

What If There Was No Europe?

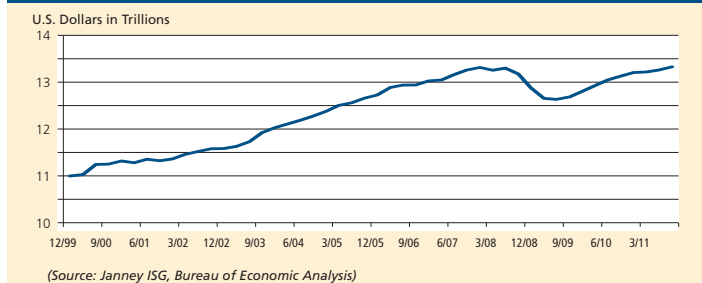
By Mark Luschini, Chief Investment Strategist



Twisting the lyrics to John Lennon’s classic song “Imagine” might bring some attention to the brightening picture in the U.S. which has been largely overshadowed by the ongoing concerns of the European debt crisis. Obviously, we cannot ignore what is happening across the pond. The evolving circumstances surrounding the liquidity and/or solvency of the continent’s peripheral countries have both a global economic and market impact. We fear, however, that investors have been so consumed by the threat of a cataclysmic outcome that better news elsewhere is being ignored. And, perhaps worse yet, investment opportunities are being overlooked that may not exist going forward should European policymakers demonstrate the resolve to produce a solution for the current fiscal imbalances of the Euro-currency member countries.

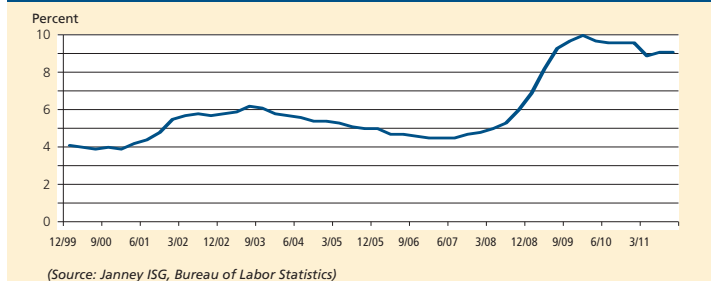
We are not so Pollyanna as to believe that economic conditions in the U.S. are terrific. It is well known that the employment situation is unsatisfactory, housing remains weak at best, wage growth is almost nonexistent, and the stock market has not yet recovered to its pre-crisis record, leaving many investment balances below the high water mark of a few years ago. However, accumulating evidence over the last several months points to a steady stream of sequentially improving news that gives us reason to believe the U.S. will skirt a recession, overcome the impact of a mild recession in Europe, and remain in a state of tepid, but positive, growth. It has not been widely advertised, but the total economic output (GDP) of the U.S. achieved record levels in the third quarter (Chart A). That is a testimony to the resiliency of the American economy and the inputs, from personal consumption to business spending, that have recovered from their recessionary lows.

Chart A: U.S. GDP [through 9-30-11]



Of course, scars remain that will take longer to heal—the biggest of which is the job market. Unemployment remains stubbornly high, which in turn hurts confidence, creates a spending void due to the absence of the fully-engaged consumer, and leaves the prospects of a self-sustaining economy vulnerable to a variety of internal and external forces. However, the trend has been improving. Recent private payroll gains have been steadily north of 100,000 per month, and the unemployment rate has begun to slowly work lower (Chart B). The economy needs to grow faster to accelerate the rate of hiring. Job growth is the key to boosting spending, rehabilitating the housing market, and driving savings so that our country can wean itself from the dependence of foreign governments to support our fiscal imbalance. So there is more work that needs to be done, but at least the momentum is directionally positive.

Chart B: U.S. Unemployment [through 9-30-11]

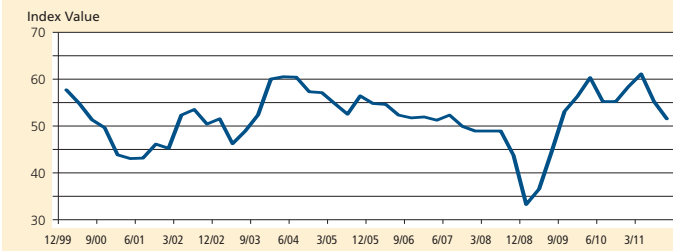


Good news continues to emanate from the all-important manufacturing sector. While a fraction of what it has historically meant to our economy, manufacturing still holds an important role and remains a bastion of high-paying jobs. Surveys of companies have consistently reported that business activity remains above the boom/bust line (Chart C). This provides further evidence of the economy, including our trading partners, still experiencing moderate growth in spite of slowing conditions in Europe and its impact on our global trading partners.

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(What If There Was No Europe?; Continued from page 1.)

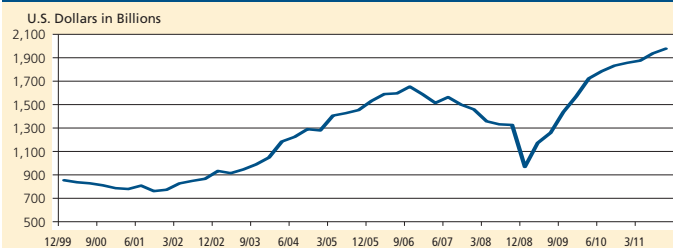
Chart C: ISM PMI [through 9–30–11]



(Source: Janney ISG, Institute for Supply Management)

In the meantime, stock prices have gyrated madly, as markets have been subject to the near-daily news flow imported from Europe. Yet even after a near 20% correction in U.S. stocks (S&P 500) from late spring through the early fall, the market is positive for the year (up 1.1% through November 30). Corporate fundamentals are exceedingly attractive, arguing for share prices to advance on some relief on the European front (Chart D). Company profits are at record highs, cash levels are robust, balance sheets are clean, and borrowing costs are low. This would usually foster an environment in which equity values would be high. Instead, the price-to-earnings ratio of the S&P 500 on 2012 earning estimates is 12, some 10% or more below historical valuations. In addition, the earnings yield of the stock market (the inverse of the P/E ratio), which stands at roughly 8%, compares handsomely to a 2% 10-year Treasury bond yield. In fact, the disparity is the widest in almost three decades.

Chart D: U.S. Corporate Profits [through 9–30–11]

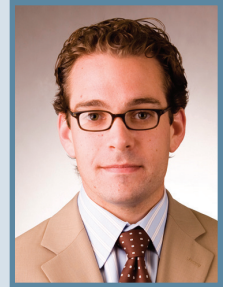


(Source: Janney ISG, Bureau of Economic Analysis)

We advocate owning U.S. high quality, dividend-paying stocks as well as corporate and municipal bonds. In our base case, a scenario in which a recession is averted but growth remains lackluster, income will be an important feature. The challenge is seeing across the valley to a time when conditions are less volatile and uncertainty is even just slightly less elevated. The issue is that waiting for that time before availing one's risk-based capital to the aforementioned investment opportunities, instead of exploiting their appeal today, may leave one uttering "coulda-shoulda-woulda." ■

Life After Greece

By Guy LeBas, Chief Fixed Income Strategist

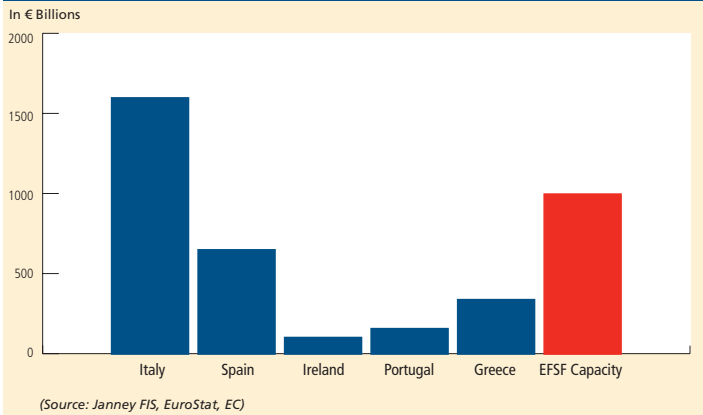


Political risk over the EU situation turned ugly in November, claiming the leadership position of not just the Greek Prime Minister, as had been widely expected, but also of the Italian leader Silvio Berlusconi. Berlusconi essentially made a profession of dodging scandals—seven such dramas spring easily to mind, ranging from lavish praise of Mussolini to a conflation of homelessness with "a camping trip." It seems, however, that the markets were too much for even the master of political dodgeball to avoid, and the Italian Parliament has finally had enough of their leader. A simple procedural vote, seen as a proxy for Berlusconi's position, was ultimately all it took to unseat the scandal survivor. But in reality, who is in power matters far less for the future of the Euro, the EU, and the global financial system than liquidity problems being tackled quickly and with overwhelming force.

Understanding the need for liquidity support as a resolution to Europe's newest round of problems requires an analysis of underlying fundamentals of the various peripheral countries' problems. Unlike the other members of the PIIGS group, Greece is clearly insolvent, and simply has too much debt to stand without default; that much the markets recognize clearly. Portugal is on the fence of solvency, and although its debt load is more manageable, the country faces long-term burdens of underinvestment that have made the nation less economically competitive. Ireland's troubles are more short-term in nature than either Greece's or Portugal's, as they are driven by a need to recapitalize the banking system after extreme losses. Economically, however, the Irish economy is in much better shape, and the one-time nature of the recapitalization needs means that Ireland's problems are inherently solvable. Spain is fundamentally solvent with an expanding economy and comparatively reasonable access to the financing markets. Italy, while the country does benefit from economic growth and has been relatively reasonable with early austerity measures, is facing severe liquidity risks, brought on by the increase in funding costs in November.

Over the past month, ten year Italian government bond yields have risen well above the psychologically-important 7% level. While there's nothing magical about this threshold, each of the three countries (Greece, Portugal, and Ireland) to see debt costs rise about 7% eventually requested bailout assistance from the EU. In fact, most requested aid immediately after yields reached those levels, though the public announcement came later. The issue with higher debt yields is that the cost of servicing debt at higher interest rates at the issuer level generates higher government spending and feeds back into credit quality of that issuer. At a certain point, that feedback creates a cycle which ends in one of two ways, assistance or default. Given the size of Italy's sovereign debt outstanding, default is very much impractical, which creates a likelihood of support, either from the EFSF or the ECB.

Chart E: Sovereign Debt Outstanding and the EFSF



While a request for aid is likely, the timing of any such request remains uncertain. Italy has managed to continue selling T-bills to fund its balance sheet in the short term, as evidenced by the recent €3 billion issuance. Moreover, the formation of a new government under Mario Monti's leadership—the second nation, after Greece, to see the Prime Minister seat taken over by a PhD economist—will take priority over any formal assistance request. As a result, we suspect the timing of Italy's request will likely fall to 2012, leaving a significant window during which the country's challenges will remain one of those systemic risk overhangs preventing the smooth functioning of global financial markets.

One of the challenges with an Italian rescue for the currently-structured EFSF is the sheer size of Italian sovereign debt. At around €1.6 trillion with more than a fifth of that amount coming due through 2012, full financing for Italy's debt load will quickly overwhelm the maximum liquidity of the €1 trillion framework established by the October 26 EFSF expansion deal. In that sense, the current size of the EFSF can do little to encourage investors to step back into the private markets for Italian bonds, which is the ultimate goal of any mechanism designed to bail out an illiquid, but fundamentally solvent entity. In short, the EFSF needs to grow well beyond its current size, or to cede authority in the bailout process to another entity that can grow larger. How big must the EFSF reach? At this point, the only safe answer appears to be the combined size of the PIIGS outstanding debt, which we estimate at €2.9 trillion, including the loans already extended to Greece, Portugal, and Ireland. In order to be fully effective in convincing private investors to begin purchasing Italian debt, the EFSF would need to be expanded three times its current size to around €3 trillion.

Political headwinds to such an expansion could prove significant, though we see an alternative to growing the EFSF in the form of the European Central Bank, the ECB. Unlike the EFSF, the ECB has essentially unlimited resources—as much like the Fed—it can create the liquidity necessary to purchase government bonds, thereby driving spreads tighter through market forces rather than a formal bailout. By signaling its willingness to purchase sovereign debt in unlimited quantity, the ECB could, ironically, end up spending relatively little, as the Central Bank's credibility and commitment is theoretically enough to encourage private buyers to jump on the suddenly lower risk and stronger liquidity of distressed European sovereigns. In our view, the serious involvement of the ECB would signal an end to Europe's two years of sovereign credit problems. ■



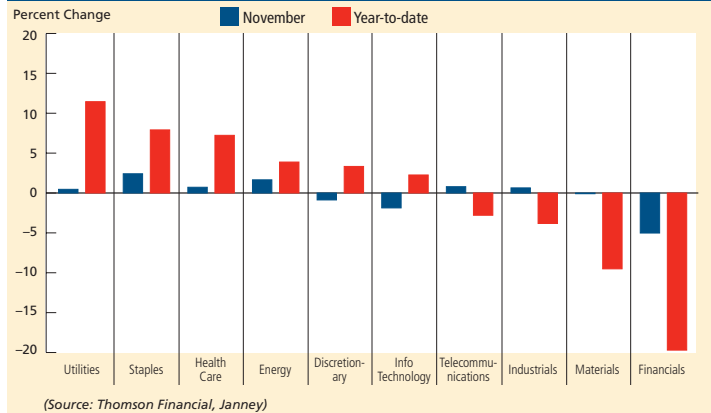
'Tis the Season

By Gregory M. Drahuschak, Market Strategist

Coaches often instruct athletes to play to the whistle or another obvious signal that play has stopped. Investors that did not stay in the game until the final bell in November were sorry they did not heed that coaching advice.

After suffering through a month that was on track to be one of the five worst Novembers for the S&P 500 since 1949, the market rallied strongly in the final days of the month to end with only a fractional loss. Any loss in November, however, is notable, since the month typically is one of the best of the year.

Chart F: S&P Sector Results Through November 2011



Historic patterns offer no absolute assurance of what December will bring, but there is strong precedent to think that this month could be good for equities. In the 21 previous years in which the S&P 500 ended November with a loss, the S&P 500 posted a December gain 19 times. The gains ranged from 0.39% in 1964 to 11.19% in 1991. The average gain for all Decembers following November losses was 2.77%. Chart G shows the results for the S&P 500 for all down Novembers and what happened in the subsequent December and January.

December generally has had a positive bias for stocks. In the last 62 years, the S&P 500 has posted a gain in December 46 times.

In addition to its splashy end to November, the S&P 500 accomplished a few positive technical tasks. The most notable of these was that the S&P 500 surpassed its 50-day moving average and then traded above 1225, which was an easily definable level of resistance. Early this month, the S&P 500 struggled to get beyond a descending trendline formed by the lower tops posted during previous rallies. Reaching above this trendline would suggest a move to the 200-day moving average at 1265 and then potentially to 1300 or more.

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(Tis the Season, Continued from page 3.)

Chart G: November Losses: Results in Subsequent Months

	November Loss	December Result	January Result
1950	-0.26%	3.81%	2.34%
1951	-0.95%	3.62%	4.29%
1956	-3.10%	1.50%	-2.97%
1963	-1.05%	2.44%	4.91%
1964	-0.52%	0.39%	2.69%
1965	-0.88%	0.90%	3.32%
1969	-3.41%	-1.87%	-0.82%
1971	-0.25%	8.62%	4.05%
1973	-11.39%	1.79%	-1.72%
1974	-5.32%	-1.78%	-1.00%
1976	-0.78%	5.25%	11.83%
1984	-1.51%	2.24%	-0.92%
1987	-8.51%	7.28%	13.18%
1988	-1.89%	1.48%	4.03%
1991	-4.39%	11.19%	4.16%
1993	-1.29%	0.98%	0.71%
1994	-3.93%	1.26%	3.24%
2000	-8.01%	0.41%	-5.09%
2007	-4.40%	1.26%	1.41%
2008	-7.49%	0.78%	-6.12%
2010	-0.23%	6.53%	-3.70%
2011	-0.51%		

(Source: Janney)

Despite concerns about deterioration in Europe that could impact the United States, earnings estimates have not fallen much. Chart H shows earnings estimates for the ten S&P 500 sectors and the overall S&P 500 for this year and next.

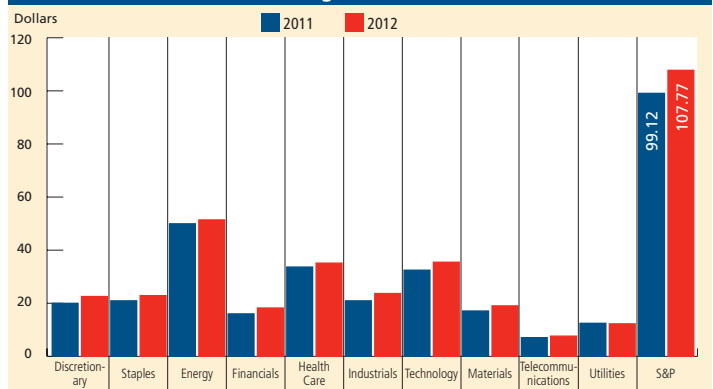
Using traditional techniques to divine the market's direction has been less than effective in recent months due to the market's extreme headline sensitivity. But when we set aside headline risk, we find a market that, at most, has a moderate valuation. The U.S. economy is showing clear signs of stabilization, and by many measures, gradual improvement. If Europe stops being a daily concern, we suspect the market can work higher into the new year and probably through the early part of 2012.

The risk, of course, is that Europe does not leave the front pages of global newspapers, and the situation worsens—most likely due to the stubbornness of Eurozone leaders to take the political risk necessary to get an effective debt reduction plan in place.

In looking at the potential risk factors for December, short of an outright disaster, the market should not violate its previous range low around 1125. Approaching this level would require some very negative events to occur. We believe that any interim weakness most likely will be contained in the 1207–1225 range for the S&P 500.

Beyond the potential for a year-end rally that possibly continues into 2012, there are issues that could provide headwinds too strong to overcome.

Chart H: S&P 500 Sector Earnings Estimates: 2011 and 2012



(Source: Standard & Poor's)

Europe is in a catch-22 situation. Reducing spending to meet demands for receiving aid will slow the economy at the very time when it needs to be stimulated. The European situation brings to mind Scarlet O'Hara's line from "Gone With The Wind." Faced with a major decision, Scarlet told Rhett Butler that "I'll think about that tomorrow."

The risk of a policy error in the EU is high in our view. Even if a catastrophic error is avoided, all the proposals we have seen thus far are merely postponements—so that EU leaders can think about them at some unspecified tomorrow. The problem is that their tomorrow is today. Hopefully they realize it.

But the U.S. has its own issues that, in some regards, are no different than those in Europe. It seems very likely that 2012 will be a year of rancorous debate (or perhaps better-termed, outright battling) over fiscal and tax issues. This debate will come amidst our own need to improve employment levels, spend more wisely and deleverage an overly indebted economy. The risk of policy errors in the U.S. may not be as high as it is in Europe, but it still is consequential.

We continue to suggest maintaining a conservative investment posture with low exposure to high beta stocks and a relatively high exposure to quality, income-producing stocks. We also believe that hedge positions in investments that are inversely correlated to the market—and a position in the U.S. dollar—are worthwhile as we move toward the new year. ■

JANNEY MONTGOMERY SCOTT LLC

1801 Market Street, Philadelphia, PA 19103 • 215.665.6000

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