



MONTHLY MARKET COMMENT

Market Update

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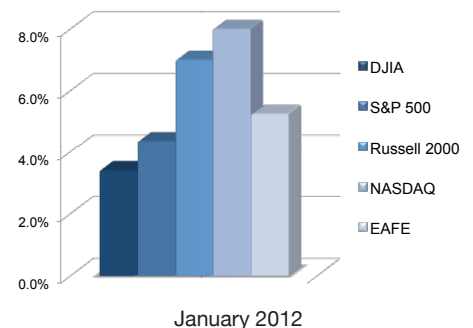
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The market volatility that dominated 2011 dissipated in January, as stocks continued to move steadily higher and are now well above the lows of last fall. The gain of 3.40% by the **Dow Jones Industrial Average**, which closed the month at 12632.91, was the Index's best annual start in performance since 1997. The **S&P 500 Index** fared better, rising 4.36% to 1312.41, marking its best January performance since 1987. The **Russell 2000 Small-Cap Index** jumped 7% to 792.82, while the **NASDAQ** was the top performer of the major US indices, soaring 8.01% to close the month at 2813.84. International stocks rebounded as well, as the **EAFE** Index was higher at month end by 5.25%, closing at 1486.74. The S&P 500 has now recovered from its almost 20% decline between April 29, 2011 to October 3, 2011 which, as we wrote at the time, was most likely a result of fear and loss of confidence than an actual renewed economic decline. At current levels the market is now close to its highest level since June 2008.

Domestic stock prices were supported in January by a string of positive US economic news and earnings, while fears of renewed inflation once again subsided. Globally, stocks were strong thanks to the European Central Bank (ECB) which announced a new program in December entitled the Long Term Refinancing Operation, which allowed European banks to borrow from the ECB at extremely low interest rates for a

Major Index Appreciation
As of 1/31/2012



term of three years. Since then, Reuters reports that banks have borrowed over half a trillion Euros providing themselves with liquidity and, more importantly, their action calmed the market worries that the sovereign debt crisis would lead to a credit and liquidity crunch similar to what occurred in the US after Lehman Brothers defaulted in 2008. The reduced level of fear can be seen in the performance of the Spanish and Italian bonds which have had a meaningful drop in yield since the ECB took this action. The risk that credit conditions in Europe could worsen and lead to a severe European recession or even credit implosion is well known and discounted by the market as evidenced by the sharp drop in the markets' P/E ratio since 2010 even as earnings continued to grow by double digits. Though this possibility exists, the actual probability of it happening has likely been overblown by the media. Though Europe will not solve its

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sovereign debt problem anytime soon, it does not mean the US economy will suffer as a result. A European recession is possible if not likely, but its effect on our economy should be minor compared to the value found in stocks. However, a credit blowup in Europe would probably lead to a US recession, but as demonstrated by their actions so far, the ECB and the Federal Reserve are focused on this potential economic risk and will move heaven and earth to prevent it from occurring.

As we have discussed in previous issues of the Monthly Market Comment, stock prices are attractive relative to historical norms and alternative investment opportunities. Depending on which statistics one examines, stock valuations at their current level are reminiscent of valuations last seen in 1973-1974. At some point this value will be recognized in the markets, though the timing, as always, remains uncertain as it is dependent upon too many unpredictable variables. There seems to be general agreement among market historians that, based on common measurements such as

price-to-earnings, price-to-book, and dividends as a percent of the average long-term payout ratio, stocks are cheap. Since 2008, earnings have risen 80% while the US economy (GDP) has expanded at an annualized rate of 2.4%. During that time, the S&P 500 has doubled in price from its low while the P/E ratio has declined by over 40%. At

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slightly less than 12.5 times expected earnings the market is well below its long-term average P/E ratio of between 15 to 16 times earnings.

The reverse of the P/E ratio is called the earnings yield, and it now stands at about 8%—very attractive compared to 10-year Treasuries at 2% or slightly higher yielding corporate bonds. Even at 5% earnings growth in 2012, the S&P 500 could rise by as much as 16% if P/E

ratios return to their level at the end of 2010, and by as much as 25% if they return to their long-term historical norm. If global issues improve and investor confidence strengthens, such a move in the market is within the realm of possibilities, though it could prove to be an uphill struggle. Investors are wrestling with continued political dysfunction in Washington and the expiration of numerous tax policies at the end of the year that were enacted to stimulate growth and investment.

If a rebound in stock prices does continue in 2012, its fuel should be provided by the need of investors to rebalance portfolios by selling bonds and buying stocks. The Investment Company Institute reported that in 2011, retail investors sold \$130 billion dollars of US equity mutual funds with 99% of the proceeds going into bond mutual funds, similar to what the markets witnessed in 2008. In the past five years, investors have liquidated more than \$450 billion of domestic equity funds while investing \$930 billion in bond funds. In addition, since 2001, stock holdings (as a percent of total financial assets) have declined to only 18% from 25%. Hedge funds, now with slightly under \$100 billion in assets, have their lowest exposure to equities since March 2009, which proved to be a generational low. Though there is not as much information on the subject, experts believe pension plans are now disproportionately exposed to the fixed income market and underexposed to equities. These actions explain the disappointing performance of stocks over the past decade where P/E ratios contracted even as earnings and dividends grew. With fixed income yields at the lowest level in our lifetimes, it does not take much imagination to suppose that at some point we will begin to see renewed inflows into equities as investor confidence in the economy improves. ▀

Outlook on Earnings

Actual fourth-quarter earnings have been coming in lower with fewer companies beating expectations than in the prior quarters of 2011. With almost half of the companies in the S&P 500 reporting so far, earnings growth is expected to be about 8% more than fourth-quarter earnings of a year ago. In each quarter of 2011, earnings growth steadily declined on a year-over-year basis.

This eventual slowdown in growth was inevitable. As companies rebounded from the Great Recession of 2008, profit margins rose to record highs partly from revenue growth, but mostly from expense control as the economic recovery and by extension, revenue

growth has been subpar when compared to prior recoveries from recession. Analysts expect this slowing of earnings growth will continue through 2012. For the year, consensus estimates are for 9% earnings growth over 2011 (down from 14% in 2011 and 40% in 2010), with earnings growth slowing in the first half of the year and then picking up by the fourth quarter. If the expected rebound does not occur later in the year, then we may see earnings growth in the 5-6% range which would still be enough to send stock prices higher, perhaps much higher if we see a return to more common price-to-earnings (P/E) levels as fears of a contagious European meltdown decline. ▀

The Economy

By the end of January, the US had experienced its 17th straight week of stronger US economic data, even as the initial report on fourth-quarter GDP growth was somewhat disappointing—coming in at less than the anticipated 3% (2.8%), even as inflation for the fourth quarter rose by only 0.4%. However, optimists found some encouragement in this slower-than-expected number as it was held back by a decrease in government spending. The rise in GDP, after subtracting the negative effect of government spending, was 4.4%. Real GDP is well above its prior peak in 2007, thus we are clearly in an economic expansion, though one held back by the continuing drag of excess debt that needs to be paid down. Though government is behind, consumers have made real progress in debt reduction. While total consumer debt remains above “normal”, interest payments by consumers have declined about 25% from their peak four years ago, and total interest payments as a percent of disposable personal income are now well below what is considered to be normal. At some point, some of this debt reduction and interest savings will flow back into consumer spending. Perhaps this has already begun as evidenced by stronger-than-expected auto sales. Consumers and manufacturing have also been helped by the warmer than normal winter and the sharp decline in natural gas prices, which accounts for about 25% of US total energy consumption.

The best economic news for January was that employment climbed by more than forecast, as payrolls increased by 243,000 jobs and unemployment dropped to 8.3%, its lowest level since February 2009. In addition, revisions to the November and December numbers added an additional 60,000 jobs. All the gains occurred in the private sector (257,000 jobs) as the

growth in government jobs remained negative at a minus 14,000. The job gains will translate into stronger income growth which should continue to buoy consumer confidence and drive consumer spending higher. A pessimist on stocks might interpret the data as evidence that we have come to the end of growth in productivity, and that profit margins are at risk of declining due to increased labor costs absent a re-acceleration in the economy. If so, this should become clearer over the next few quarters. The Institute for Supply Management (ISM) indices of manufacturing and nonmanufacturing activity also came in higher than expected in January and remain well above the 50 level that signifies our economy is expanding. So far our economy seems to be weathering the European sovereign debt crisis. The International Monetary Fund (IMF) predicts global growth will expand 3.3% in 2012, even as Europe experiences a “mild recession” and will grow at 3.9% in 2013.

One labor statistic that remains stubbornly high is the broader measure of unemployment which also considers people who would like to work but have stopped looking and those working only part-time who would like full-time jobs. This measurement dropped to 15.1% from 15.2% in January and remains too high. However a recent report by the Chicago Federal Reserve sheds some light on why this may be the case. Their research has shown that just under half of the post-1999 decline in the US labor force participation rate can be explained by long-running demographic patterns that should continue to have the effect of understating improvements to the percent of the working labor force until the number of those available for employment is properly adjusted for this research. The main causes are apparently the ongoing retirement of the baby boomer generation coupled

with a long-running downtrend in teenage workers. These trends should continue for at least the next decade, thus this broad range of employment measurement (that includes both part-time workers and those not seeking employment) needs adjusting, as it is currently based on data that overstates the size of the labor force used to calculate our underutilization of human resources.

One other important economic event that may be occurring during 2012 is a turn in the outlook for the housing market. Home building stocks are up sharply from last fall, and it was recently reported that the number of new homes under construction is trending higher for the first time since housing peaked in 2006. This suggests housing inventories may have finally reached a level of equilibrium, and that the decline in home prices may end this year, though prices could fall 5% or so before the bottom is reached, as the overhang of foreclosure properties will likely remain a while longer. An upturn in new home construction was inevitable as, over the past three years, even with approximately three million of new household formation, attrition in housing due to the ravages of time and natural disasters has resulted in no net new additions to the housing supply. We continue to see increases in new household formation, an easing of mortgage-lending conditions, historically low mortgage rates and an improving labor market which has pushed home affordability to a generational high. In January it was reported that the supply of unsold homes has fallen and the median price of housing actually rose. Any improvement will be welcome. However, any improvement will be slow and uneven as it will take some time to clear the supply of distressed homes on the market. ▀



The Fed Opens Up

In January, the Federal Reserve announced it would keep short-term interest rates at current levels through 2014 (an extension of their previous plan to stay at current levels through mid-2013), and that it could restart a third round of quantitative easing by purchasing mortgages and longer dated US government bonds in its efforts to support a stronger economy.

Clearly, the Fed is becoming more confident in its expectations for inflation, while growing frustrated by our economy's slow pace of growth. The Fed chairman stated there would be a "very strong case" for a third round of quantitative easing "if the recovery continues to be modest and progress on unemployment very slow and inflation appears to be likely to be below target for a number of years out." It also released for the first time the interest rate expectations of each of the 12 Fed district presidents and its board of governors. This data indicated the Fed will hold the federal-funds rate target near zero as long as unemployment remains well above 5.2% to 6%. Currently the Fed expects inflation will remain below 2% and

unemployment above 6.7% through 2014.

In its statement the Fed came out with its first "official" inflation target as it implements a new communication strategy that explicitly outlines its interest rate and inflation goals over three years. The Fed believes that greater openness through publishing its predictions makes its policies more effective while helping the public to better understand its actions. In this first instance of the "new openness" the Fed hopes to create immediate and greater demand for long termed bonds which would bring down longer term interest rates, while in the process reduce credit spreads to under five percentage points for high-yield bonds, and under 1.25 percentage points for investment-grade corporate, according to Jon Lonski, chief economist for Moody's Capital Markets Research Group. As a result of central bank actions here and abroad, bond prices rallied in January with all sectors and risk levels of the bond market from government to high-yield performing very well as yields dropped and bond prices rose. ▀

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