

The Week

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What about stocks?

We have been saying for some time, that many of the current market trends have been fueled in part by the Fed's second round of quantitative easing, or QEII as the traders call it. Moreover, we have been concerned that once QEII ends in June, these trends could change. During much of the past month, the stock market was soft, suggesting that other investors probably share these concerns. We remain cautious on equities during the second half of this year, but longer-term positive.

Our equity strategy team's base-case year-end target for the S&P 500 remains 1250-1300. We have been saying since late last year that the stock market could do well in the first half of the year when liquidity is high and earnings comparisons are favorable. However, we continue to believe that stocks could make their 2011 highs mid-year and then consolidate in the second half of the year. So far, the stock market continues to move in line with our 2011 outlook.

So what should equity investors do? First, it is important to remember that no one knows the future. Our analysis is based on fundamentals that drive the market. But we realize that unexpected events could cause the market to do better or worse than we anticipate. For example, if there are positive developments, like an unexpected sharp drop in energy prices later this year, the stock market could do better than our base-case scenario. Alternatively, if an unexpected negative shock occurs like a sharp spike in energy prices, the market could do worse than our base-case forecast. Therefore, it is important for equity investors to follow a disciplined strategy for approaching the equity markets the rest of this year.

We are not looking for a major bear market. Instead, we are looking for the stock market to experience a modest correction. The U.S. economy appears to be entering a slowdown, and the Fed is going to be adding less liquidity to the financial system. Together, these factors would be slightly negative for stocks but not overly bearish. That's because at the same time, the economy is still likely to expand and corporate profits are likely to increase at a subdued pace. These positive fundamentals should be supportive for the stock

market, partially offsetting other negative factors. Obviously, it would be nice if the stock market could continue to rally at a robust pace that has prevailed since the lows in March 2009. However, history suggests that recent market behavior is not typical. The U.S. stock market rallied more than 85% from its cycle low on a monthly closing basis at the end of February 2009 through its recent high at the end of April 2011. There have been only four other times since 1926 when large-cap stocks experienced a similar or better advance over a short 26-month period. Unfortunately, the market was volatile after these moves and only once did the market continue to advance at a robust pace after the strong initial surge. That was in the midst of the great depression when the stock market was rebounding after four years of steep losses.

We believe that the stock market is due for a consolidation after the Fed stops the supply of extra liquidity that has been supporting the rally. Therefore, investors should make sure that their portfolio is appropriately diversified in order to weather potential market volatility. If the portfolio is over-weighted in stocks, an investor should use strength to rebalance the portfolio back to its appropriate weighting. Similarly, if a portfolio is under weighted in stocks, investors should use periods of market weakness to add to equities.

The good news is equities are not overvalued at this point relative to earnings, bonds and inflation. We expect the economy will continue to grow during the next few years, leading to increased corporate profits. Comparing current equity values to our projected earnings, the price-to-earnings

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ratio of the S&P 500 is slightly below the long-run average and is low relative to current inflation.

Moreover, the earnings yield on large-cap equities is higher than the current low yield available on fixed income securities. This means that stocks are undervalued relative to bonds. In addition, equities have an advantage over most fixed income investments if inflation were to increase in the years ahead. Stocks prices have the potential to increase as earnings grow, provided inflation is moderate and not so high as to derail the economic expansion. Fixed income investments, on the other hand, have fixed payment streams that have decreased purchasing power in an inflationary environment. Thus fixed-income securities do not tend to do as well as equities if inflation increases at a moderate pace.

In summary, the stock market has rallied sharply during the past 26 months, and may now be due for a period of consolidation when the Fed begins to take its foot off the accelerator. Our equity strategy team's base-case year-end target for the S&P 500 remains 1250-1300, slightly below current prices. Fortunately, the Fed is still signaling that it will keep interest rates low for an extended period. That means that the Fed may not begin to step on the brakes until later this year or early next year. If the market enters a correction or consolidation as we anticipate, investors should use periods of strength to rebalance and reduce over-weighted equity portfolios and use periods of weakness to average into under-weighted equity portfolios.

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