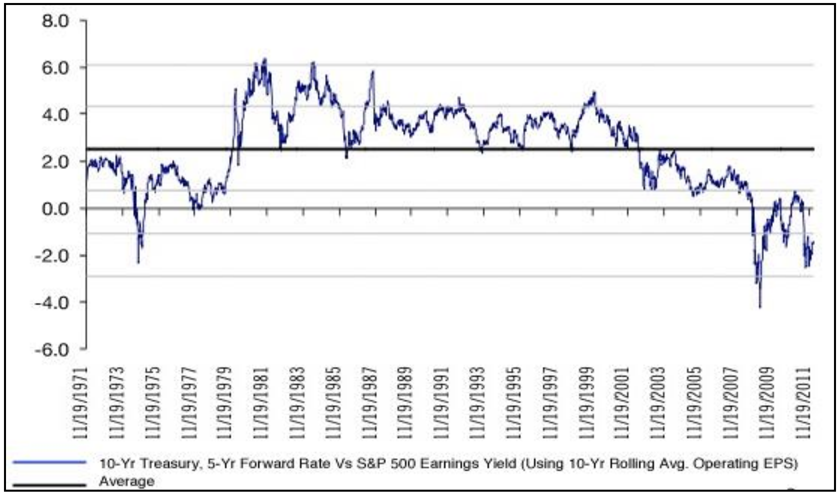
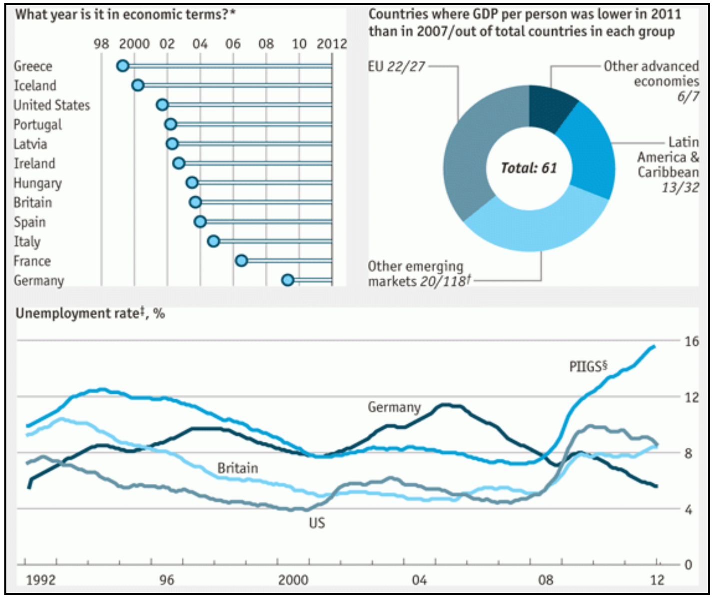
Market Recap

10-Year Treasury Vs. S&P 500 Earnings Yield



Source: Citigroup

Lost Economic Decade



Source: The Economist, IMF

With the dramatic run-up in the stock market at the beginning of the year, it has become more difficult to find fundamentals that suggest continued market outperformance. However, one measure that indicates that stocks remain undervalued is the spread between the S&P 500 earnings yield and the 10-year Treasury yield. Comparing the S&P 500 10-year rolling earnings to the yield on the 10-year Treasury, the spread is significantly wider than its historical average. In order for the differential to return to its norm, one scenario is that the stock market would need to advance 24% during the next 12 months. In 1999, when stocks were near a peak, the spread was reversed, as investors were getting far more yield from risk-free Treasuries than they were from equities.

Talk of a Japanese-style 'lost decade' has persisted since the financial crisis took hold in late 2008. According to a report by The Economist, the U.S. has regressed in time some ten years in economic terms. The study was based on seven indicators covering economic output, wealth, and labor markets. GDP per person was at a higher level in 2005 than today. In addition, most stock market indices were higher in 1999. Of the countries considered, Greece has fared the worst. In economic terms, it is just entering the new millennium again. Overall, wealthy nations have been hardest hit by the financial crisis. Just six of the 34 most advanced economies report GDP per person at a higher level in 2011 than in 2007.

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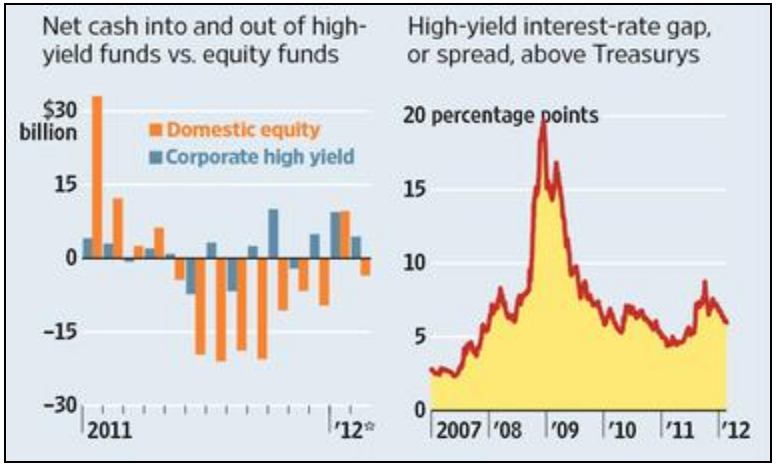
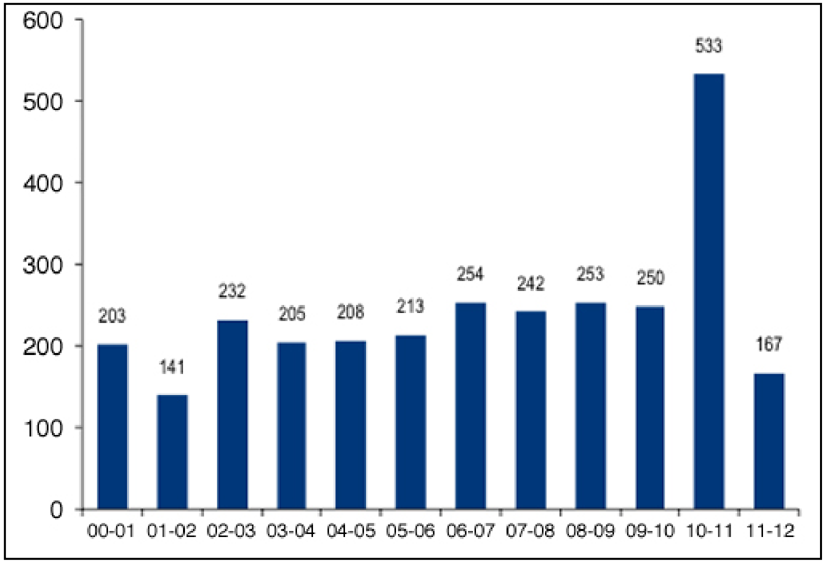
High Yield Bonds



Source: WSJ, Lipper

People Unable to Work Due to Bad Weather (Dec.-Jan. Average)



Source: Bureau of Labor Statistics

Year to date, investors have been piling into 'junk' bonds (bonds rated BBB or below). Buyers are coming in two forms - bond investors shunning the low yields of Treasuries and stock investors seeking shelter from market volatility. A current strength of high-yield bonds is that company balance sheets have been improving. Companies have used the recovery of the past three years to refinance their debt at lower rates rather than taking on new debt. According to Lipper, investors have plowed $11.8 billion into high-yield bond mutual funds this year, compared with $4.8 billion for stock funds and $9.9 billion for investment-grade bond funds. Those who believe that high-yield bonds are poised for growth cite that their current yield is 7.15% versus the 6.75% low of a year ago. In addition, the premium, or spread, between high-yield bonds and Treasuries is 6.3%, still well above the record low of 2.43% reached at the peak of the credit boom in mid-2007. Buyers should be mindful that yield is only one of many considerations when investing in high-yield bonds.

This has been one of the most unseasonably mild winters on record, highlighted by very few snow storms. According to statistics compiled by the Labor Department, this has been the least disruptive winter for workers in a decade. During December and January, 167k people were unable to work due to snow compared to 533k in the same period a year ago. Warm weather and an absence of severe snow storms has a tendency to boost construction, retail sales, and general economic activity. In addition to the benefits derived from a mild winter, the economy has been boosted by both foreclosure delays and low gas prices. The influence of all these factors is temporary and may wane in the coming months.

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