

# The Week

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## The stock market has discounted a lot of good news

*New economic data show that the U.S. economy grew at the fastest pace in six quarters during the final three months of last year. The economy is clearly not in recession but still faces many problems. Therefore, the Federal Reserve voted to keep short-term interest rates at low levels until late 2014. Investors have responded positively to the good economic news during the past few months, and the stock market has rallied considerably from its 2011 lows last fall. With all this good news factored into current prices, the stock market recovery is probably due for a time out.*

The U.S. stock market has come a long way since its early October lows. Investor sentiment was very negative back then, and most investors probably did not expect the stock market to be where it is today. In hindsight, it is clear that the stock market had discounted a lot of negative news from last summer. Fortunately, the economic news did not get a lot worse, and the stock market rallied when investor sentiment turned from negative to positive.

No one knows exactly what will happen in the future. The best investors can do is determine if the markets fully reflect the current trends. Last year, the U.S. economy was not as weak as many investors thought, and the U.S. economy did not fall into a double-dip recession as many investors feared. As concerns about recession decreased, the stock market recovered.

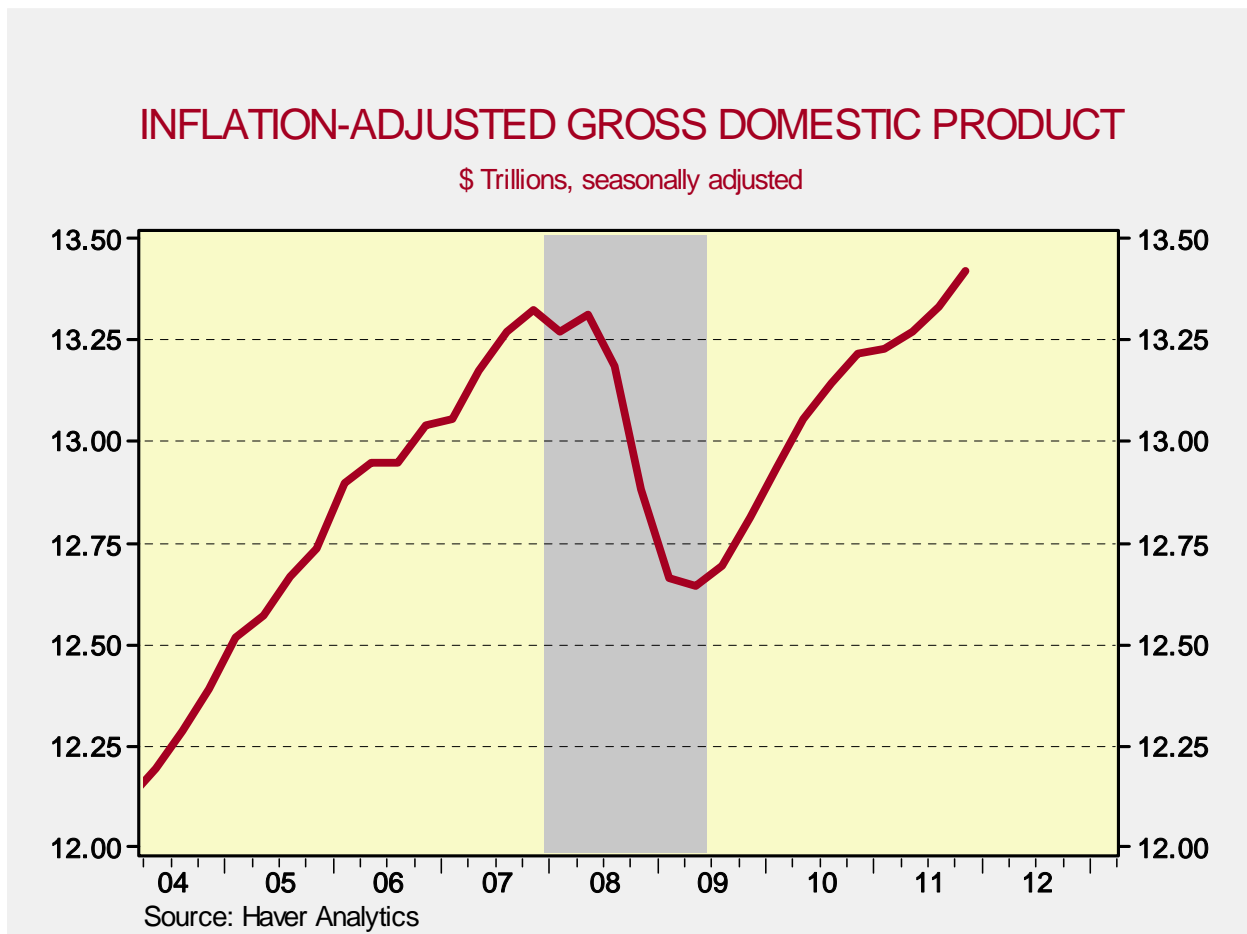
Now the stock market is near its highs of early last year, and a lot of good news is factored into current prices. However, we do not think that the stock market is overly optimistic. Therefore, the market is more likely to experience a correction rather than a reversal in its recent upward trend.

In early 2011 when the stock market was near current levels, investor sentiment was overly optimistic. Stocks had rallied approximately 100% in the two years since the March 2009 lows. Equally important, the rally in the stock market was widespread, with more than 80% of stocks in the S&P 500 trading above their 200-day moving average. With so many stocks already at high

prices, there were few stocks left to push the market higher. Optimistic investors were also borrowing against rising equity values, and margin debt was elevated.

Today, the stock market is near those same 2011 highs, although other conditions are not the same. Investor sentiment is not overly optimistic. Sentiment has improved during the past few months, but many investors are still cautious. Trading volume has been relatively light during the recent rally, suggesting that a lot of investors have probably not been buying stocks. In addition, the number of stocks in the S&P 500 trading above their 200-day moving average has increased but are not as high as they were early last year when the stock market was near the current levels. This suggests that there is still some upside potential in the market. There are still a lot of stocks that can increase in price and drive the market higher. Finally, margin debt has declined during the past eight months. As a result, fewer investors are likely to liquidate stocks to pay down their margin debts, if the stock market declines again.

Last fall when the stock market was depressed, we noted that the decline in the stock market was widespread. The number of industries with declining equity values was close to the same level that occurred when the stock market hit its March 2009 lows. If events had continued to worsen, the stock market could have dropped further. Instead, the economy was not as bad as investors feared, and sentiment was too negative. Therefore, the stock market recovered from the early October lows.



Today, the stock market has discounted a lot of good news. The U.S. economy expanded at a moderate 2.8% annual rate in the fourth quarter. The Fed voted last week to extend its low interest rate policies, and European policymakers are making progress to contain their debt crisis. With all this good news driving stock prices upward, the S&P 500 could be due for a pull back on profit taking during the next few weeks.

Looking ahead, we still expect U.S. investor sentiment to improve further this year as the U.S. economy continues to grow and central banks in many countries provide more monetary stimulus. In addition, many investors are probably wishing they had bought equities during the past few months when the market was lower. Therefore, we are only expecting a modest pull back at this time.

Obviously, anything can happen. Events could take a turn for the worse. We are closely watching the growing tensions with Iran and the risk of higher oil prices. However, at this point, we do not believe that the stock market is overvalued. Sentiment does not appear to be overly optimistic, and investors do not seem to be overly leveraged. Finally on the positive side, policymakers are adding liquidity to the global economy this year, not draining liquidity like they were early last year when inflation was the primary policy concern. Based on our macro view for further modest economic growth and declining inflation in 2012, we would view the potential for stock market weakness at this time as a buying opportunity.

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