



Common Sense is Uncommon: Our Hidden Economic Resilience Equity Strategy Update-Winter 2011

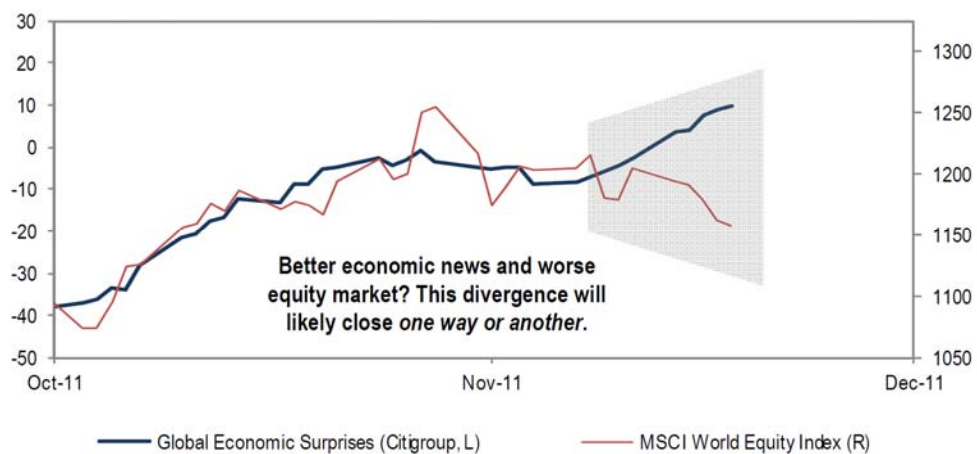
The U.S. stock market has shown a certain toughness despite all the noise surrounding Europe. In fact, despite Europe constituting a large piece of the foreign revenues for the U.S. market, the S&P 500 is down just 1.5% this year, outperforming other world indices, many of which are down double digits.ⁱ Although the European crisis may continue to add some volatility in the U.S., the influence of Europe appears to be overestimated. At the heart of the S&P 500's outperformance has been our improving domestic economy. Although some of these signs of improvement are being ignored, recent economic data, which has been better than expected, should make investors feel much more optimistic than their current despondent state. In the labor market, for example, weekly jobless claims have declined to 388k, which is the best reading since early 2011. Interestingly, much of the incremental job growth has been fueled by the housing sector, one of the key drivers of the US economy.ⁱⁱ Also, the Citigroup Economic Surprise Index has been climbing to its latest level of 49.9, or the best reading since March 2011. JP Morgan analyst, Thomas Lee, notes that we can see "the elements of a year-end rally in place" as we not only enjoy better economic data, but enormous liquidity, investor underperformance, attractive valuations and a positive seasonal effect.ⁱⁱⁱ Importantly, these are all elements that have little to do with Europe. In short, although Europe continues to face problems, the US economic momentum remains strong and I would expect this to translate into a year-end rally.

According to the USDA, GDP estimates for 2011 reflect that the U.S. has been maintaining (for nearly forty years!) its share of world GDP, which is currently 26%, and actually higher than it was in 1982 (25.8%).^{iv} According to economist Mark Perry, the fact that it has "remained constant over time is a testament to how America's dynamism, resiliency, and culture of innovation and entrepreneurship have enabled us to continue to be productive and competitive."^v A key engine of growth in the U.S. has come from our exports. Recent data has shown that the Los Angeles Port reached a record for shipments in October, which reflects the demand for U.S. products in an expanding global market. The global economy has also hit new highs as real world GDP exceeded \$50 trillion for the first time ever this year.^{vi}

Another positive signal for the U.S. market comes from the relative outperformance of regional banks over money center banks, which trade derivatives (including credit default swaps) and execute currency swaps with large European banks. So far this year, the regional bank ETF (KRE) has outperformed the S&P bank ETF (KBE, which includes the money centers) by nearly 15 percent.^{vii} Tim Hayes, strategist at Ned Davis Research, was quoted in Barron's stating "that continuing evidence of economic resilience (which was much in evidence last week in the housing, retail, unemployment-claims and leading-indicators data) should confirm the stock market's refusal (so far) to buckle all together."^{viii} He also added that "investor worry is a positive condition. The market says it wants to go higher." Investor fear, however, still permeates the market. Wolfe Trahan recently highlighted (in the

chart below) that there has been a wide divergence between the equity markets and economic surprises.^{ix} The market rallied in October on the back of stronger economic data, which is reflected when comparing the trends of the Citigroup Economic Surprise Index with the MSCI World Equity Index. Recently, however, both indices have diverged as fears surrounding Europe have overwhelmed the market, thus temporarily drowning out any positive economic data. Eventually, the two will converge. People are afraid of a contagion, yet the S&P this year has even outperformed the Russell 2000, consisting of domestically focused small caps.

Economic Surprises Up, Markets Down ... A Divergence Of Fear?



Source: Wolfe Trahan & Co. Portfolio Strategy.

The widespread fear by the investment community is driven by the recency effect of the excessive losses in 2008 and by the “group think” mentality that is so prevalent today. An example of this consensus thinking was captured recently by Barron’s columnist Michael Santoli as he wrote, “When your ‘stop-loss’ order matches that of so many others, it becomes a ‘start-loss’ order.”^x Essentially, “stop-loss” is mislabeled as it does not necessarily offer protection, but may add to the probability of downside loss. Overall, investors continue to focus on the wrong factors. If one thing has become clear these days, macro factors increasingly determine the valuations at the micro level. Although the valuation of individual stocks used to determine the value of the market as a whole, stock selection is now subordinate to asset allocation. Even Bill Miller, the ultimate bottom-up investor, is going to lose his job after thirty years at the helm of Legg Mason Value Trust. Investors need to begin to focus on the positive signals that the market is sending us--better economic data will be a boon for the U.S. stock market.

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ⁱ Performance as of November 18, 2011, Bloomberg

ⁱⁱ JPMorgan – US Equity Strategy – November 17, 2011

ⁱⁱⁱ Ibid

^{iv} Carpe Diem – Mark Perry - November 17, 2011

^v Ibid

^{vi} Ibid

^{vii} Bloomberg

^{viii} Barron's – November 19, 2011

^{ix} Wolfe Trahan – Portfolio Strategy - November 21, 2011

^x Barron's – November 19, 2011