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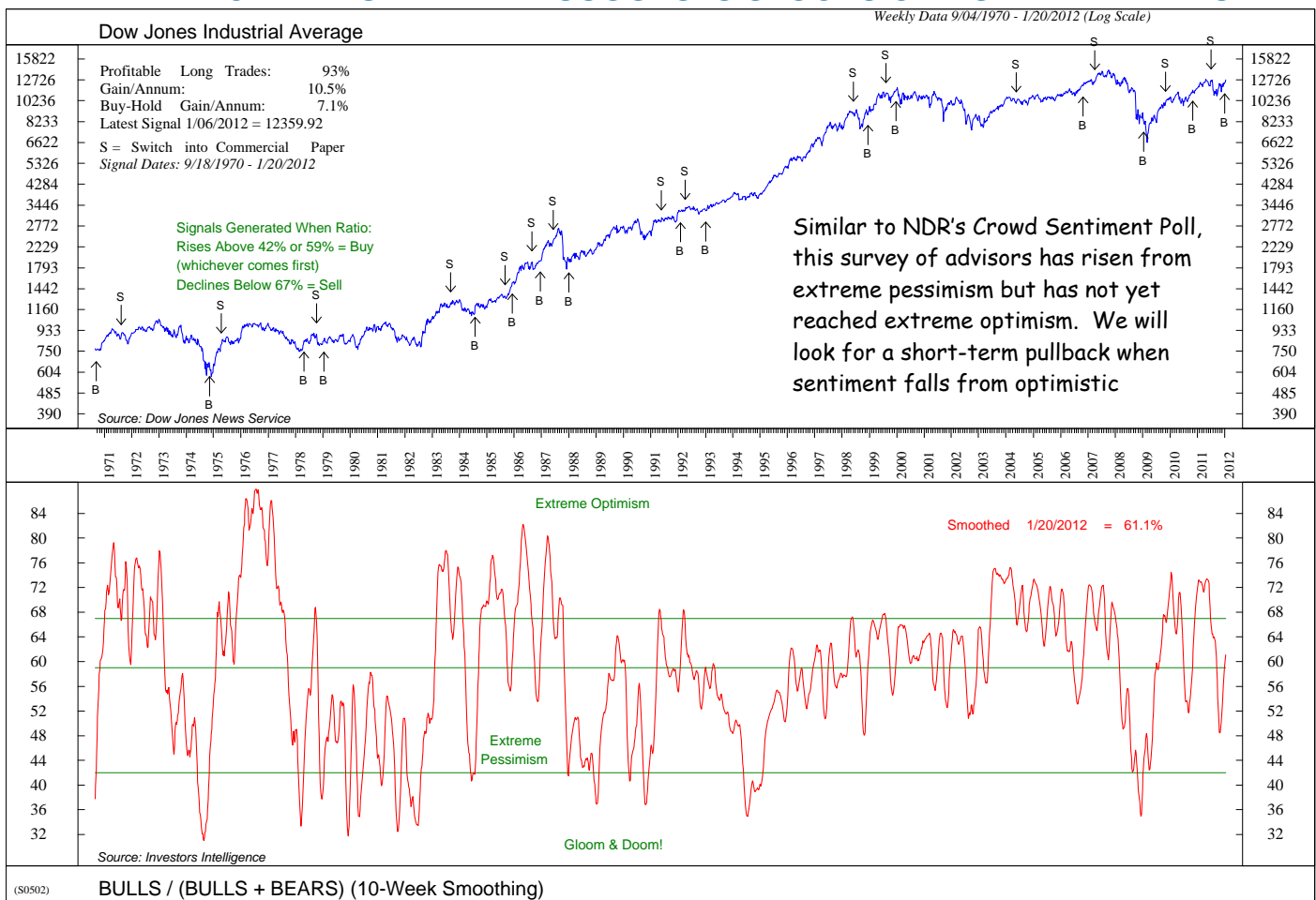
## 'Risk On' In January But Policy Purgatory Persists

- Risk assets have had a good early start to 2012; the S&P 500 is up 5% year to date, while long-term US Treasuries are down 2%. We think this could continue for another week or two. Investor pessimism is receding, but has not yet been replaced by excessive optimism, which has tended to be the best environment for stocks according to Ned Davis Research's weekly Crowd Sentiment Poll. We expect that the S&P 500 will encounter technical resistance around 1360, its 2011 high, as optimism becomes excessive. Fourth-quarter earnings have been coming in slightly better than consensus estimates, but these estimates have been guided lower entering into earnings season. We do not anticipate much top-line growth in 2012, particularly with Europe in recession, China slowing, and the US muddling through. However, lackluster sales growth should be offset to some degree by further balance sheet expansion among the world's major central banks and selective policy easing in emerging markets, especially with inflation decelerating around the world. In addition, profit margins are likely to remain high amid ongoing technologically-driven (labor-saving) productivity improvements, not to mention an abundant supply of global labor and a notable absence of escalating protectionism.
- As we wrote last week, we think much of the apparent increase in investors' risk appetite is policy related, with fears diminishing over collapses in European banks or Chinese property. Recent actions by monetary and fiscal authorities have calmed markets – yields on 2-year Italian government bonds have fallen to 3.9% from 7.8% in late November and Spanish government yields have fallen to 3.3% from a high of 6.2%. But risks remain. Greece has an upcoming €14.4 billion debt payment on March 20 that, without help, it appears unlikely to make. This underscores the fragile capital bases of Europe's banks, which will require an estimated €115 billion by mid-year. Another ECB long-term refinancing operation scheduled for the end of February may help ease any funding and liquidity problems banks may still have, but capital adequacy and sovereign solvency issues remain unresolved. In China, property construction and residential housing prices are now declining year over year, a deliberate outcome that policymakers would like to see continue. On the other hand, with civil unrest a primary concern, China's new leadership will likely enact fiscal stimulus and public investment (such as in health care and education) aimed at boosting consumption and the nascent service economy.
- Recent US economic data has been encouraging and supports our belief that the economy is moving toward self-sustaining expansion and not about to fall back into recession. Initial jobless claims for unemployment insurance dropped to 352,000 last week, the lowest level in almost four years. If the four-week moving average (the weekly series can be volatile) — currently at 379,000 — continues to fall, then we think economic growth should be able to accelerate. Jobless claims have a fairly high correlation with GDP and present levels suggest 2%-plus growth (up from sub-2% growth rates last year). However, if payroll tax reductions and jobless benefits are not extended beyond February by Congress, the fiscal drag could weigh on economic growth later in the year when austerity measures take effect. As employment trends continue to improve, inflation both at the wholesale and retail level is decelerating. Declining energy prices, led by a glut of natural gas and relatively warm winter weather, have freed up some discretionary income, helping raise consumer confidence. Finally, existing home sales are starting to pick up, with December sales up 3.6% from the previous year as mortgage rates have reached record lows around 4%. Also, thanks to downward revisions to listed homes, housing inventory has declined substantially. At current

sales rates inventories represent six months supply (down from seven in November), which has traditionally been considered normal. However, there are still a significant amount of properties in the foreclosure pipeline, which are likely to continue to weigh on home prices in markets where there are large percentages of negative equity.

- The Federal Reserve is expected to reveal a new communications strategy on Wednesday following its committee meeting. From the last meeting: "the SEP [Summary of Economic Projections] will include information about participants' projections of the appropriate level of the target federal funds rate in the fourth quarter of the current year and the next few calendar years, and over the longer run; the SEP also will report participants' current projections of the likely timing of the first increase in the target rate given their projections of future economic conditions. An accompanying narrative will describe the key factors underlying those assessments as well as qualitative information regarding participants' expectations for the Federal Reserve's balance sheet." Currently, the Fed's only forward guidance on rates is "exceptionally low levels for the federal funds rate at least through mid-2013." While increasing transparency in the decision-making process, with each participant potentially having different views, there may be some confusion as to which view takes precedence or is 'more equal' than others. Previously, a 'central tendency' to an average has prevailed, but the new reporting format is likely to draw more attention to 'outliers' (and their records for accuracy).

**THE WEEKLY CHART: SENTIMENT SUGGESTS STOCKS CAN GRIND A BIT HIGHER**



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