Investment Perspective

Has the old adage "the market climbs a wall of worry" ever seemed more fitting? Confronted by a litany of actual and potential problems, including multiple outbreaks of civil war in the Middle East, a horrifying earthquake/tsunami and potential nuclear disaster in Japan, soaring food and energy prices, and a double-dip in the U.S. housing market, stocks have remained steadfast in their ascent. Indeed, after a brief retrenchment in March where the S&P 500 gave up all of its previous gains for the year, stocks stubbornly shook off the dismal news and ended the first quarter up over 5%.

Is the market's resilience a sign of underlying fundamental strength? Or, is it simply an indication that the 2-year bull run has finally given retail investors the confidence to resume contributions to equity funds? Time will tell, yet it is noteworthy that the most recent leg of stock advancement has been on very light volume, down by as much as 30% on an average day compared to last year, perhaps a sign that institutional investors are sitting this phase out. Still, recent data suggest individual investors' multi-year preference for bonds over stocks may be coming to an end. Therefore, mutual fund flows into stock funds might provide further support for equities, even in the face of negative news.

Despite some of the scary headlines, the broad economy and corporations seem to be doing quite well. The U.S. economy expanded at a slightly faster pace late last year as real GDP grew at a 3.1% rate in the fourth quarter of 2010 vs. 2.6% in Q3. Many indicators are signaling continued strong growth: the Institute for Supply Management's (ISM) latest Report on Business' Manufacturing Index was 61.4, the highest since May 2004, and the Conference Board's Leading Economic Index increased again in February and at 113.4 stands at an all-time high. Finally, S&P 500 companies are still generating robust profits and remain on track to surpass record earnings this year.

What of the U.S. consumer, who accounts for two-thirds of economic activity? Spending has been on the rise, yet surging fuel and food prices have understandably left consumers in a dour mood. The University of Michigan's latest reading on consumer sentiment showed a 19% drop in expectations to 57.9, one of the largest drops on record. The index of consumer expectations now sits at a level just above where it was in the depths of the Great Recession in March of 2009, and only 21% of consumers expect the economy to improve during the year. Markets seemed to largely ignore this news, however, as consumer confidence readings are not historically reliable predictors of consumer spending. Still, such a significant drop is disconcerting and portends potentially slower spending ahead.

June looms large, as it will mark the official end of the Federal Reserve's second round of quantitative easing, aka "QE." Recall the Fed has been buying $75 billion of U.S. Treasury securities per month since November – as much as 70% of the market for new government issuance by some estimates. What will happen when the largest buyer in the market exits? That remains to be seen, but recent commentary suggests there is increasing support among FOMC members for the view that the U.S. economy has reached a self-sustaining rate of growth. In other words, the Fed may be done providing additional liquidity, at least for now.

The various cross currents of economic data and markets appear increasingly at odds. The ultimate resolution of these conflicting trends is unclear, but the path will likely include bouts of volatility. Volatility inevitably leads to uncertainty and fear, but one thing is for sure, high quality, well-balanced portfolios will be better positioned to withstand the market's ups and downs, regardless of whether or not the moves seem rational.

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