Roosevelt Investments Market Commentary

February 2012

The stock market continued its uptrend and performed strongly in January, with the S&P 500 index notching a total return of 4.5%, which was more than double its return for all of last year. From the market's mid-December low near 1160, it has been almost an uninterrupted run up to 1350, or a 16% move. We believe the market is continuing to respond to the events we discussed in our recent quarterly note, in particular the U.S. economic recovery and decoupling from Europe, central bank liquidity and the reduced risk environment.

Of the roughly two-thirds of the companies in the S&P 500 index which have reported quarterly earnings so far, 70% of those have reported positive earnings surprises while 57% have reported sales above expectations. Reported revenue growth has been nearly 7% on average, while earnings have grown by just 4%. While this level of earnings growth might be viewed as disappointing, it is important to note that the stronger U.S. dollar has had a negative earnings impact for many multinational companies, and in addition the accounting impact of accelerated depreciation incentives for purchasing machinery in 2011 also likely depressed profits.

It has now been eighteen straight weeks that the U.S. economy has been on an improving trajectory as indicated by macroeconomic data, including ISM surveys, durable goods orders, regional Fed surveys, and consumer sentiment. Given that consumer spending is a disproportionate driver of our economy, labor statistics are also of critical importance. On this front, unemployment claims have been steadily declining, as layoffs have fallen with improved activity and better sentiment by employers. New claims are now at the lowest level since April 2008, and the unemployment rate has fallen to 8.3%.

Reports also indicate that the number of people quitting their jobs has now exceeded the number of workers being laid off for over a year, and the spread is growing. This shows workers are more confident in their ability to find a better employment situation, as well as a greater number of job openings to apply for. There has been broad-based hiring activity in manufacturing, construction, accounting firms, restaurants and retailers. High profit margins may be acting as an inducement for employers to hire more workers, as the economy begins to show more signs of life. U.S. manufacturing activity is now at the strongest level in seven months, and somewhat surprisingly, manufacturing and services have expanded in the Eurozone in January, led by Germany and France. This helps reduce the likelihood of a severe recession in Europe this year, despite pressures which are still abundant particularly in the weaker periphery countries.

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Roosevelt Investments Market Commentary, Cont'd.

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The Federal Reserve at a late January meeting indicated that interest rates would likely remain lower for a longer period of time, perhaps until 2014. Slack capacity and still-high unemployment has eased concerns about inflationary pressures creeping into the economy. Chairman Bernanke also suggested that QE3 might be a possibility if the level of economic activity does not improve. The Fed's easy monetary stance adds to a market environment that is already quite supportive of capital markets. Recall that in the last two months of 2011, the Fed, the European Central Bank (ECB), and other large central banks undertook several actions which effectively increased the global money supply, and the Fed is now saying that if that is not enough, we are ready to provide more. In addition, the ECB later this month will engage in a second long-term refinancing operation (LTRO) by which Eurozone banks can borrow at very low rates. We will now recite an investing mantra to share with you our thoughts on all of this liquidity: "Don't Fight the [global] Fed"!

Trading volumes have been somewhat weak so far this year and data indicates that the preponderance of hedge funds have relatively low exposure to equities, meaning that they have generally missed much of the rally. It seems likely that many investors may not have participated in the rally when one takes into consideration the massive amounts of money withdrawn from stocks in recent years. Given the relatively low yields offered in the bond market today, it is not difficult to imagine a scenario where some of this cash, along with the underinvested hedge fund community, will increasingly feel pressure to return to the stock market and propel a further rally. This is particularly true in light of the greatly improved risk environment and credit spreads which have fallen dramatically in response to the liquidity conditions discussed above.

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We remain constructive on the market and believe we have reached the point of self-sustaining economic growth. At its heart, this virtuous cycle starts with an improving employment picture which feeds into increasing consumer confidence levels. A consumer who is feeling better (particularly after having survived several tough years) is more likely to go and kick the tires on a new car, think about buying a new home or perhaps renovate an existing one, all of which drive manufacturing activity of one sort or another and create additional ripples of economic activity that may spur further hiring or production. Taking this argument further, since both housing and automobile production are still at very depressed levels relative to the middle of the last decade, it is conceivable that economic activity might well accelerate significantly from current levels, although we are not building more than a modest improvement into our forecasts.

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