

## Bittles' Market Notes

January 30, 2012

The logo for Baird, consisting of the word "BAIRD" in white, uppercase letters on a blue, parallelogram-shaped background.

Please refer to Appendix – Important Disclosures.

### Stock Gains Fuel Rise in Complacency

Stocks rode the promise of continued support from the Federal Reserve to new highs for the year last week. While finishing off of its highest levels, the S&P 500 still managed to post a gain for the fourth week in a row. The Dow Industrials posted their first losing week of the year. While stocks no longer benefit from the widespread pessimism and oversold conditions that were present at the mid-December lows, the popular averages now enjoy improving intermediate-term trends, gathering momentum and increasingly broad support. Our industry group up-trend indicator rose again last week, moving up from 61% to 65%, while the aggregate advance/decline line for the S&P 1500 is now pacing the gains seen by the index. New highs are expanding and short-term breadth is supportive, suggesting that absent excessive optimism, the path of least resistance for stocks in the near term is higher. The caveat is that the S&P 500 is overbought after having rallied 100 points over the last six weeks. Another flare-up in the European situation could prompt near-term profit-taking in our domestic markets.

The FOMC last week surprised the markets, moving the expected period of exceptionally low interest rates out from mid-2013 to late-2014, providing an effective easing in monetary policy. It also laid out a logical basis for resuming large-scale asset purchases (QE3). By acknowledging that it views its dual mandates (full employment and price stability) equally, and also forecasting below-goal inflation and above-goal unemployment, the Fed appears poised to further expand its balance sheet, sooner not later. The burden of proof now appears to be on the argument against QE3. Gold rallied sharply on this news, breaking out of the down-trend that had emerged since the August peak. Gold is now up \$200/oz since December. Earnings season is now in full swing, and with half of the companies in the S&P 500 having reported, positive earnings surprises are at their lowest level (~50%) in years, even though expectations for earnings coming into the quarter were muted. So far, at least, stocks have been able to overcome this disappointment.

The move toward excessive optimism stalled last week. Sentiment has not yet become problematic, and with the improvements being seen in the broad market, truly excessive optimism may be necessary to raise a caution flag. The AAI survey last week showed that individual investors remain hopeful, as bulls rose from 47% to 48% and bears dropped from 24% to 19%. Bulls likely need to rise above 55% (or exceed bears by three to one) to become excessive. Advisory services, as measured by Investors Intelligence, were little changed, with 50% bulls and 29% bears. Bears likely need to drop below 20%, and bulls rise above 55%, to turn this indicator bearish. Active money managers continue to add long exposure, although at 56% the NAAIM number remains neutral. The options data showed an easing in complacency last week. The 10-day CBOE put/call ratio rose from 81% to 85% (less than 80% would be bearish), while the 3-day CBOE equity-only put/call ratio was up to 62% from 51% (64% and below is bearish). The VIX remains at 18, signaling a lack of fear. Renewed declines in the put/call ratios could leave stocks vulnerable to a near-term pullback, although any weakness that does emerge is likely to be limited in both time and price.

The first look at the fourth-quarter GDP data showed a continued acceleration in growth, to 2.8% up from 1.8% in the third quarter. This may, however, overstate the health of the economy. Growth for all of 2011 was only 1.6%, and the entire increase in the Q4 data can be attributed to inventory building and auto sales (motor vehicle sales posted their best quarter since Cash for Clunkers in the third quarter of 2009). Overall GDP-based inflation rose only 0.4% in the fourth quarter, bolstering the Fed's claim that inflation is not a near-term issue. This brings more clarity on the health of the U.S. economy. The ISM purchasing managers' index for January (due on Wednesday) is expected to rise from 53.9 to 54.5. Initial jobless claims, which rose last week from 356,000 to 377,000, are expected to be largely unchanged this week, although the longer-term trend remains lower. The impact of Friday's release of the monthly employment figures could be amplified as it will also include annual data revisions. For January, payrolls are expected to have risen by 170,000, while the unemployment rate is seen as holding steady at 8.5%.

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**Sector Strategies**

**No.1 Industrials** = Improving RS – Buy. Groups expected to outperform: Building Products, Farm Machinery & Heavy Trucks, and Environmental Services.

**No. 2 Consumer Discretionary** = RS trends stay strong – buy. Groups expected to outperform: Motorcycle Manufacturers, Movies & Entertainment, and Homebuilding.

**No. 3 Health Care** = Near-term laggard, but overall trend still favorable – Buy. Groups expected to outperform: Health Care Equipment, Health Care Services, and Biotechnology.

**No. 4 Consumer Staples** = RS showing some weakness – Buy. Groups expected to outperform: Food Retail, Personal Products, Drug Retail.

**No. 5 Materials** = Improving RS trends – Buy. Groups expected to outperform: Diversified Chemicals, Metal & Glass Containers, and Diversified Metals & Mining.

**No. 6 Utilities** = Still longer-term RS leader – Hold. Groups expected to outperform: Gas Utilities.

**No. 7 Information Technology** = RS climbing on near-term leadership – Hold. Groups expected to outperform: Semiconductors, Semiconductor Equipment, and Computer Hardware.

**No. 8 Financials** = RS trends still improving – Hold. Groups expected to outperform: REITs, Diversified Financial Services, and Diversified Banks.

**No. 9 Energy** = Reduce exposure on rallies - Hold. Groups expected to outperform: Oil & Gas Storage & Transportation and Integrated Oil & Gas.

**No. 10 Telecom Services** = Poor RS – Hold. Group expected to outperform: Integrated.

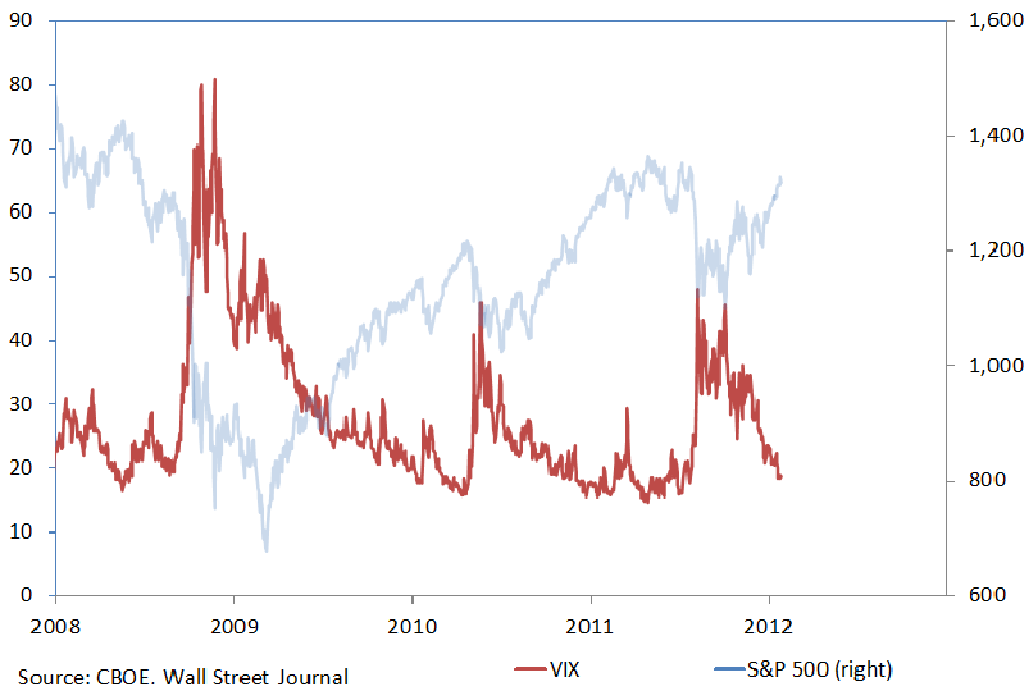
**Market Overview**

**Stocks**

Short-Term  
Long-Term

Trading range with risk to 1285 and reward to 1330 on the S&P 500  
Major support is 1100 on the S&P 500 and the reward is to 1400

**Volatility and the S&P 500**



## Appendix – Important Disclosures and Analyst Certification

This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

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