

Moving in the Right Direction

By Mark Luschini, Chief Investment Strategist



The International Monetary Fund raised its forecast for global growth in 2010 to 3.9% from its previous estimate of 3.1% forwarded just last October. Clearly, the improvement in economic conditions around the world has occurred more rapidly than expected. The composition of their prognostication, however, is bifurcated between the slower growth expected to come from “advanced” countries, such as the United States, Europe and Japan, and that which is expected to be generated by the developing or “emerging market” countries, such as those in Latin America and the Asia-Pacific region. The United States, for instance, has the highest expected economic growth relative to other mature markets (2.7%), while China leads the developing country sweepstakes with a GDP estimate of 10% for this year. Chart A compiles a sample of countries from around the world and their expected growth rates for 2010. It portrays an interesting scenario for two primary reasons. The first is to locate the sources of growth and parlay that into investment opportunities found by squaring to it. The second is where the growth is not and qualifying the consequences of that regime.

On the first point, we believe that companies positioned to participate in the fast growing markets of Brazil, China and India to name a few, stand to benefit from the improved fiscal conditions, large consumer base and expanding appetite for a greater quality of life (which includes infrastructure and diet). Additionally, during a period like today when a premium is placed on revenue growth, companies are reporting stronger sales from international markets that to a large degree exceed domestic demand. That is not to say that companies that derive the majority of their business from mature markets can't prosper, it is just that the challenges may be greater and anything less than a trend line recovery in consumption will disadvantage their prospects. While that also means companies inside these emerging countries should reward investors, we are wary that these markets are overbought at this juncture and may be vulnerable to an event that might trigger a sharp equity correction. Even so, the secular case for direct ownership of emerging market equities is very strong and will likely remain so for many years. Therefore, our enthusiasm for these markets is manifested in the strategy of bidding on what these countries consume, through companies that offer better valuations, diversified

Chart A: Latest IMF Projections

(year-over-year percentage change)

	2010	2011
World Output	3.9	4.3
Developed Markets		
United States	2.7	2.4
Canada	2.6	3.6
Euro Area	1.0	1.6
Japan	1.7	2.2
Emerging Markets		
Brazil	4.7	3.7
India	7.7	7.8
China	10.0	9.7
Central and Eastern Europe	2.0	3.7

(Source: IMF, Janney ISG)

businesses, and where possible, a healthy dividend. That profile tends to be found in high quality, multinational companies based in the U.S., but also in export-driven countries in Europe such as Germany.

Speaking to the second point, there are a few spots that flag not only caution for investment purposes, but are a prospective catalyst for a problem of larger scale to erupt. Principally speaking, the countries in this camp have fiscal issues that are troublesome and while not exclusive to the European community, it is a region that has been a source of most recent news related to this topic. A basket of these countries in fact—Portugal, Ireland, Italy, Greece and Spain—were given the unceremonious acronym, “PIIGS”. While not necessarily economically sizeable on their own, collectively this group is mired in a swamp of debt and weakened economic conditions that renders concerns of default and sends an important message to other debtor nations, including the United States. That being the lack of fiscal discipline exerts an exacting toll if market participants waiver in supporting the habit. Since these countries are participants in the unity of the Euro zone under a single currency—the Euro—the central debate at the moment is what should happen to solve their fiscal condition. This has had ramifications in the marketplace pertaining to the sovereign debt of these nations and to the value of the Euro vis-à-vis other currencies.

The recession has ended in most countries and economies are for the most part moving in the right direction. Still, the question remains whether the removal of life support provided by governmental authorities will come without undermining the building strength in global economies, or in the absence of stimulus programs and exceedingly low borrowing costs will underlying weaknesses reassert themselves. The answer to that will not come at once, nor will it necessarily exert its influence on the market accompanied by an advertisement. It, therefore, bears watching even as we enjoy the current uptick in global economic activity. ■



Yogi Was Right

By Gregory M. Drahuschak, Market Strategist

A robust start to 2010 was blunted in the middle of January as investors worried about numerous issues. The dominant issue that prompted a mid-month reversal was the projection from the Congressional Budget office regarding the federal budget deficit for this year and well into the future. By January 19, the S&P 500 was up 3.15%, but by the end of the month, the S&P was down 3.7%. Only the Healthcare sector ended the month with a gain, and that was only 0.42%. The other nine sectors produced losses ranging from 1.21% for the Industrial sector to 9.32% for the Telecom sector. (See Chart B)

This January produced the 12th weakest result for the month in the last 61 years—although this was dramatically better than the year before when the S&P 500 posted its worst January in the same 61 years. After ending last month in a downbeat fashion, the old adage, as January goes so goes the year, is probably on many investors' minds. As we noted last month in *Investment Perspectives*, "Historic precedents like the January effect in recent years have proven to be far less reliable than they had been for decades."

According to Standard & Poor's, since 1945, whenever the S&P 500 rose in January it posted an average gain (excluding dividends) of 12.7% and produced a gain 80% of the time. Whenever the S&P 500 fell in January, it recorded an average decline of 0.7% through the ensuing 12 months; however, it correctly forecasts the direction of stock prices only 48% of time.

Data like this tends to suggest that the January barometer is far from being a good gauge of the overall market activity for the balance of a year. January activity, however, does seem to have more reliability when applied to sectors within the S&P 500. (See Chart C)

Chart B: 2009 Index Performance (Price Only)

2010 Market Data		Prior Close	Last	Change	% Daily	% Yearly	% Jan
DJ Industries	.DJIA	10120.46	10067.33	(53.13)	(0.52)	(3.46)	(3.46)
S&P 500	SPX	1084.53	1073.87	(10.66)	(0.98)	(3.70)	(3.70)
NASDAQ Comp	COMP	2179.00	2147.35	(31.65)	(1.45)	(5.37)	(5.37)
SOX Index	SOX	327.25	316.07	(11.18)	(3.42)	(12.18)	(12.18)
Biotech Index	BTK	959.17	964.34	5.17	0.54	2.36	2.36
DJ Transports	.TRANS	3940.25	3895.53	(44.72)	(1.13)	(4.98)	(4.98)
DJ Utilities	.UTIL	380.62	378.25	(2.37)	(0.62)	(4.96)	(4.96)
Volatility Index	VIX	23.73	24.62	0.89	3.75	13.56	13.56
S&P Midcap 400	MID	712.44	702.80	(9.64)	(1.35)	(3.28)	(3.28)
S&P 100	.OEX	499.67	495.09	(4.58)	(0.92)	(3.70)	(3.70)
Gold ETF	GLD	106.48	105.96	(0.52)	(0.49)	(1.26)	(1.26)
Russell 1000 Index	.RUI	595.64	589.41	(6.23)	(1.05)	(3.69)	(3.69)
Russell 2000 Index	.RUT	607.93	602.04	(5.89)	(0.97)	(3.73)	(3.73)

(Source: Standard & Poor's)

Since 1990, which is as far back as the S&P sector index data goes, the three best performing sectors in January went on to post a compound annual growth rate of 8.2% in the following 12 months, versus a 6.1% return for the S&P 500, and beat the market 70% of the time.

This January was the best performing sector with a gain of 0.42%. The next best sector performance was in the Industrials and Staples sectors that produced losses of 1.2% and 1.25% respectively.

Since 1990, if you had invested in the worst three sectors every year (Information Technology, Materials and Telecom Services this year) your total results would be substantially below what the general market produced through the same period.

As for the immediate impact of a down January, since 1949 and prior to this year, the S&P 500 produced a January loss 24 times. Following the 24 losing January results, the S&P had a loss in February 15 times. Although this represents a 62.5% rate it is hardly enough to suggest there is a strong connection between a losing January and what might happen in February.

The S&P 500 has gained at least 25% (total return) 8 times in the last 25 calendar years including last year (26.5% in 2009). In the calendar year following the seven previous "25% and up" years, the S&P 500 was up six out of seven years, gaining an average of 14.8% annually. This might be a worthwhile consideration for investors who think that stocks are doomed to slide this year because of the jump last year.

Chart C: Sector Results for January

	Market Cap	YTD
S&P 500	9,561,485.06	-3.70%
Health Care	1,259,499.30	0.42%
Industrials	1,004,776.93	-1.21%
Cons Staples	1,113,688.39	-1.25%
Financials	1,406,291.34	-1.48%
Cons Disc	924,524.32	-2.95%
Energy	1,088,531.26	-4.51%
Utilities	355,563.40	-5.10%
Info Tech	1,797,624.00	-8.45%
Materials	326,266.95	-8.66%
Telecom Svc	284,719.17	-9.32%

(Source: Standard & Poor's and Janney)

The pace of the market's advance from last year's low, the modestly weaker short-term technical picture, as well as ongoing geopolitical and domestic fiscal worries might restrain the market short-term. Our worst case assumption would be a slide in the S&P 500 to roughly the 975 level. More likely, a short-term pullback should find support around 1050. It will take a clear breakthrough of the January high to erase the near-term technical worries.

The key in our view this month is to not allow any short-term market factors to frighten investors into thinking that another major move down is likely and that the high for this cycle still is ahead. We would exercise care in establishing new equity positions by keeping an eye on the market short-term, but barring fundamental reason that could prompt changes in portfolio positions, we would not alter significantly existing positions.

As noted in our 2010 Outlook report, "We would suggest a strong focus on high quality stocks with amply covered dividends accompanied by solid balance sheets with minimal debt as a percentage of total capital."

To borrow from the very quotable Yogi Berra, "It ain't over 'till it's over," and the market's upside for 2010 ain't over yet. ■

The major positive for the market is that earnings largely have beaten elevated expectations. At the end of January, of the 222 S&P 500 companies that reported earnings, 78% beat their earnings estimates, while 15% reported negative surprises.

Based on current estimates and some actual results, the S&P 500 is on track to report 2009 earnings of \$61.21 and \$78.27 for 2010. The 2010 estimate is about \$2.00 higher than estimated at the end of December. We find an interesting coincidence between the earnings estimate for the S&P 500 Index and what we think is a reasonable valuation and technical target for the Index. All three suggest that 1250 is a reasonable target for 2010. How we get there could be the most important element in how investors position portfolios early this year.

In our 2010 outlook report, *Turning the Corner*, we suggested that the corner is behind us, but the pace as we move forward may be slower than some now estimate. The "flash" estimate of the fourth quarter Gross Domestic Product showed that the economy grew 5.7%. Sustaining a rate anywhere near this level we think is unlikely. However, much more moderate growth in the 2.5–3% range would underpin the market and allow stock prices to edge higher.

Municipals: Skiing the Steeper Slopes

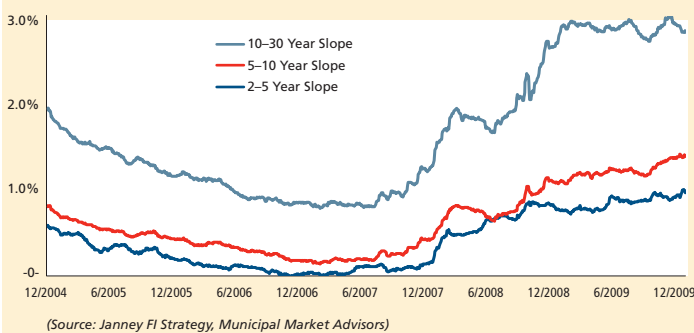
By Alan Schankel, Managing Director



Deciding what maturity bonds to invest in has become a more challenging concern as worries about long-term government spending and inflation risks have weighed more heavily on investors' minds. As a reminder, our baseline expectations include relatively constrained inflation for the next couple of years, but risks of higher price levels should begin to rise in 2015 and beyond. In light of this outlook, our investing recommendations tend to be relatively conservative, with the exception of a few markets, most notable among them, the municipal markets. The slope of the tax-free municipal yield curve has been persistently steep for the past year and we believe tax-free investors should consider extending duration to capture the incremental yield pick-up available in longer maturities.

Contending technical forces are keeping long-term tax-free municipal yields relatively high. Despite predictions that Build America Bonds (BABs), first marketed in March 2009, would lower the supply of long maturity tax-free bonds, leading to lower yields, long-term municipal yields remain elevated. The forces which may move yields higher or lower are somewhat balanced, but this logjam will change.

Chart D: Municipal Yield Curve Slope



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Arguments for higher municipal yields:

- Expectations for rising Treasury yields due to deficit, improving economy and higher inflation
- State and local government will borrow more to offset falling revenues (i.e., more supply)
- Concerns about falling credit quality of governmental issuers, given wide spread budget deficits with stresses on tax collections and other revenues

Arguments for lower municipal yields:

- Likelihood of income tax increases to finance deficit, health care reform etc. making municipals relatively more attractive
- More municipal long-term borrowing done with taxable BABs, leading to lower supply of long-term tax-free municipal bonds
- With short-term yields, particularly money market rates, extremely low, large amounts of cash on the sidelines will gradually be deployed to capture higher yields

The slope of the yield curve, as measured by the basis point differential between two-year and 30-year maturities has hovered above 350 basis points for the past year. In coming months we expect the slope to diminish, which should create opportunities for stronger total return in longer maturities due to both coupon and positive price performance relative to other maturities. (See Chart D)

To be sure we may see upward pressure on yields across the curve. Municipal yields are inextricably related to yields of Treasuries and other fixed income securities. If Treasury yields rise sharply, they will pull municipal yields along for the ride, but consistent with our 2010 Outlook, which suggests underweighting Treasuries and overweighting municipals, we believe municipals will outperform Treasuries, even if yields in general move higher.

We are not suggesting a deployment entirely to longer maturities. A laddered portfolio structure is still the way to go for most investors, but the duration of ladders should be extended. A ladder with maturities running one to 10 years might be extended to 15 years for example. General obligation and essential purpose bonds still hold the most appeal from a credit perspective, and although we favor the higher grade area, it's worth noting that AAA rated bonds are becoming more scarce with the downgrades of bond insurers and fewer AAA issues—only six of the 50 states are rated AAA by both Moody's and S&P. Tax backed and essential purpose issuers in the high A and AA categories will offer more value than pure AAA bonds. ■