

# The Week

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## Investor sentiment shifts

*Recent market action shows that investors are turning more positive and less risk averse. This can be seen in the continued advance in U.S. equities during the past few weeks at the same time that the U.S. credit markets, especially the Treasury market, dropped. This seems to be a significant shift from the past two years, when investors favored the safety of bonds over the risk of stocks. It now looks like many investors are more willing to take risk and are shifting from bonds into stocks. This is a vote of confidence in U.S. economic prospects. However, investors still need to be selective.*

In last week's report we provided the executive summary of our 2011 Economic and Market Outlook which is titled Opportunities in Challenging Times. Throughout this report we discussed sectors within the equity markets, credit markets, currencies and commodities that are likely to present the best opportunities for investors to find favorable returns. We are only looking for modest gains in the U.S. equity markets during the next year, and we expect 10-year Treasury note yield to increase slightly from the current level. If we are correct, investors will want to be in the best performing sectors in order to do better than the moderate returns of the market averages.

Many investors who are looking more seriously at stocks may be asking several questions. First, is it too late to get into stocks after the big gains since the market hit bottom in March 2009? Second, if investors are turning more favorable on stocks, won't all markets do better? Third, should investors holding big bond portfolios significantly reduce their positions because bond prices have dropped recently as yields increased?

Our answer to all three questions is no. First, we do not believe it is too late to get into stocks, although it won't be clear sailing going forward. Second, all markets are unlikely to do better even if investors are turning more positive. Our country still faces many challenges and some parts of the economy should perform better than others. Therefore, we are not looking for every sector to do well. Third, the drop in the bond market during the past few weeks is probably overdone, and selling into weakness now to reduce bond portfolios may not be the best strategy. There are likely to be better opportunities to scale back bond

portfolios than at currently depressed prices, if an investor wants to take more risk in the year ahead.

So let's look at each of these questions more closely. First, we do not believe it is too late to get into stocks for investors willing to take more risk. During the past year, the resiliency of the stock market was tested several times. However, the market passed those tests. Investors now believe that the economy is likely to be stronger in the year ahead, thanks to increased corporate profits, the Fed's second round of quantitative easing, the extension of the Bush era tax rates and the one-year cut in Social Security payroll taxes. In addition, the price-to-earnings (P/E) ratio on the S&P 500 is still very reasonable and not too high as it often is when the stock market is overvalued. If the P/E ratio was very high, then it would be too risky to be getting into stocks at that point. Fortunately, we are not there yet. Nevertheless, investors wading back into the stock market now are not getting in early. The equity markets are up substantially from their lows, and gains going forward are likely to be modest compared to the big gains in the early stages of this rally.

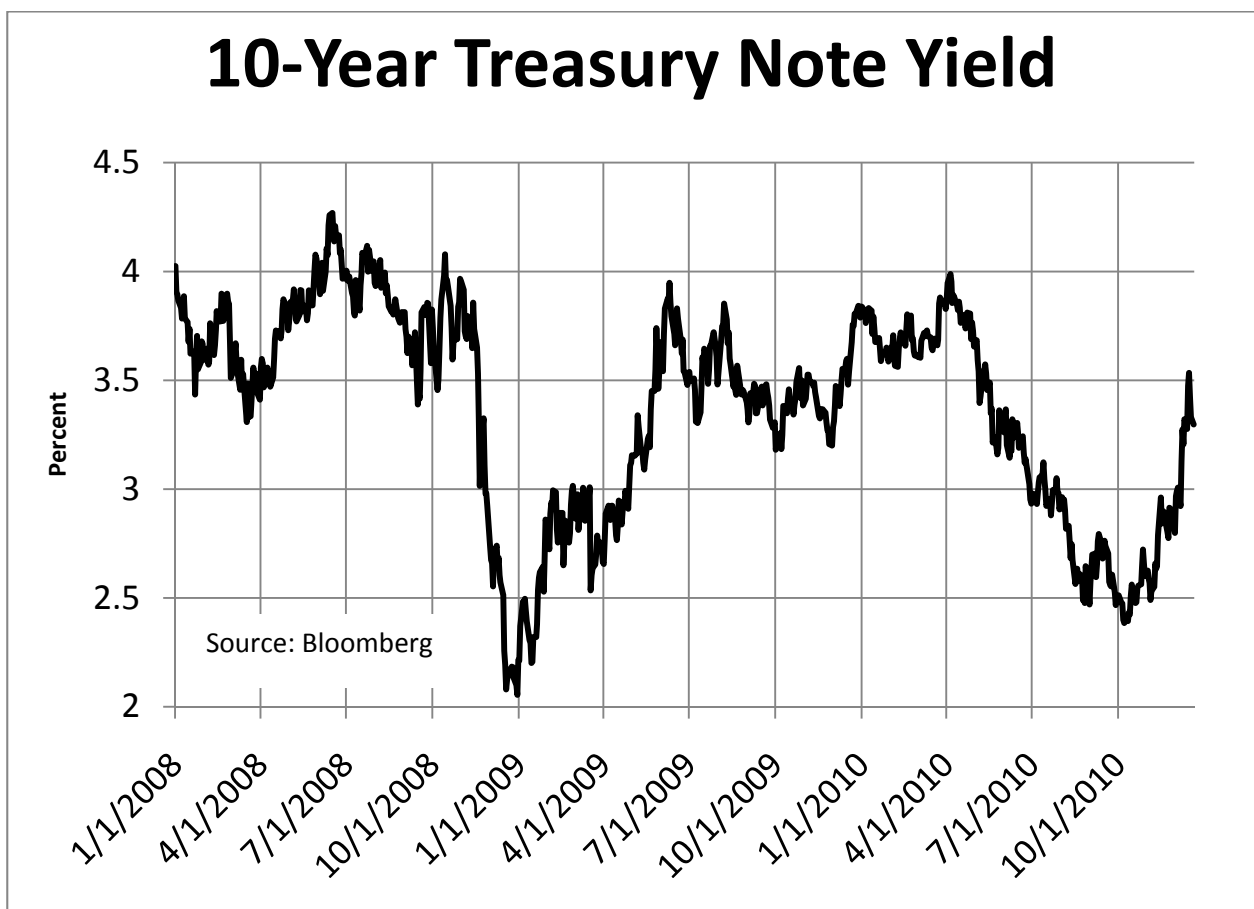
Looking more deeply at the second question, not every sector of the market is likely to do well, even if investors are putting more money into stocks. Many investors are likely to do what we are advising, seek out the best opportunities. If so, then we expect the cyclically sensitive sectors of the stock market, especially the industrials and materials sectors to outperform the defensive sectors. After all, industrials and materials are likely to do better as the economy expands in 2011. On the other side of the spectrum, the defensive consumer staples and the health care

sectors are not likely to attract as many investors, if investors are seeking higher returns in more cyclically sensitive sectors.

Returning to the third question, we do not expect investors to dump bonds even though there has been a lot of talk about a bond bubble. To begin with, we expect inflation to increase only modestly in 2011. Bonds would still offer an attractive return over inflation if consumer prices increase at a 2.0% rate as we anticipate. Moreover, we expect the Fed to keep short-term interest rates near zero. Consequently, many investors are likely to buy bonds, supporting the bond market, if yields increase relative to that near-zero-short-term interest rate. Finally, it is important to remember that the memories of the 2008 financial crisis have not faded completely. Many investors close to retirement cannot afford to watch their portfolio

suffer like that again. Therefore, a lot of investors will still probably want to buy and hold bonds as long as these memories linger, and the economic outlook remains uncertain.

So what should investors expect going forward? We believe that these are still challenging times. Our budget deficit and unemployment problems have not gone away. In addition, as we said in our outlook report, the United States is following the lead of stronger economic growth overseas, making us vulnerable to unexpected global events. Therefore, investors who want to take more risk by shifting from bonds into stocks should be patient and wait for the right opportunities. Markets will not move in only one direction. The stock market will be tested again. Investors are still likely to get an opportunity to buy stocks on pull backs and sell bonds on rallies, if they want to do so.



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