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Weekly Update: Why the consensus is wrong and we are right (just like last year!)

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What's Ahead

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The consensus seems to be for a choppy market this year. Some think we'll reach a high by mid-year, only to give the gains back. Others think we'll be in a long sideways market. Yes, there are too few bears. But truly, investor sentiment is weak and bulls are not at an extreme—only in the last week of '09 did we see money going into equity funds for the 1st time in 19 weeks. ***And we have reached new cycle highs on good breadth,*** although volume is poor, and the NYSE advance/decline line closed at a new cycle high this week. Nobody disagrees we're in recovery, but many feel it's being driven purely by the government, not consumers. We're more bullish than that. ***We think the stars are aligning on the 2 things we're looking for to take us to the next leg***—a consumer who wants to spend and something other than a jobless recovery (*see comments below*). The markets may be lamenting today's jobs report but at this writing, markets are flat—and we think they want to go up. ***Furthermore, we think earnings will surprise***—First Call earnings revisions rose 74% last week and the strength of the upward revisions the past 13 weeks is unprecedented. We had sideways in November and December, and think the market is poised for that next leg.

Recent Positives

- ***Santa was good to retailers*** On Thursday, retail chains posted much stronger-than-expected December results, with many raising their outlooks for the quarter. December auto sales also were strong, and auto makers are optimistic about 2010. All systems go.

- ***Manufacturing in a 'V' recovery*** December ISM manufacturing came in well above expectations, rising at an annualized rate that corresponds to a 4.6% increase in real GDP, well above the current consensus of about 3%. The percentage of respondents saying inventories are too low was the highest in the history of the survey. This is bullish for growth in coming quarters. November factory orders also more than doubled estimates. December's ISM services wasn't as strong but still crossed into positive territory—given that services represent 80% of the economy, we need this to improve.

- ***FOMC minutes suggest all systems go*** Minutes from December's Fed meeting shows most of the talk was about the recovery's fragility, not potential inflation. This, coupled with the fed funds futures reaction to today's jobs report, means the fed funds rate likely will remain stuck at its historic low, where it's been an unprecedented 13 months. The Fed most likely will raise rates sometime this year, and may even take it to 1% to 2%. But while that will dominate the market discussion, we'll still have a very low real fed funds rate. Besides, interest rate changes tend to lead GDP as much as 2 years. This suggests all systems go.

Recent Negatives

- ***Slight disappointment on jobs*** This morning's jobs report showed payrolls fell 85,000 in December, vs. a consensus around flat, as the jobless rate remained stuck at 10%. Still, November was revised to a slight gain, temporary jobs continued strong, wage increases were still slowing (no inflation worries yet for the Fed), December's online ads had their biggest monthly gain in more than 4 years, with new ads up a record, and we're talking about December numbers—it's the first half where we expect to see a turnaround. This is all fine with us, although the continued contraction of the labor force and the stubbornness of small businessmen to hire will be ongoing concerns.

- ***Housing isn't out of the woods*** Foreclosures in process jumped 80% in '09, pending home sales plunged a record in November (though there was a lot of noise about this figure because of the November expiration of the since-expanded home buyer's credit), and 12 months after exiting default, borrowers are redefaulting at a 60% rate. Total construction spending slid a 7th straight month in November in part because builders found it hard to justify building homes. Housing probably won't provide much lift to the recovery, though the White House, acting on Christmas Eve to let Fannie Mae and Freddie Mac borrow limitlessly from the Treasury, seems committed to preventing it from being a drag.

- ***No end to state and local pain*** With 31 states already facing shortfalls and tax receipts falling by a record the first three quarters of '09, cumulative state budget deficits are projected to hit $193 billion in the current fiscal year that runs through June. The coming fiscal year isn't expected to be much better, with deficits totaling an estimated $180 billion. Fiscal woes are so bad that some state and local governments are considering 4-day workweeks.

What else?

- ***The fun game of looking at January's nonfundamentals sends mixed market signals*** Since '28, the S&P 500 has averaged a 1.3% gain the first month of the year, and whenever the first 5 trading days are positive, such as may be the case this year depending on how today closes, the whole year has been up 70% of the time—8% on average. On the other hand, the presidential cycle suggest caution for stocks—only a 1.6% return when a Dem is in the White House. And going back to 1900, 60% of the time, years ending 0 brought losses averaging more than 6%.

- ***Good investor karma*** As we closed out 2009, Europe's volatility index hit a 15-month low, while the U.S. VIX hit a 16-month low in this first trading week of the New Year.

- ***If only the tax code were like the Copenhagen climate wrap-up*** To the dismay of some delegates, the climate summit concluded with a 12-paragraph document—a statement of intentions, not even a binding document. By comparison, the standard federal tax publication has grown from 540 pages in 1939 to more than 70,000 pages.

The New York Stock Exchange (NYSE) advance/decline line is a reflection of a market movement's breadth that measures the ratio of advancing stocks to declining stocks.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking index derived from a monthly survey of U.S. businesses.

The Institute of Supply Management (ISM) nonmanufacturing, or services, index is a composite, forward-looking index derived from a monthly survey of U.S. businesses.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

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