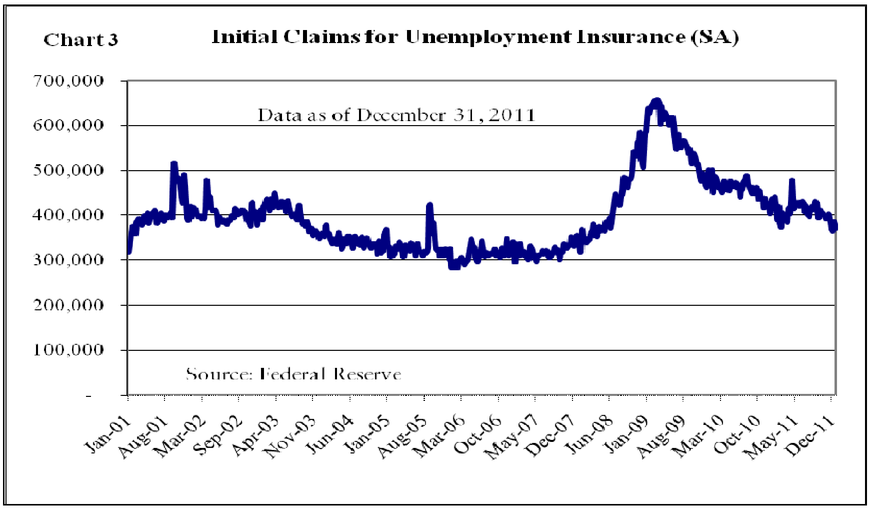
Areas that performed most poorly in 2011 were some of our favorites: cyclical companies in the materials, industrials and technology sectors. Valuations were not important factors last year. Regardless of how cheap a stock was, investors severely punished companies that failed to meet expectations. And with growth coming in weaker than anticipated at the start of the year, it was the cyclically sensitive businesses that most disappointed and which had the worst stock performance. Valuations in these areas now, obviously, are even better than at the start of 2011. The real question is whether growth will continue to disappoint or whether the surprises will be to the upside. Because of the depressed valuations, these stocks could do very well in 2012 if growth meets or beats expectations.

Real GDP for the fourth quarter of 2011 is to be reported on January 27th. Recent data have been modestly better than expected and suggests that growth for the quarter will be in the 3%-to-4% range. Pessimism has been running so high that it's not very hard to beat expectations. New home construction in the U.S., which was 6% of GDP at the peak, has been a big drag on growth as home construction shrank to recent levels of only about 2% of GDP. While home prices are likely to remain depressed for an extended period because of the continued workout of foreclosed properties, new home construction has shown unmistakable signs of improvement. New housing starts increased to an annualized rate of 685,000 units in November, up from the trough of 478,000 units in April 2009. Housing is not expected to be a big positive for growth going forward, but it is no longer expected to be a big drag either.

There have been other signs of improvement in manufacturing including good export data and a rebound in new orders. The ISM Manufacturing New Orders Index rose to 57.6 in December, the third consecutive monthly improvement. At the same time, the ISM index for manufacturing inventories showed that inventories are very lean as that index fell to 47.1 in December from 48.3 a month before and 52.0 three months earlier. Such data suggests that industrial production will have to accelerate in order to meet demand and replenish inventories. In Chart 2, for example, the blue line shows the ratio of new orders to inventories. When the line is rising new orders are being filled by manufacturers shipping goods out of existing inventories. Consequently, one can see industrial production (the red line) follows the blue line with some lag time as manufacturers adjust production to meet changes in demand. The recent ISM data therefore suggests that industrial production should accelerate to a year-over-year growth rate of perhaps 7% or 8%.



There are even signs that conditions are improving for the beleaguered American worker. Initial claims for unemployment insurance have been steadily declining since the first quarter of 2009 and in recent weeks have been consistently below 400,000 (see Chart 3). This indicates that U.S. businesses are experiencing enough demand that they can't afford to let any more workers go. Net change in payrolls is also showing signs of improvement. As shown in Chart 4, payrolls have on net (new hires minus jobs lost) been growing at about a 1% annualized rate. This rate of growth is not enough to significantly reduce the unemployment rate but the data suggests that payroll growth could accelerate especially if business confidence improves.



A primary key to future equity returns will be changes in inflation. The world's central banks will have more freedom to provide further monetary accommodation as long as inflation cools. From May 2011 through the end of the year, the CRB Index, which is a broad index of basic commodity prices, fell 18% in dollar terms. The plunge in commodities reflects not only global growth worries, as evidenced by declines in copper and crude oil, but also that central bank policy is inappropriately tight, as evidenced by declining gold and silver prices. But the good news is that this decline in commodity prices is now paying off in the form of declining inflation and there are indications that this is a fairly widespread global phenomenon. The Japanese have already effectively begun to ease monetary policy through their attempts to weaken the Yen. The Chinese have begun to reduce bank reserve requirements and, with the Chinese inflation rate now coming down, many analysts think the chances are growing for more aggressive accommodation by the Chinese central bank. A recent survey of primary U.S. government bond dealers indicated that a majority expect a QE3 in the year ahead. And even the ECB, which is widely seen as the most conservative of the major central banks, cut interest rates and has begun to significantly increase its balance sheet. We cannot be sure that there will be further policy accommodation, but with commodity prices and inflationary pressure declining, the chances are improving that central banks will be willing to provide liquidity to the capital markets if needed.

It appears that the Central Banks have put some floor under the downside to the markets. This has become increasingly clear following the November 30th coordinated announcement by the Fed, BoC, BOE, BOJ, ECB, SNB to lower the pricing on the existing temporary U.S. dollar liquidity swap arrangements by 50 basis points. As a contingency measure, these central banks have also agreed to establish temporary bilateral liquidity swap arrangements so that liquidity can be provided in each jurisdiction in any of their currencies should market conditions so warrant. The heart of the matter is that the Fed essentially has agreed to provide the ECB any dollar amounts necessary to fund European banks for business that is conducted in dollars, as much business and trade is. This was followed by Draghi's December 1st address to the EU Parliament. Then later in the month, the ECB flooded the financial system with 489 billion Euros of ultra cheap 1% three year loans. Some analysts are interpreting these actions as implicitly removing the risk of a "tail" sovereign catastrophe. We agree. The Central Banks want to keep pressure on Washington and the capitals of Europe to deal with the fiscal issues, but they are not about to allow the financial markets to seize up as they did in 2008-9.

The outlook for the equity markets is quite good thanks to low expectations, which are easier to beat, attractive valuations, and signs that growth may actually be accelerating. Of course plenty of risk remains. Reasonable short-term "trading" calls are problematic because of a lack of trading liquidity and hyper sensitive reactions to unpredictable headline news. But from our perspective, investors who put money in the bank or fixed income securities are being penalized. Short term deposits effectively pay no interest and even 10 year treasury bonds yield only 2%, which is right at the current inflation rate. But still, people are afraid of risk and would rather earn safe negative real returns rather than risk investing in the stock market. This condition will not always last and when it ends there could be an explosive rally to the upside as investors shift from bonds to stocks. As we mentioned early in this report, the S&P 500, under normal conditions, should be trading at about 15 times operating earnings. Hence, our price target of 1500 for the S&P 500 shown in Table 1 approximates that valuation. Again, it's the fear factor that is creating the flood gates that are holding back all the cash sloshing around the world. At the inflection point when sentiment changes because investors become convinced that the financial crisis born in 2008 is really under control, and that a sustainable business expansion is on the horizon, the flood gates will open and the cash will run to cheap equities and out of expensive fixed income. Tactically, these conditions led us to believe that the most prudent investment strategy is to gradually move cash into equities on any price declines—buy on the dips as they say. Furthermore, the beaten up cyclical issues of 2011 are a good place to look for good companies at low valuations that have the potential for strong outperformance.