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INSIGHTS

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2012 Q1 Market Recap

Written on April 5, 2012 with the S&P at 1398.

RECAP: The S&P 500 bull market turned 3 years old this quarter. How did the equity index celebrate? It posted gains in 11 of 13 weeks and had a positive performance every month. This consistent string of profits drove the market to its best quarter since 2009. This included its best first quarter since 1998 with a gain of over 12%. Stocks easily beat bonds as the latter lost -0.30% in Q1.

The quarter may have marked the time when equity markets started on a path back to "normalcy." Stocks started to react to actual fundamentals (increasing earnings, low valuations) rather than moving as one in lock-step to the latest overseas news. While not yet close to normal, the bond market became less irrational. Even with Bernanke and the Fed controlling a large percentage of Treasuries, the bond market reacted to stronger economic data and 10-year yields moved up 34 bps to end the quarter at 2.21% (an 18% move from the 10-Year Treasury yield of 1.87% at year-end).

	Sector	Q1	TTM
Stocks	S&P 500 (Large Cap)	12.29	8.54
	Russell 2000 (Small Cap)	12.44	-0.18
	World ex-US (International)	10.48	-9.88
	Emerging Markets Equity	13.65	-11.05
Bonds	Aggregate Bond	0.30	7.71
	Short-Term Bonds	0.42	1.93
	High Yield	5.34	6.45
	Global ex-US Aggregate	1.16	3.70

Fundamentals mattered once again perhaps because there was not much news out there to begin with. The first three months were a stark contrast to 2011:

- No Japan-like disaster: Although there were some large storms there were no major natural disasters—and in fact the weather in most of the country was very benign and spring-like benefitting retailers, homebuilders, etc.
- No Arab-Spring: The turmoil in Syria and constant chatter about Iran does linger but appear to be on the back-burner for now
- No Congressional showdowns: Q1 was a nice respite from the debt-showdown of last summer and the upcoming elections
- No string of disappointing economic indicators: Some leading indicators are deteriorating but for the time being they have been countered with other improving data elsewhere

The result? No reason to sell and thus no volatility. The current quarter is in stark contrast to the last 5 years when investors witnessed extreme volatility in equity markets.

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EQUITY: The main characteristic of the first quarter was the positive reversal in the stocks that underperformed in 2011. Big Banks joined Technology and Consumer Discretionary as the sectors that led the S&P while more defensive areas such as Utilities lagged. Growth led Value (14.6% to 11.1%) and Small Caps nearly matched the S&P, trailing by only 15 bps. Overseas, Emerging Markets outperformed Developed Markets (13.6% vs. 10.5%).

FIXED INCOME: While the Aggregate Bond Index posted a negative quarter, the losses were confined primarily to the Government Sector. In fact, corporate bonds did quite well. Investment grade debt was up over 2% and High Yield gained over 5%. However, current real yields (yields after inflation) on the 10-year Treasury still hover around 0.20% and were recently *negative*—ensuring inflation-adjusted losses over the life of the bond.

OUTLOOK: Unfortunately, stocks and corporate bonds were not the only "asset" to post sizeable gains. Oil and Gasoline prices were up as well with further increases threatening to slow our fledgling economy. Higher energy prices serve as a dual edge sword as they not only crimp margins by raising input costs but also hurt demand as higher gas prices crimps discretionary income.

Equity Markets have gained over 30% since the lows in October. We believe it is safe to say that the next 30% won't be as easy nor will it come as quickly. Potential problems could center on:

- United States
  - Below trend GDP and declining Leading Economic Indicators
  - Declining earnings due to higher oil prices
  - November elections
- Overseas
  - The European debt crisis could flare up and this time center around Spain
  - Europe on the brink of recession
  - China's economy may experience a hard landing
  - Iran and their nuclear capabilities

An average historical valuation of the S&P 500 would imply a rise of about 14% to 1600. However, as we have stated before, these are not normal times. Even with the headlines above, investors would be wise to revisit our August guidance on *relative valuations* and acknowledge the fact that bonds are historically expensive while stocks are (now) reasonably valued. In the last 6 months, Price/Earnings have expanded from 10 to the 13 range. While a further expansion to 16 is eventually probable, near term it may not be plausible given the speed and amount of the recent appreciation.

For additional copies of *Insights* or the *SEIA Report* please contact Allison Crandall at (800) 723-5115.

We at SEIA thank you for your continued support.

Sincerely,
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