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ECONOMIC & MARKET UPDATE: JANUARY 18, 2011
"PUNDITS CALL FOR A CORRECTION, BUT WHERE IS IT?"

Economic Data - Previous Week					
Date	Series	Actual	Survey	Prior	
1/11	Small Business Optimism	92.6	94.5	93.2	Small business optimism fails to rise as expected
1/11	Wholesale Inventories	-0.2%	1.0%	1.9%	A pullback in food prices affects Nov inventories
1/13	Producer Price Index	1.1%	0.8%	0.8%	Core PPI relatively flat, but commodities rising
1/14	Consumer Price Index	0.5%	0.4%	0.1%	Energy prices higher, core inflation still muted
1/14	Retail Sales	0.6%	0.8%	0.8%	Retail sales positive for sixth straight month
1/14	Industrial Production	0.8%	0.5%	0.3%	Utility output boosts, but mfg still expanding
1/14	Michigan Confidence	72.7	75.5	74.5	Labor conditions weighing on sentiment
Economic Data - Upcoming Week					
Date	Series	Actual	Consensus	Previous	
1/19	Housing Starts	--	550K	555K	Analysts expect stability in home building
1/20	Existing Home Sales	--	4.87M	4.68M	Uptrend since July expected to continue

Source: Bloomberg

EQUITIES MAY REMAIN OVERBOUGHT…BUT ONLY FOR SO LONG

Equity markets trended higher for the seventh consecutive week, raising concerns about the potential for a long overdue correction. The S&P 500 Index was up 1.7% and the Dow Jones Industrial Average rose 1.0%.

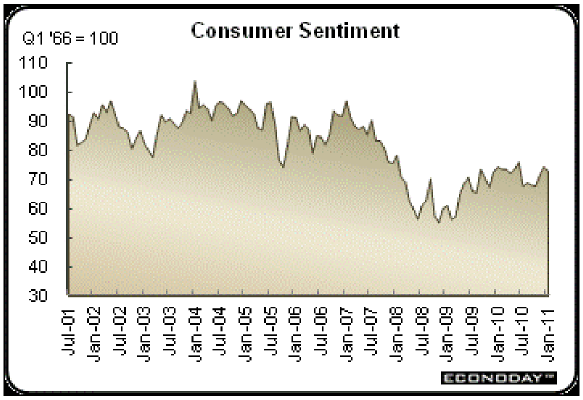
Economic data proved to be somewhat mixed, but largely supportive of the move higher in equity prices.

Retail sales, for instance, which reached an all-time high in December, increased 0.6% in the month, slightly below economists' expectations for a 0.8% gain. Auto sales provided a strong boost throughout the past quarter, but even excluding those figures, retail sales were increasing at a healthy pace.

December proved mildly disappointing in part due to the massive snowstorm that hampered shopping in the Northeast, as well as indications that many consumers finished the bulk of their holiday shopping in November.

Source: The Atlantic

Although consumers are doing their part to support the economic recovery, an uncertain labor market is dampening consumer sentiment, which may eventually create troubles for retailers. The latest reading of consumer sentiment from the University of Michigan fell from 74.5 to 72.7 in mid-January. Consumers' views of current economic conditions deteriorated noticeably in the survey, but this was partially offset by a more optimistic outlook for business conditions over the next twelve months.

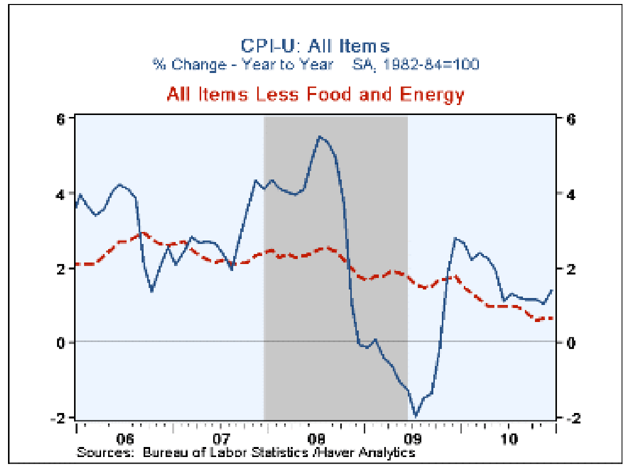


Source: Econoday

The other area of particular focus last week was producer and consumer inflation. Inflation at both levels jumped at a fairly sizeable rate in December, with the Consumer Price Index rising 0.5% and the Producer Price Index up 1.1%.

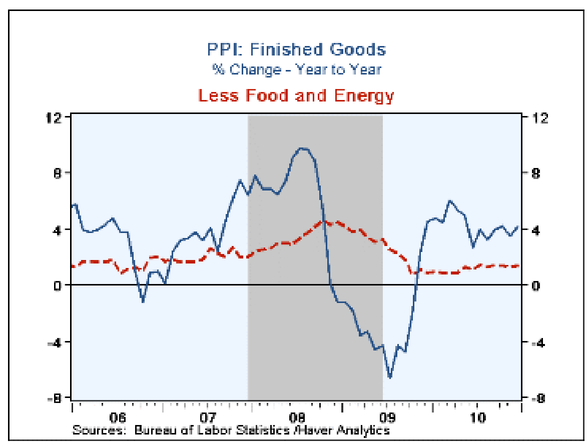
The sudden acceleration in the CPI was the result of a 4.6% spike in energy costs. If we exclude the ever volatile food and energy components, however, the consumer inflation picture remains quite the same. Core-CPI trudged higher by 0.1% in the month for a yearly gain of 0.8%, one of the lowest readings on record.

Shelter costs, the equivalent housing measure in the CPI Index, remains the sticking point. For the last twelve months, shelter costs were up a mere 0.4%. Given the 32% weight assigned to shelter costs, it is no surprise that consumer inflation is mostly benign.



Source: Haver Analytics

Producers, on the other hand, are being shown no mercy since the recovery took hold. Following a robust 1.1% gain in December, the PPI registered a full year increase of 4.3%. Energy costs were once again the culprit, posting gains of more than 12% in 2010.



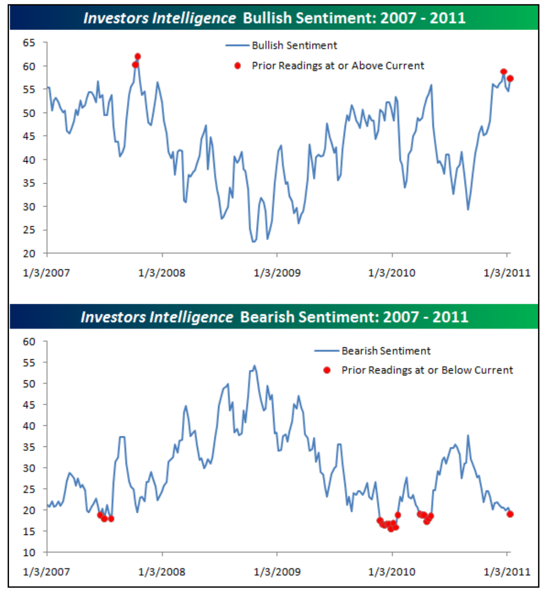
Source: Haver Analytics

Regardless of the moderate improvement seen in the economic outlook, this is no time for investors to fall asleep at the proverbial wheel.

Based on virtually every major indicator, equity markets are overbought and bullish sentiment is at unhealthy extremes. Retail investors, as measured by the AAII Investor Sentiment Survey, are especially optimistic about the six month outlook for stocks.

Approximately 52% of investors in the AAII survey are bullish on the outlook, down from the 63% reading in late December, but still well above the 39% long-term average.

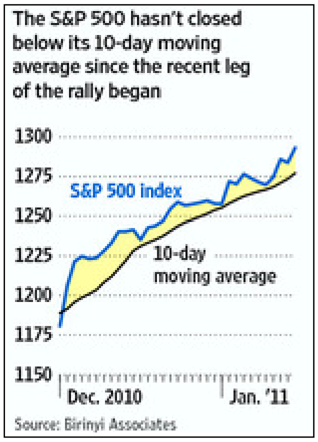
Even the institutional investors are buying into the most recent rally. Institutional investors frequently buck the trend when it comes to investing with retail money, but not this time. A survey of advisors from Investors Intelligence shows that bullishness stands at 57.3%, levels seen in December and in mid-2007. Bearish sentiment at 19.1%, however, is problematic because the last time it was this low was in early May, just prior to a major market correction driven by the combined events of the "flash crash" and the European debt crisis.



Source: Bespoke Investment Group

Additionally, the S&P 500 index, which registered gains in each of the past seven weeks, has never once before been able to accomplish that feat, according to UBS Financial Services.

Add in the fact that the S&P 500 has not closed below its 10-day moving average for thirty consecutive trading days, another rare phenomenon, and the market is appearing ripe for a correction. The 10-day moving average is used to assess momentum in the equity markets.



Source: Wall Street Journal

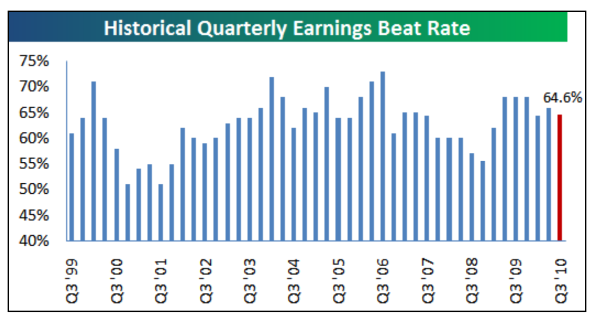
Further complications arise when looking at the VIX, commonly referred to as the "fear gauge." Currently at 15, the VIX is near levels last seen in 2007, and well below the peak seen in May of last year. This is frequently an indicator that investors are becoming complacent.

Source: Bloomberg

Perhaps the biggest warning sign of all is one that does not even reside in the US. The Shanghai Composite Index, referenced for its acumen as a leading indicator, has been on a steady decline since November. In mid-April, the Shanghai Composite began a sharp sell off several weeks prior to the S&P 500 following suit.

Source: Bloomberg

Some of the enthusiasm is likely based on the upcoming earnings season, one with lofty expectations. Nearly 65% of companies beat earnings expectations last quarter, a lofty goal that could bring disappointment to companies and investors alike this quarter.



Source: Bespoke Investment Group

There is no reason to believe that market sentiment cannot stay overextended and earnings may potentially offer up another blow out quarter, but it is obvious that this market is toeing a dangerous line.

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OIL PRICES ON THE VERGE OF RECREATING 2008?

In recent weeks, the price of a barrel of oil came dangerously close to the psychologically significant $100 price. While $100/barrel in and of itself is an insignificant threshold, the trend higher in oil and gas prices offers a dangerous headwind to economic growth in 2011.

Since reaching an intermediate term bottom in late August, the price for one barrel of Brent Crude has been on a gradual incline, moving from less than $75/barrel to more than $99/barrel over that period.

Source: Financial Times

To date, the move to $100/barrel is not as severe as the energy crisis we experienced in the summer of 2008, but there is no doubt that higher costs are already being felt in the broader economy.

Over the weekend, countries such as Iran, Venezuela and Libya expressed their collective satisfaction with oil trading at $100, but OPEC revealed on Tuesday that is was unexpectedly increasing oil production in December and January.

Iran and its cohorts experience the obvious economic benefits of oil trading at $100 or more, but in the US, there is a detrimental effect when prices are this high.

Daily Finance pointed out last week that "every $1 increase in the price of oil adds about 2.5 cents to the price of a gallon of gasoline." An even bigger challenge is that "every $1 per barrel rise in oil decreases US GDP by about $100 billion per year and, every one cent increase in the gasoline price decreases US consumer disposable income by about $600 million per year."

Consumers are arguably in a better position to weather those increases now, as opposed to early 2008, when home prices were stretched and debt was spiraling out of control, but that position would take a severe blow if oil and gas prices surged higher from here.

THE WEEK AHEAD

The holiday shortened week offers only a smattering of economic releases to digest. Existing home sales for December are expected to show a slight uptick on the heels of encouraging news on pending home sales. Additionally, the index of leading indicators from the Conference Board is likely to show continued forward momentum in the economy.

Earnings garner the most attention throughout the week as a number of blue chip firms are scheduled to report. Roughly 40 companies from the S&P 500 Index will report. The most notable companies to report this week include Apple, Citigroup, IBM, Bank of New York, EBay, Goldman Sachs, State Street, Wells Fargo, Google, Morgan Stanley, Bank of America, General Electric and Schlumberger.

President Obama will meet with Chinese President Hu Jintao on Wednesday to address a host of economic and geopolitical concerns.

China will release its monthly inflation numbers on Thursday. Inflation in China is running uncomfortably high and investors will pay close attention to see if further inflation will materialize in China.

LIGHTER SIDE

Source: Investment Postcards from Capetown