

Glass Half Full — Glass Half Empty

What's Happening?

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2011 Outlook

GDP GROWTH:

2.6% - 2.9%

UNEMPLOYMENT:

9.0%

INFLATION:

1.75%

FED FUNDS RATE:

0.35%

Too many moving parts. That is what the current investment environment is displaying. With this in mind, it makes sense to list the major driving factors, both positive and negative. This may help determine the trajectory of not only the economic environment, but also the financial markets. This list is not meant to be all-inclusive; rather, it is a reasonable inventory of fundamental drivers.

Glass Half Full

- Corporate earnings are positive. Historically there is a 71.0 percent probability that when earnings rise, stock prices rise.
- Corporate balance sheets are flush, which may provide fresh fuel for buyouts, dividend increases or share buy-backs.
- Valuation is reasonable. At 14x earnings, stock prices do not appear particularly expensive.
- Friendly Fed. The Fed has shown their hand in attempting to fuel economic growth. They are willing to see inflation push to the upside in the “employment at all costs” game.
- Interest rates are low, and will probably stay low, leading to limited competition to stocks.
- Employment picture is getting better. Unemployment is still high, but it appears people have at least stopped letting people go, en masse.
- Tax rates are steady – for the time being.

Glass Half Empty

- Washington seems to be non-functional. What about the debt ceiling? What about deficit spending?
- Structurally, the developed world has been living beyond their means for decades. This is now coming home to roost.
- With the wind-down of QE2, what is next to provide the liquidity fire-power necessary for the equity market to continue to rise?
- Earnings momentum is slowing. First half S&P 500 earnings grew at roughly 19.0 percent, second half expected at six percent growth.
- Banking and sovereign debt problems persist. The world's bond investors are questioning how Greece, Portugal, Ireland and now perhaps Spain, Belgium or Italy are going to not only continue underwriting more debt, but pay investors back for current issues outstanding.

- Growth of M3 has fallen by 1.5 percent on an annualized rate since the start of QE2, reflecting a lack of credit creation (this is probably reflecting a lack of credit demand). Has QE2 failed?
- When bond yields and bank stock prices both fall in tandem, it seldom foreshadows anything good. So far this year, the 10-year note is down 11 basis points and financials have declined by 3.5 percent, underperforming the market by almost eight percent.
- Is inflation starting to rise?
- According to the economists at Morgan Stanley, 71.0 percent of the world's central banking systems are currently, or will soon be in a "tightening" mode (as measured by GDP levels).
- More than 10.0 percent of the world economy is in contraction (Japan, areas of Europe and MENA).
- Another 15.0 percent is close to slipping into negative territory (Britain, Belgium, France, Italy, Spain, New Zealand, Slovenia, Venezuela and the Netherlands).
- The market has moved up 105.0 percent from the March 2009 low. We have only seen one correction of more than 15.0 percent during that upward charge. The "Presidential Cycle" would suggest the second half of 2011 may be a difficult period, based on historical standards.

Final Word

At the end of the day, we suspect the summer months may be a little "hotter" for the world's investors than has been the case over the last couple of years. We do suspect that any weakness may indeed be temporary in nature.

We also believe that during times when the momentum of economic growth is slowing, higher-quality assets tend to outperform lower quality competitors. We think it makes sense from a timing standpoint to highlight higher-quality investments in most cases.



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