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Banks Boost Liquidity As United States Growth Accelerates

Highlights:

- ✓ *U.S. remains most attractive investment area*
- ✓ *Recent temporary liquidity provisions not cure for Europe*
- ✓ *Public to private sector "handoff" continues as seen in recent employment report*
- ✓ *Although valuation seems to favor equities over bonds, uncertainty over policy remains a key impediment*

Central Banks Add Liquidity... Again...

Markets heaved a collective sigh of relief on news that the world's central banks were again willing to cooperate to relieve mounting stresses within the global banking system. For the third time in as many years, the six largest central banks announced last week that they would cooperate in providing credit to one another on a temporary basis, and that such credit would be available at a lower cost. At the same time, China cut its "reserve requirement" for its banks. Unlike western banks' temporary liquidity injection, China's move has longer-lasting implications, because lower required reserves on deposits permits banks to "permanently" expand the overall level of credit available to the economy. This "cocktail" of monetary actions was the primary reason for the stock market's 7% rally last week.

Beyond Banks

Beyond the fray of central banks and credit markets, there are signs that the real domestic economy continues to chug along while foreign economies are faring worse. The national survey of purchasing managers, published by the Institute for Supply Managers, indicated modest expansion in the United States last month, and the pace of growth seemed to pick up. Orders also appear to be expanding faster than inventories, which suggest the potential need for some increased future production. While it may be a bit premature to sound the "all clear" bell, the overall pace of manufacturing growth appears consistent with slow, but positive growth right here in the United States.

Friday's jobs report also continued to make slow progress here at home. Every major category of employment expanded except for government jobs. The private sector added +140,000 jobs in the month of November, with increases in retail, professional services, leisure and hospitality, and healthcare. State and Federal government employment detracted 20,000 jobs from the private sector number (there were 5,000 job losses associated with the struggling postal system alone). This shift from publicly led expansion to privately led

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expansion is consistent with the ongoing "handoff" of leadership from the public to private sector. In the meantime, slow-but-positive net job growth remains the prevailing trend here in the United States. This is not to say that all is well, but positive numbers are a far cry better than the alternative.

U.S. As Best Option

Europe's financial crisis has had its impact on growth overseas. It has impacted confidence, government spending, and credit availability. A "mild deterioration in overall operating conditions for the third straight month" was seen in a global purchasing manager's survey compiled by JP Morgan. According to the report, "manufacturing production dipped marginally for the fourth successive month. However, the near-stagnation signaled at the headline level masked rising national disparities beneath the surface." In other words, the strength of the United States made the report less bad than it would have otherwise been.

The report goes on to further describe the divergence in activity. The survey states that overall growth would have been "materially worse" last month if it hadn't been for the United States. Specifically, Europe and China are suffering the sharpest falloffs in activity seen since spring 2009. Japan, South Korea, and Taiwan are also experiencing similar slowdowns in output. Of particular interest is the fact that the slowdowns are occurring in unison and are the result of declines in new orders, rather than due to an interruption in supply chains.

Long-Run Valuations

We continue to see that S&P 500 earnings are holding above the $100 mark, based on forward 12-month analyst expectations. With the S&P 500 trading near 1,250, the forward-looking "earnings yield" is near 8%. This is about 6% above the 10-year Treasury yield. In other words, investors in stocks appear to be getting a relatively attractive value compared to bonds when viewed from a long-term perspective. Even if earnings were to be cut to $80, the yield would provide a relatively attractive alternative. Better valuations, plus an improvement in fundamentals, could provide a very compelling case for equities after a long period of rocky performance.

Our takeaways from last week are fourfold:

First, the United States remains the most attractive investment arena based on fundamentals, in our view.

Second, there remain significant stresses in overseas markets that are requiring special attention by central banks, but recent liquidity provisions are not cures to underlying ailments.

Third, there remains ongoing transition to private-led economic growth from government-driven growth. This transition is, by nature, awkward, but necessary for the return to a more balanced and well-functioning economy.

Fourth, long-run valuations seem to favor stocks over bonds given current earnings and interest rates. Improved confidence in policy and better fundamental outlook would go a long way in unlocking some of the potential value creation in equity markets.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."