

The Week

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Expectations are low

The fourth-quarter earnings reporting season begins this week. The good news is expectations are low despite the economy showing some signs of improvement. We believe investors are more likely to see better-than-expected results rather than weaker-than-expected results.

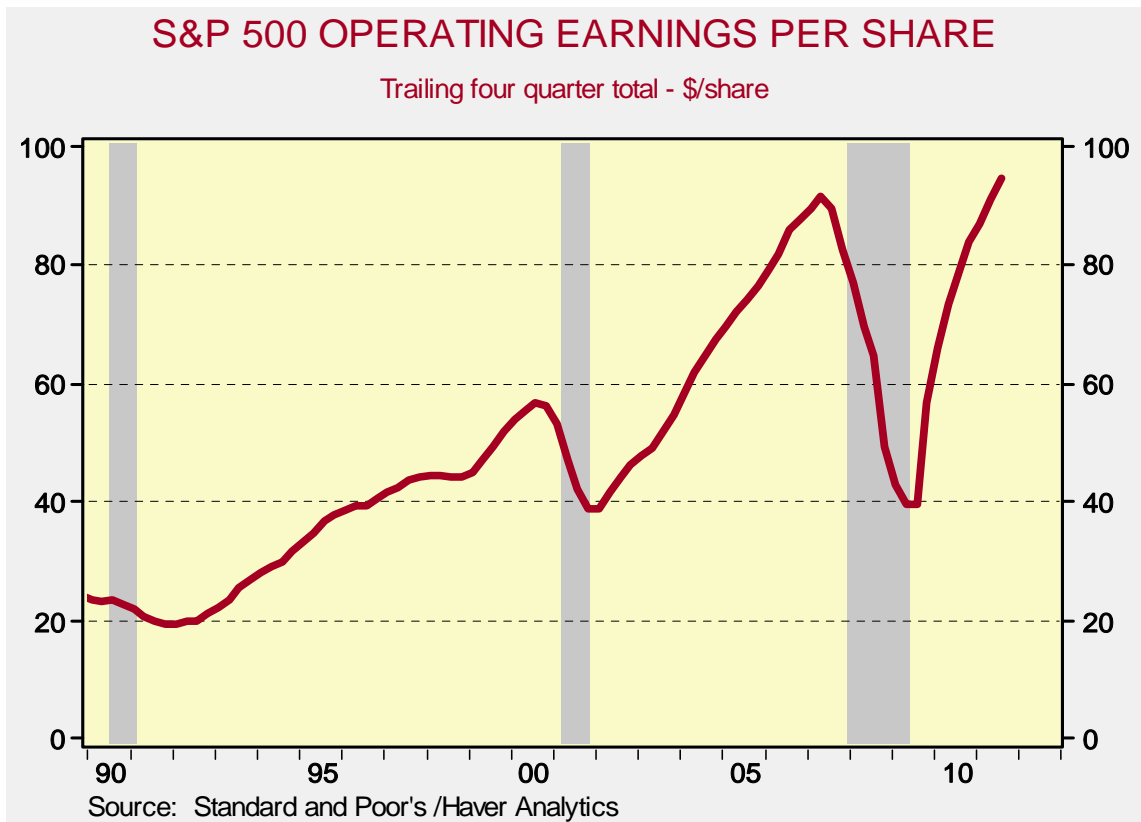
Investors face many risks. Generally, though, there are two types of risk. There is the risk that asset prices will go down, causing investors to lose money on current positions. On the other end of the spectrum, there is the risk that asset prices could go up, and underinvested investors could miss an opportunity for market gains. When expectations are high, investors are often optimistic and fully invested. That's when the risk of losses from price declines is usually the greater risk. Alternatively, when expectations are low, investors are often cautious and underinvested. In that case, the risk of missing an opportunity for market gains is usually the greater risk.

In last week's report, we said that investors are not as fearful as they were last summer during the shock to confidence that followed the U.S. debt downgrade and the escalation of the European debt crisis. Nevertheless, previous market action in December, including the dips in the market and the better performance of defensive stock market sectors suggested that investors were still cautious.

Fortunately, investor sentiment seemed to turn more positive during the first week of the new year as the economic news showed that the U.S. economy is getting better in several areas. One indication of the sentiment shift was the better

performance of cyclical stocks over defensive stocks last week. This is an encouraging sign that the recent recovery in the stock market could continue, and the S&P 500 could move up toward the highs of last spring.

Good earnings news could be the fuel that lifts the markets during the next few months. After all, earnings expectations are currently much lower than they were early last year. For example, analysts forecast that fourth-quarter 2011 operating earnings of the companies that make up the S&P 500 are likely to be only modestly higher than fourth-quarter 2010 earnings. Expectations were much higher this past spring when investors were generally optimistic and the stock market was at its highest level in three years. Specifically, in early May of last year, analysts were looking for fourth-quarter 2011 operating earnings to be 17.5% higher than the same period in 2010. Those expectations declined during the past eight months as the global economy slowed down. As a result, the soon-to-be reported fourth-quarter operating earnings are expected to be just 6.0% to 8.0% higher than a year ago. This was a substantial decrease in expectations since last spring. Consequently, the risks of negative earnings disappointments are probably less than the risks of positive earnings surprises.



Past performance is not a guarantee of future results.

Expectations for U.S. economic growth are also low. Recent surveys show economists expect U.S. inflation-adjusted gross domestic product to grow at a below-average rate in 2012, even though energy prices and job losses have declined during the past few months. Forecasters appear to be waiting for confirmation that the economy is improving before revising forecasts upward. Our work suggests many economic fundamentals are similar today to those that prevailed near important market and economic lows during the past two decades. Unfortunately, it could take several quarters before investors believe the economy is clearly better. With all the uncertainty around the globe, it is probably too early to forecast any significant strengthening in the U.S. economy. In the meantime, with low expectations, positive surprises may occur more often than negative surprises in 2012.

There is one final risk that investors always face. That is the risk from unexpected events such as last year's Japanese earthquake or Libya's civil war that can alter the path of the markets and the economy. During the past few months, investors

have worried about unexpected shocks from the European debt crisis. More recently, during the past two weeks, there has been increasing tension between Iran and the United States. In a worst-case situation, Iran is threatening to close the shipping lanes through the Persian Gulf in retaliation for Western government efforts to increase sanctions against Iran for continuing its nuclear program. Investors will be watching this situation closely.

In summary, investors always have something to worry about. Some of these risks are known and some are unknown until an unexpected event occurs. Investors need to position for evolving trends but be prepared if something unexpected happens. The economy appears to be getting better. But at this point, expectations for earnings growth are low as the fourth-quarter earnings reporting season gets underway. Therefore, we believe that investors could see more positive surprises than negative surprises in the weeks ahead, provided there are no major unexpected events that occur during this earnings reporting season.

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