



## A Disappointing start

Equity markets opened 2010 on an upward trend, but a sell-off in the second half of the month pushed major U.S. indices into negative territory. The Dow Jones Industrial Average closed the month down 3.32 percent, while the S&P 500 Index lost 3.60 percent. This is the first month in which the S&P has shown a loss since March 2009, and it has left some investors contemplating whether the rally can continue, especially given last year's huge run-up—during which the S&P 500 gained more than 60 percent from its closing lows in March and advanced more than 25 percent for the year. It's also becoming clear that the success drivers in 2009 probably won't be the same ones to fuel performance in 2010.

One key difference has to do with significantly different fundamentals for stocks and bonds as we start the year. Stock valuations have pushed higher, and the price/earnings ratio on the S&P 500 is now more than 18 times trailing earnings. In early 2009, lower valuations had stocks trading at a little more than 14 times earnings. The landscape is also significantly different for bonds after a strong 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 yield spreads, which would push prices higher and fuel additional gains. In fact, high-yield spreads actually *widened* by more than 50 basis points in the second half of January, and corporate spreads also widened during the same period. Despite this slide in the latter half of the month, the broad-based Barclays Capital Aggregate Bond Index gained 1.53 percent.

## Revisiting the case for a weak market

Most recently, we described a scenario for both a weak market and a strong market in 2010. Although a month does not a trend make, it seems that the bears have had it right so far. We've seen weakness in the markets, as stocks looking to advance on better-than-expected data have instead sold off. Case in point: a strong gross domestic product (GDP) number—indicating that the economy grew at a 5.70-percent rate in the fourth quarter—was released on the last day of the month. Although stocks briefly pushed higher on the news, the bears ultimately took the day when the markets traded down sharply. This may have been due to the fact that more than half of the GDP number—about 3.50 percent—was attributed to a rebuilding of inventory, not to actual economic growth.

There are some signs, however, that the economy is continuing to improve as many economists have predicted. Consumer confidence edged higher, to 55.9, in January—up from a prior level of 53.6 in December 2009. These levels likely are not a sign that consumer spending is set to return to pre-recession levels, but the trend is pointing to an improving outlook for the economy. Still, investors'

optimism continues to be challenged by a high unemployment rate and news that discouraged workers, after exhausting their job search efforts, are simply dropping out of the labor pool. Though the unemployment rate in January fell slightly to 9.70 percent, the economy still shed 20,000 jobs. It is highly unlikely that we will see a strong economic recovery in the absence of new job growth to drive spending.

### **The earnings keep coming strong**

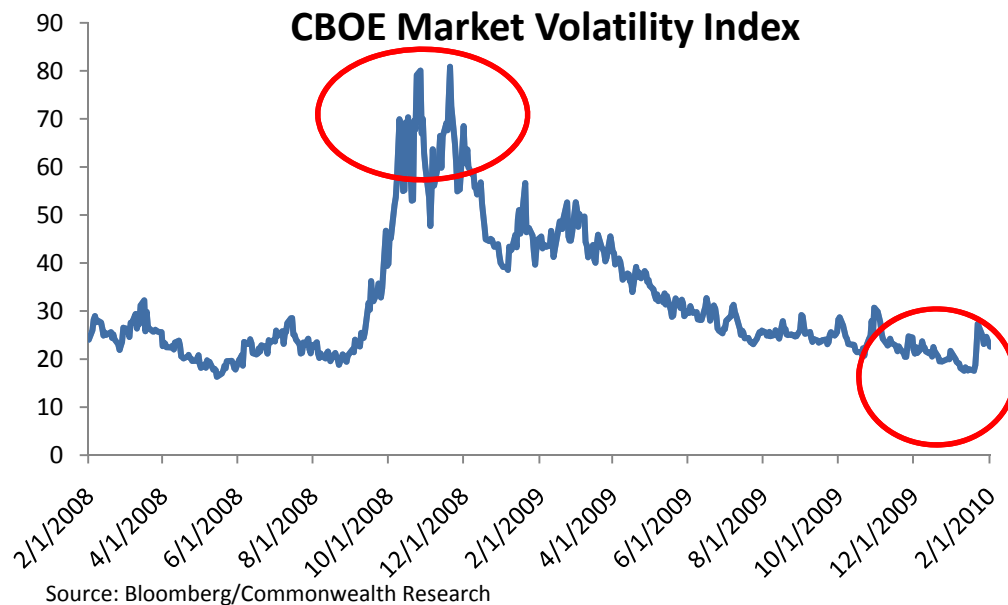
As we contemplate the economic pressures that point to a slow recovery, it is difficult to ignore the strong fourth-quarter earnings reported thus far. As of the end of January, 220 of the S&P 500 companies had reported earnings; 78 percent of them beat analysts' estimates, while only 14 percent came up short. The blended earnings growth rate for the S&P 500 stands at 206 percent year-over-year, as companies have significantly beat the highly depressed earnings of last year. Yet the market has shown little enthusiasm for these strong earnings reports, again raising concerns over the potential for markets to move higher in the near term.

### **The government is still our business partner**

The government continues to drive the agenda on Main Street and is looking for ways to further influence actions on Wall Street. Because markets have reacted favorably to stimulus, monetary policy, and the various programs to purchase and support mortgage assets, it will be critical for the government to sustain the economic recovery. In his recent budget, President Obama did propose modest spending cuts, but the budget 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—no doubt raises concerns over the budget's potential impact on economic growth. There is also uncertainty following the Massachusetts senatorial election, given that the Democrats no longer have a filibuster-proof majority. All of this has intensified concerns regarding future policy decisions.

### **Prepare for heightened volatility**

As we finished 2009, the markets seemed to be complacent regarding risk, but it's evident that investors will need to be vigilant in the near term. The VIX, a measure of volatility in the S&P 500, compressed significantly in early January, hovering around 18. We saw the VIX move higher, to around 25, by the end of the month, however. While still a far cry from the highs of 75–80 that we saw during the market downturn, the VIX is definitely pointing to signs of renewed volatility in the equity markets.



It's impossible to predict where the markets will head in the near term, but there are indeed signs that this year will not be the same as last year. With that in mind, we suggest preparing for potential volatility and advise you not to be afraid to realize some of the hard-earned profits in your portfolios. In short, look to reduce portfolio risk where possible. It's our view that, while the economy will continue to chug along and markets may eke out modest gains during the year, 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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