

January 2010 Market Recap

Presented by Sean Gross

A disappointing start

Equity markets opened 2010 on an upswing, but a sell-off in the second half of the month pushed major U.S. indices into negative territory.

- The Dow Jones Industrial Average lost 3.32 percent, while the S&P 500 Index lost 3.60 percent—its first monthly loss since March 2009.
- Investors are left wondering whether the rally can continue, especially since the S&P 500 has gained more than 60 percent from its March lows and advanced more than 25 percent in 2009.

It's becoming clear that the success drivers in 2009 probably won't be the same ones to fuel performance in 2010.

- One difference has to do with fundamentals for stocks and bonds.
- Stock valuations have pushed higher; the price/earnings ratio on the S&P 500 is now more than 18 times trailing earnings. It was a little more than 14 times earnings in early 2009.
- Bond spreads have narrowed substantially in both the corporate and high-yield spaces to hover around their long-term averages. This makes a difficult case for a further narrowing of spreads, which would push prices higher and fuel gains.
- In fact, high-yield spreads actually *widened* by more than 50 basis points in the second half of January; corporate spreads widened as well.
- Despite this slide, the Barclays Capital Aggregate Bond Index gained 1.53 percent.

Revisiting the case for a weak market

Last month, we described scenarios for weak and strong markets in 2010. So far, the bears seem to have it right.

- Stocks looking to advance on better-than-expected data have instead sold off.
 - Stocks briefly pushed higher on news of a strong gross domestic product (GDP) number—indicating that the economy grew at a 5.70-percent rate in the fourth quarter—on the last day of the month. Yet, by the end of the day, the markets had traded down sharply.

- This was perhaps a reaction to news that about 3.50 percent of the GDP number was attributed to a rebuilding of inventory, not to actual growth.

There are some signs, however, that the economy is improving.

- Consumer confidence rose to 55.9 in January.
- While likely not a sign that consumer spending is returning to pre-recession levels, the trend points to an improving economic outlook.

Still, investor optimism continues to be challenged by high unemployment.

- The rate in January fell slightly to 9.70 percent, but the economy still shed 20,000 jobs.
- It is unlikely that we'll see a strong economic recovery without new job growth to drive spending.

The earnings keep coming strong

It's difficult to ignore the strong fourth-quarter earnings reported thus far.

- As of January 29, 220 of the S&P 500 companies had reported earnings.
 - 78 percent of them beat analysts' estimates, while only 14 percent came up short.
 - The blended earnings growth rate for the S&P 500 stood at 206 percent year-over-year.

Yet the market seems to be doing so, again raising concerns over the potential for near-term growth.

The government is still our business partner

The government continues to drive the Main Street agenda and is looking for ways to further influence actions on Wall Street.

- Because markets have reacted favorably to stimulus, monetary policy, and programs to purchase and support mortgage assets, it will be critical for the government to sustain the recovery.
- President Obama's budget proposes modest spending cuts, but it still shows a projected deficit of \$1.6 trillion for the coming year.
 - This—coupled with his intention to raise taxes on individuals making more than \$250,000, banks, and multinational companies—raises concerns over the budget's potential impact on economic growth.

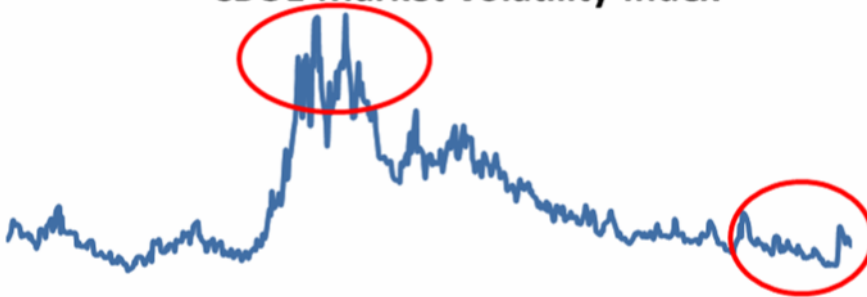
- The Democrats' loss of their filibuster-proof majority following the Massachusetts senatorial election has also intensified concerns regarding future policy decisions.

Prepare for heightened volatility

Risk complacency at the end of 2009 is being replaced with the need for vigilance in the near term.

- The VIX, a measure of volatility in the S&P 500, rose from a compressed level of 18 to 25 by the end of January.
- While a far cry from the highs of 75–80 seen during the market downturn, it's definitely a sign of renewed volatility in the equity markets.

CBOE Market Volatility Index



It's impossible to predict where the markets will head, but there are signs that this year will not be the same as last year.

- We suggest preparing for potential volatility—looking to reduce portfolio risk where possible—and advise you not to be afraid to realize some of the hard-earned profits in your portfolios.
- It's our view that, while the economy will continue to chug along and markets may eke out modest gains in 2010, it is likely going to be a rough ride.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Barclays Capital Aggregate Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar-denominated. It covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities.*

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