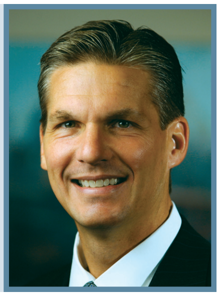
INVESTMENT PERSPECTIVES

JANUARY 2012

JANNEY MONTGOMERY SCOTT LLC

Is There Anything to Revel About?

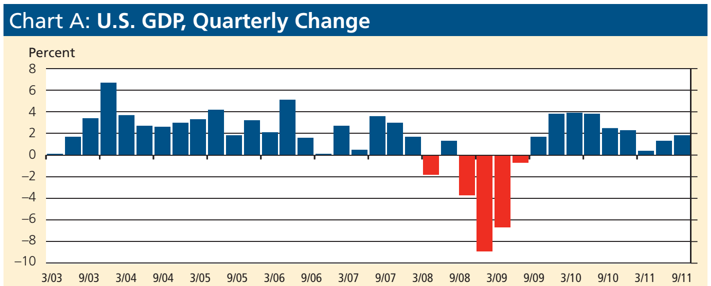


By Mark Luschini, Chief Investment Strategist

The ball dropping in Times Square is a wonderful tradition. On one hand, it signals the end of the year, which in the case of 2011, many are glad to see pass. On the other hand, it brings the anticipation of new beginnings and a chance to start over again. It is a calendar version of hitting the reset button.

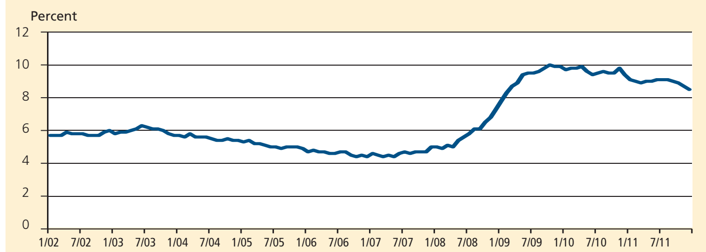
Reflecting on the economy and financial markets from the past year may, for many, provide an unnecessary reminder of all that went wrong. The year started pretty well as the economy came out of 2010 with momentum, and the stock market rose neatly through April. Only then did things begin to turn for the worse. First, we were reacquainted with the sovereign debt issues in Europe. Second, an unannounced deterioration in domestic economic data resulted in concerns of a double-dip recession. The stock market treated neither condition fondly, losing double digit percentages through the end of September. Yet while many were seeking the refuge of cash or bonds to guard against the worst, the news suddenly improved enough to offer some hope that better times might lie ahead. Without a cue, markets rallied sharply in October while the economy grew sturdier. The convalescence carried through December, offering the prospect that 2012 holds the ingredients for durable, if tepid, growth. The picture, in the absence of market concerns primarily outside the U.S., actually looks relatively good. Our economy has grown for 10 consecutive quarters and forecasts for 2012 imply the recent pace of steady if unspectacular activity should continue. The labor market is gradually improving, which is key to reinforcing a stable expansion. A falling unemployment rate is a sign that the economy is slowly gaining traction on that front.

Chart A: U.S. GDP, Quarterly Change



(Source: Janney ISG, BEA)

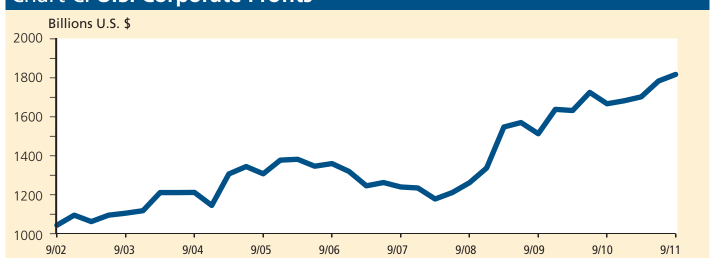
Chart B: Unemployment Rate



(Source: Janney ISG, BLS)

Corporations are in terrific shape and profits are at all-time highs, suggesting that even minimal growth should allow companies to increase revenues and expand hiring plans.

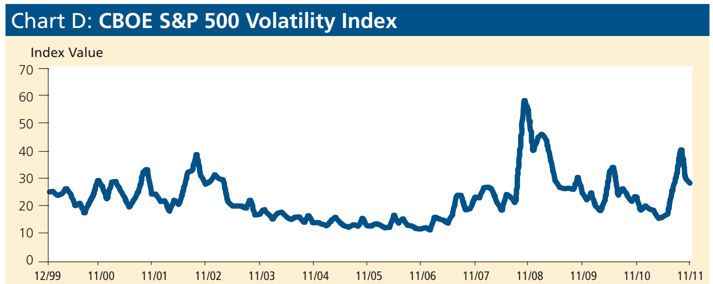
Chart C: U.S. Corporate Profits



(Source: Janney ISG, BEA)

The price of one widely-quoted market benchmark finishing the year almost exactly where it began was a rare and interesting event. The S&P 500 index, an oft-used proxy for the U.S. stock market, finished the year at 1257.6. It requires one to look two digits to the right of the decimal point to see the difference from the beginning of 2011. If dividends produced by companies in the index are added, the total return for the S&P 500 in 2011 was 2.1%. While positive, that performance belies the stomach-churning volatility investors were subject to in 2011, let alone the underrepresentation of return that certain components of the market delivered. The market's gyrations were in some cases unprecedented—and overall—were among the worst in the last decade.

Chart D: CBOE S&P 500 Volatility Index



(Source: Janney ISG, CBOE, Bloomberg)

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Back to the Future

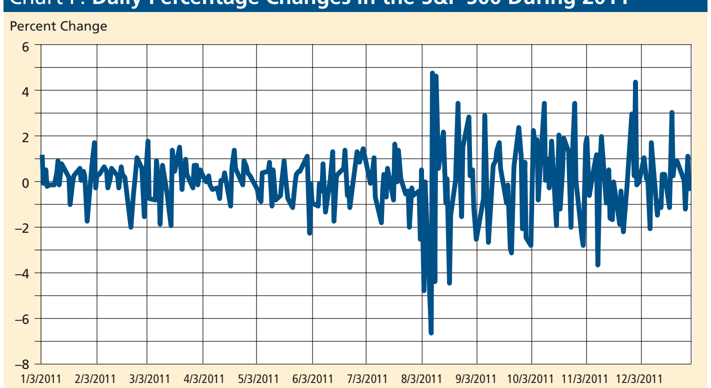
By Gregory M. Drahuschak, Market Strategist

Our 2012 market outlook does not require firing up a DeLorean to 88 miles an hour so that its "flux capacitor" can thrust us back in time to provide perspective about what happened to the market or what might happen. But looking backwards could offer some hints about what to expect from stocks this year.

If there is a single word to characterize the 2011 stock market, volatile is it. The S&P 500 last year moved through seven broad movement waves. Intraday volatility often produced high to low movement in excess of 2% and numerous times resulted in more than twice this percentage change. Europe provided the fuel for much of the market's volatility in the second half of 2011.

The chart below illustrates the dizzying pattern of daily volatility experienced last year. As the chart illustrates, volatility increased notably in the final third of 2011 as the market became consumed by the European debt crisis.

Chart F: **Daily Percentage Changes in the S&P 500 During 2011**

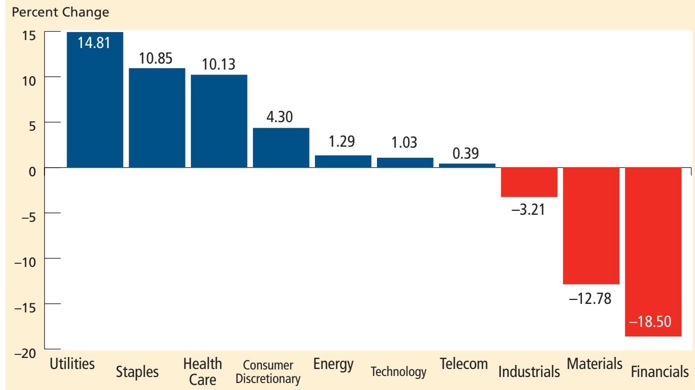


(Source: Standard & Poor's)

Initially, the market focused on corporate earnings that propelled the S&P 500 to its 2011 intraday peak of 1370.58 on May 2. Earnings remained solid for the rest of the year, but worries about Europe in time overwhelmed everything.

Europe was a major reason for the equity market's bias toward typically defensive sectors, which was best reflected by the sector-leading 14.83% gain for the utility sector. This was closely followed by 10.53% and 10.18% gains, respectively, for the classically-defensive staples and health care sectors. European worries, however, extracted a dramatic toll on the financial sector that fell 18.50%.

Chart G: **Sector % Changes**



(Source: Standard & Poor's, Janney)

Market volatility established some notable technical benchmarks that had a major hand in how the market acted last year. The market's initial earnings-driven upswing early last year reached a high at 1,340.43 on February 17. The subsequent month and a half downturn was followed by another rally to 1,361.22 by May 2. Another interim correction though the middle of June led to one more rally that took the S&P 500 to a July 7 close at 1353.22. One last feeble upturn that failed to match the prior peaks led to a slide that reached a panic-induced low early in October.

The pattern of three interim peaks followed by a significant sell-off gave way to a recovery that has extended into the early part of 2012, but the peaks also represented a significant intermediate-term hurdle for the S&P 500 to cross.

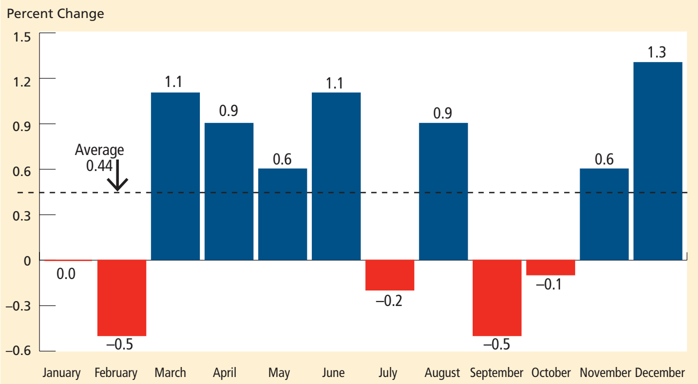
The market's recovery from the October low was credible from a technical standpoint and was underpinned by the belief that Europe at least was charting a course that could lead to a resolution of the region's most worrisome short-term problems.

Despite the credible rally off last year's October low, the peaks outlined earlier will be a restraint at some time this year, but the market's trading pattern suggests that a challenge of these peaks is a reasonable expectation. As was true last year, corporate earnings probably will offer key support for the market.

Earnings expectations for 2012 have moderated from what they were in the middle of last year, but they still point to a roughly 8% earnings rise this year. In our view, the probability of a rise in interest rates is very low to virtually nonexistent. Interest rates, therefore, should not be a drag on the price-earnings ratio for the S&P 500.

A recent article in *Barron's* highlighted a study focused on the fact that last year the S&P 500 ended essentially flat. In the prior 84 years, the S&P's total return for a single year has been between –5% and +5% only nine times. In the year following those nine years, the S&P 500 on average posted substantial gains—with a loss happening only once, in 1940, which can be explained away since this was when Germany invaded Poland to effectively start World War II.

Chart H: **Average S&P 500 % Price Changes During Presidential Election Years 1948 – 2008**



(Source: Standard & Poor's and Janney)

The mean return for the years following a year when the S&P had a gain or loss within the 10% range referenced above was 26.3%, and the median return was 26.9%. There was a 9.8% loss in 1940, but the other eight next-year returns ranged from 14.3% for 1971 to 52.6% for 1954. As is true for any historical data, there is no assurance that what has happened will be repeated, but the consistency of the data is interesting.

This year is a presidential election year, which also offers some reason for optimism. Early last year, we noted that the third year of the presidential election cycle typically provides the best performance of the four years in the cycle, but election year results are not bad.

Standard & Poor's uncovered an interesting pattern of how the market evolves through an election year. Their work clearly points to the majority of the market's gain coming in the final quarter of the year. The chart below illustrates the pattern well.

From a different perspective, we find that, like the S&P data, the market is likely to experience at least one notable decline sometime in 2012. At this point, we doubt that such a decline would move the S&P 500 below 1100. Our suspicion is that some external event (most likely from Europe again) will be the catalyst for an interim decline.

For many months, we have stressed our preference for owning dividend-paying stocks. In 2012, we think that dividends will provide a significant enhancement to the total return most portfolios can achieve. Dividend yields in the 3½ – 5% range from credit-worthy companies are very attractive as an adjunct to whatever earnings-driven stock price gains will produce.

In sum, 2012 looks like a year of positive market returns, but one in which there will be bouts of volatility. Earnings progress will be important to monitor. We view this year as a transition period building toward the start of a secular bull market that could extend for a number of years. ■

Chart I: **S&P 500 Percentage Changes During the Presidential Cycle**
Data From 12/31/1944 through 12/30/2011

Year of Presidential Cycle	Average S&P 500 % Changes (Without Dividends Reinvested)					Average % Frequencies of Quarterly Price Advances				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Year 1	–1.0	2.6	0.9	3.4	**6.3**	47	53	59	76	**59**
Year 2	1.2	–2.5	–0.3	7.0	**5.3**	47	50	56	81	**59**
Year 3	7.0	5.0	1.0	2.9	**16.1**	88	76	59	71	**88**
Year 4	0.5	2.6	0.1	1.9	**5.7**	56	69	50	81	**75**
All Years	**1.9**	**1.9**	**0.4**	**3.8**	**8.4**	**60**	**61**	**57**	**78**	**70**

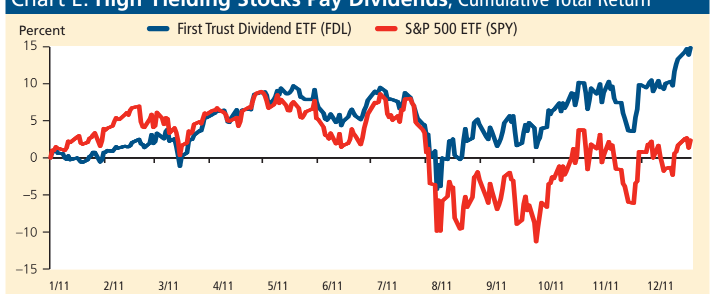
(Source: Standard & Poor's and Capital IQ)

(Is There Anything to Revel About?; Continued from page 1.)

And yet large, U.S. high dividend-paying stocks, an investment theme we advocated "owning" coming into the year and oft-repeated throughout, generally had a very good year. In the graph, an exchange-traded fund (symbol FDL) is used to depict the performance of a basket of companies that possess these characteristics. Not only did this fund outperform the S&P 500 index, but it returned 14.4%, a handsome return in any year!

Given the lack of resolution to many of the issues that created havoc and uncertainty in 2011, we are carrying over to the New Year our belief that high quality companies that pay fat dividends will repeat as winners. We shift our emphasis, however, away from classic yield-rich sectors like utilities and consumer staples. Instead, we prefer energy, health care and technology as sectors that are attractive from a valuation standpoint—and still provide a deep pool of dividend-payers from which to select. ■

Chart E: **High Yielding Stocks Pay Dividends**, Cumulative Total Return



(Source: Janney ISG, First Trust, Bloomberg)

Top 10 Surprises for 2012

By Guy LeBas, Chief Fixed Income Strategist

Each January, we publish our Top Surprises for the New Year, which we define as macroeconomic and capital markets-wide events which have a reasonable chance of occurring, yet which are not priced into the markets efficiently. Keep in mind that these events are not absolute forecasts per se, but rather possibilities that, in our view, present trading opportunities based on a "grey swan" philosophy (these events aren't nearly unlikely enough to qualify as a black swan).

For 2011, five of our eleven surprises came to pass, including our high-probability bet on home price declines triggering further mortgage defaults, our moderate-probability surprise of further Fed policy expansion, and, most significantly, our moderate-probability concern of a Greece re-bailout leading to troubles in the Eurozone. On this last count, it seems that one of our top surprises of the prior year has become a market-dominating event, though the fact that Greece's challenges fed through to Italian distress means the surprise went deeper than we had anticipated.

Looking to the coming year, we believe that market performance will be increasingly contingent on policymakers' response to global economic and liquidity phenomena, which in turn makes more of our surprises dependent on these rather binary policy actions. Key highlights of the list include a still-substantial risk of U.S. recession from a European-driven credit pullback, concerns about Congress' efforts to blunt the Budget Control Act and the effect on the U.S.' ratings, and a possible optimistic surprise out of China, whose policymakers may have actually gotten it right on the whole soft landing thing.

U.S. Macro

1. A European-driven credit pullback piles onto already-stressed consumers, causing the U.S. economy to fall into recession, albeit a relatively shallow one.
» Moderate probability, moderate impact

2. Congress waters down the Budget Control Act, casting doubt on the U.S.' willingness to achieve deficit reduction, and causing real yields to rise in maturities of seven years and beyond. Moody's and Fitch downgrade the U.S. to Aa1/AA+. S&P warns about a downgrade to AA.
» Moderate probability, high impact

3. The Federal Reserve launches QE3 by mid-year, causing the yield curve to initially steepen on higher inflation expectations, followed by a flattening reversion.
» High probability, low impact

Global Macro

4. Greece issues a credible threat on and makes preparations for exiting the Euro currency, though the country does not yet execute on the threat. The Euro continues to fall, and sovereign credit spreads blow out (increase) an additional 100 basis points versus German bunds.
» Moderate probability, high impact

5. Several EU member nations reject proposed treaty changes requiring greater fiscal coordination, thereby reducing the value of those provisions and failing to solve the root cause of sovereign credit problems.
» Moderate probability, high impact

6. Faced with a Greek exit and/or inaction from fiscal powers, the ECB agrees to purchase EU peripheral sovereign debt aggressively, reversing the spread blowout and, ironically, supporting the value of the Euro.
» Moderate probability, high impact

7. China's economy slows far less than feared (executing the so-called "soft landing"), as policymakers have efficiently tamed inflation risk in the country, though nervousness about property bubbles keeps external investment in China constrained.
» High probability, low impact

Credit

8. High yield U.S. corporate default rates tick higher from 1.7% in 2011 to the 3–4% range for 2012, as global liquidity stress creates challenges in refinancing debt maturities. Still, defaults are the exception not the rule, and the high yield markets outperform.
» Moderate probability, moderate impact

9. Domestic non-financial corporate profitability growth slows markedly, along with business spending, thereby compressing margins, and stimulating a major pickup in M&A activity to $1.5 trillion domestically from $1.0 trillion in 2011.
» Moderate probability, high impact

Commodities

10. A further flare up in tension between Iran and Israel—including limited military action—results in a sharp spike in energy prices, with crude oil prices briefly clearing 2008 highs.
» Moderate probability, high impact ■

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