



Commentary

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So much of what has been covered in the media of late has focused on the unrest in North Africa and the Middle East. The spread of democratic ideas, accelerated by the rise of the internet, has led to abrupt upheavals in that region. The world watches and wonders what kind of change may follow now that the proverbial "genie" is "out of the bottle."

Financial markets, however, remember all too well the 2008 spike in oil prices to \$145 a barrel. There is understandable concern that higher energy prices resulting from unrest could throw cold water on the nascent expansion. We recognize this risk, but also realize that there is no sure or reliable link between short-term oil price volatility and economic or market performance.

If prices do remain elevated for an extended period of time, it will then affect fundamentals, and we would expect to see that manifest across a wide variety of inputs to our investment process.

Most Trends Are Favorable

In short, the pulse of the recovery appears strong. As our readers know, we have a series of indices that track thirty different aspects of market and economic behavior. A far greater proportion of those observations are leaning toward recovery than contraction at this point. Not only are stocks generally outperforming bonds, and credit markets are behaving in a way that suggests risk-taking appetite is alive and well, but most of the "hard" data on the economy is moving in the right direction too.

Compared to the start of the year:

The WCA Credit Conditions Index™ has slipped slightly to 65 from 70

The WCA U.S. Economic Conditions Index™ has risen to 80 from 70

The WCA Foreign Conditions Index™ has risen to 65 from 60

The WCA Fundamental Conditions Index™ has risen to 70 from 65



Recent Economic Data Is Improving

Both the Economic Research Cycle Institute and the Conference Board's index of leading indicators are moving higher.

A greater percentage of the U.S. population is working, and continuing claims for unemployment benefits are falling along with new weekly claims. Private sector payroll gains have proceeded for eleven months, and 1.3 million jobs have been added in the private sector.

The monthly employment report for February showed continued improvement in the jobs picture. Nonfarm payroll jobs increased 192,000. If we exclude net job losses at the government level, private payrolls look even better, as they increased by the most since last April to 222,000. Manufacturing also added 33,000 jobs. The labor force participation rate remained depressed at 64% (it had been over 66% before the recession). The combination of more jobs and a smaller labor pool, as defined by the Bureau of Labor Statistics, produced a drop in the official unemployment rate to 8.9% from 9.0% the prior month.

A pickup in spending is mirroring the improvement seen in the employment picture. Consumer spending is rising at the best year-over-year rate (2.8%) since 2007, while the average American is holding slightly lower weeks of income as cash (35.6 weeks vs. 36 weeks in November). Chain store sales are rising at a 4% year-over-year pace based on the average of the past 3 months. Automobile sales are running at a 12.8 million average annual rate over the past three months vs. 11.8 million units in November.

Orders for capital goods (excluding aircraft and defense) are rising at a \$64.5 billion 3-month average rate vs. a \$63.5 billion rate in November, while new manufacturing orders are rising faster than inventories (the 3-month average ratio was 1.3 in January vs. 1.0 in November).

Housing remains a lag, however.

Based on the most recent S&P Case/Shiller data, the national 20-city price index remains negative year-over-year (-2.38% through December). All of the following metropolitan areas are also again contracting year-over-year: New York, Boston, Miami, Chicago, Portland (Oregon), Cleveland, Denver, Atlanta, Miami, Philadelphia, and Las Vegas, for a total of 12 of 16 areas. The four areas still showing gains are: San Diego, San Francisco, Los Angeles, and Washington, DC.

Meanwhile, new home sales, pending home sales, and building permits were all down sequentially from December to January. The weather was poor in January, but the spring selling season is now in full swing. The February and March data will be closely watched for signs of improvement.

Deficits Remain Very High

The Federal budget deficit remains over 8% of GDP. This level is five times the size of the deficit that prevailed between 1990 and 2008. This is consistent with a level of government involvement in the economy that is typically associated with wartime, rather than peacetime economies.

Because there is no way to untangle the effects of government actions from the private sector in the data we review, there is also no way to discern how much of the improvement is the result of private actions, and how much is dependent on government deficit-financed spending. What we do know is that an expanding economy will tend to reduce the deficit because tax revenues will expand faster than expenditures. A contracting economy tends to contract revenues and bring about cries for more government spending.

The recent budget proposal continues relatively high levels of current and anticipated spending, just as the Federal Reserve continues to indicate the need for exceptional monetary ease. The longer into the recovery that fiscal and monetary policy remain on an "emergency footing," the more likely the distorting effects on asset prices.



Earnings and Equity Valuations

Consensus opinion among analysts is that earnings for the S&P 500 should amount to approximately \$100 in 2011 (14% growth), \$110 in 2012 (13% growth), and \$120 in 2013 (11% growth).

In addition, the bond market appears to be pricing in a 2.4% inflation rate, although that rate has been rising sharply of late, which could put some upward pressure on interest rates.

Our target remains 1,440 for the S&P 500 by year's end. This would approximate a 10% expected return. The key assumptions underlying this estimate are:

1. Economy continues to expand at a +3% rate
2. The WCA Fundamental Conditions Index™ remains above 50
3. Inflation remains in a 2-3% range with long-term Treasury bond yields remaining between 3-4%.

Conclusion

We continue to see improving trends in most of the data we examine. Recommended portfolio weights continue to be tilted in favor of equities over bonds. Small capitalization, emerging markets, cyclical sectors, and growth style categories are more heavily represented in model portfolios.

As for fixed income, we maintain a range of exposure from short-term Treasuries to high-grade and high-yield corporate bonds.

Alternative assets in the portfolio mix include gold and real estate investment trusts.

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