STUART INVESTMENT
MANAGEMENT LIMITED

Weekly Economic and Market Comment 1-29-2012

The week ahead: The more important data releases this week are as follows:

- Tuesday, January 31: The Conference Board's measure of January Consumer Confidence will be released at 10am EST and is expected jump to 68 from 64.5 extending a string of better numbers. The rise is mostly due to some improvement in the jobs situation and a rise in stock prices.
- Wednesday, February 1: The private ADP estimate of the change in private payrolls will be released at 8:15am EST. It is expected to show that private payrolls (ADP does not pick up the change in public employment that has been declining) increased by 172,000 in January. It is important because it often causes forecasters to revise their estimate of the employment report and it can move the market.
- Wednesday, February 1: The January ISM manufacturing index will be released at 10am EST and is expected to rise to 54.5 from 53.9 indicting moderate growth in the manufacturing sector. In addition to the overall index I consider the new orders sub-index to be the most important.
- Friday, February 3: The most important monthly report, the January employment report will be released at 8:30am EST. Payrolls are expected to increase by 135,000 vs. the strong 200,000 rise in December.
- Friday, February 3: The January ISM non-manufacturing index will be released at 10am EST and is expected to rise to 53.3 vs. 52.6 in December and mirroring the small improvement in manufacturing.

Europe: Europe will continue to struggle with its debt problems despite a probable agreement between key banks and Greece on a restructuring of sovereign debt. It is by no means clear that Greece will be able to honor its commitments despite the huge haircut creditors are taking on existing debt. Nor is it clear that Portugal, Italy and Spain are adequately "ring-fenced" from the Greek problem. If investors increasingly feel that one of these counties will be looking for a similar arrangement with creditors, they will have to issue new debt at onerous levels.

The U.S.: Friday's GDP release was the most important data release in the quarter and came in at 2.8% a bit weaker than the consensus and in my 2.5-3.0% estimate window. But, in my opinion, the number was much weaker. While there are a number of caveats, the one I consider far the most important is the inventory swing.

- The inventory build added 1.94% to growth. Without this contribution, growth would have been just .86%. Consumer spending was about as expected but government subtracted nearly a percent, and investment and net exports were a bit weaker than expected.
- To contrast the inventory effect, in the third quarter growth was 1.8%, but inventories subtracted 1.79%, so that growth ex inventories was a much stronger 4.09%. Perhaps some of the inventory build this quarter represented a desired result as businesses rebuilt lean inventories that were held back by the Japanese earthquake and the Thai floods. But to the extent that some of the growth is undesired, it will not contribute and could even subtract from future growth. The number will be revised and I don't expect government to subtract as much in future quarters, but the inventory number makes me more comfortable with my below-consensus growth forecast in the first half.
- In my opinion, today's data release is supportive of the Fed's accommodative strategy. The inflation data also support the Fed's assertion that inflation pressures are easing.

The Market: The market consolidated last week but generally held up better than I forecast. The main reason was, in my opinion, that the Fed's communiqué following the FOMC meeting indicated a more accommodative stance than market participants, including myself, expected. January is coming to a close and some progress is being made on the debt situation in Europe, so the market will likely rally a bit more early in the week. Last week it exceeded the top of my range (1,320). Near term, I look for a move to the 1,330-1,345 area. But in the case of a Greek debt agreement it may be a case of "buy on the rumor, sell on the news". I continue to expect a correction from a bit higher level than I was previously forecasting. Given the Fed's supportive stance, I think a correction will be limited to a move down to the 1,275-1,295 area.