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HEADLINES SUMMARY: The S&P 500 Index rose 1.0% last week and is 5% below its all-time high of 1565, reached in October 2007. Meanwhile, the U.S. deleveraging cycle is at least half over (a typical consumer deleveraging cycle that follows a credit-driven housing boom/bust lasts 5-7 years). Consumer delinquency rates and debt service burdens have fallen back to levels not seen since the early 1990s, and home prices are no longer falling. Household net worth is also close to the 2007 peak. Consumer and business spending growth should gradually accelerate as the deleveraging matures. In summary, the U.S. economy should be able to withstand the fiscal tightening coming from the increase in payroll taxes and other measures.

What Is Ahead: We get additional earnings and housing data this week.

INDEX	WTD	YTD	1-YR
DOW JONES	1.2	4.3	11.5
S&P 500	1.0	4.3	16.2
MSCI EAFE	-0.1	3.2	18.9
MSCI EMERGING MARKETS	0.7	2.4	13.3
YIELDS	CURRENT	2011	2010
10-YEAR U.S. TREASURY	1.84	1.88	3.29
30-YEAR U.S. TREASURY	3.03	2.89	4.33

Source: Janney ISG, Bloomberg. Data as of 1/18/13.

U.S. ECONOMIC NEWS – JOBLESS CLAIMS HAVE DROPPED TO PRE-CRISIS LEVELS WHILE INFLATION REMAINS WELL CONTAINED

- OECD Composite Leading Indicator (CLI) rose to highest level since February 2008. CLI rose for fourth straight month, indicating firming economic growth.
- December Federal budget deficit narrowed, and 12-month total deficit represented 6.8% of GDP. Receipts rose 7.9% while outlays contracted 0.2%.
- December retail sales rose a widespread 0.5%. Sales are up 4% on a y/y basis.
- Fed's Beige Book showed economic activity grew in all 12 districts.
- Initial jobless claims fell 37,000 to 335,000, the lowest level since January 2008, before the height of financial crisis. The 4-week average fell to 359,250.
- December Producer Price Index (PPI) fell 0.2%, its third decline in a row. For the full year, PPI rose 1.3%, well below the average 3.4% inflation over the past decade. Consumer Price Index (CPI) was flat and up 1.7% y/y.
- December housing starts soared 12.1% to a 954,000 unit annual rate.

ECONOMIC DATA CONCLUSION: While the federal budget deficit has narrowed, it remains on an unsustainable path. We are looking for a modest hit to consumer spending in early 2013, given the increase in payroll taxes. Inflation remains well contained. Housing continues to improve, and we have a long way to go in this housing recovery. Overall, the U.S. economic recovery continues with low inflationary pressures.

GLOBAL MARKET CONDITIONS – WHY WE CONTINUE TO LIKE INTERNATIONAL EQUITIES

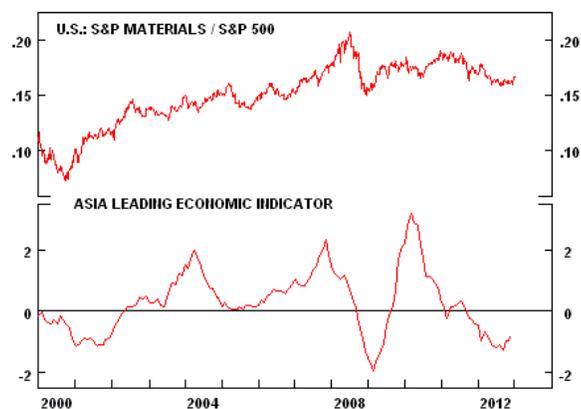
The U.S. stock market is by no means expensive, but euro area, Japan, and China are way cheaper using price to book and forward P/E ratios for comparison. The recovery in the rest of the world has also just begun. Meanwhile, severe European fiscal austerity has crested, and most crisis-stricken countries are adopting much softer targets or measures to regain their fiscal balance. In Japan, the Abe government has announced a new stimulus package amounting to 2% of GDP. In China, the government has been actively beefing up fiscal spending on infrastructure. As a result, fiscal policy in the rest of the world is becoming more stimulative. All of this suggests outperformance from global equities. See the Investable Themes section of the Investment Strategy Group Home Page for investment ideas.

WE HAVE WARMED UP TO MATERIALS WHERE EXPECTATIONS HAVE BEEN LOWERED WHILE GLOBAL GROWTH CONDITIONS ARE IMPROVING

It has been two years since the materials sector began to discount the slowdown in global economic growth. Most global leading economic indicators peaked in late 2010/early 2011, including those in China, which encouraged a rotation out of global-exposed equity sectors.

The good news is that previously exuberant expectations have been reduced. Sector sales and earnings growth expectations that were anticipating significant outperformance are now in line with the overall corporate sector. Valuations have also moved to the low end of the range in place over the past decade. Companies have also responded to the global slowdown by trimming labor costs and carrying lower inventories. Importantly, the recovery in the Chinese manufacturing PMI, reacceleration in infrastructure spending, and firming in domestic commodity prices, such as steel and iron ore, suggest that final demand growth is improving. The trough in emerging Asian leading economic indicators, and rally in Chinese-sensitive Australian stocks, reinforce that conditions in the region have improved.

All of this implies improved sales and earnings for the Material sector with U.S. manufacturers well positioned to compete against global counterparts due to lowered cost structures. See the Material Sector Strategy Spotlight for ideas.



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