

ECONOMIC & MARKET UPDATE: FEBRUARY 6, 2012 "CORPORATE EARNINGS HIT A ROUGH PATCH"

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Economic Data - Previous Week

Date	Series	Actual	Forecast	Prior	
1/30	Personal Spending	0.0%	0.1%	0.1%	Spending flat, but personal incomes rise 0.5%
1/31	S&P/CS 20 City MoM	-0.70%	-0.40%	-0.62%	Home price declines continue to accelerate
1/31	Consumer Confidence	61.1	68.0	64.5	Unexpected fall in current conditions assessment
2/1	ISM Manufacturing	54.1	54.5	53.1	Broad gains boost manufacturing index
2/3	Nonfarm Payrolls	243K	140K	203K	Payrolls surge on broad-based improvement
2/3	Unemployment Rate	8.3%	8.5%	8.5%	Unexpected fall as number of employed rises
2/3	ISM Non-mfg Index	56.8	53.2	52.6	Employment, new orders boost services index

Economic Data - Upcoming Week

Date	Series	Actual	Forecast	Prior	
2/7	Consumer Credit	--	\$7.00B	\$20.37B	Another solid gain in consumer debt expected
2/9	Wholesale Inventories	--	0.4%	0.1%	Inventories should rebound after soft November
2/10	Trade Balance	--	-\$48.5B	-\$47.8B	Trade deficit expected to widen as exports fall
2/10	UMich Confidence	--	74.5	75.0	Consumer confidence report suggests decline

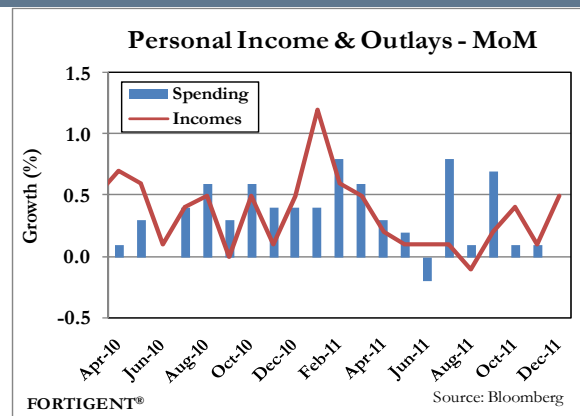
Source: Bloomberg

IMPRESSIVE JOBS REPORT HEADLINES STRONG WEEK

Equity markets resumed their upward march after pausing in the previous week. Unexpectedly strong economic data helped propel the S&P 500 and Dow Jones Industrial Average higher, as they gained 2.2% and 1.6%, respectively.

In a very busy week of economic data, investors received generally positive news, headlined by robust improvement in the government jobs report on Friday.

The week started slow, however, with a mixed personal income and outlays report from the Bureau of Economic Analysis. While consumer spending was flat in December, incomes grew 0.5% – above expectations and the biggest gain since March. The lack of spending growth is concerning, but somewhat expected given stagnating wage growth. Spending to this point has largely been financed through savings, making December's income boost a much welcome improvement for consumers.

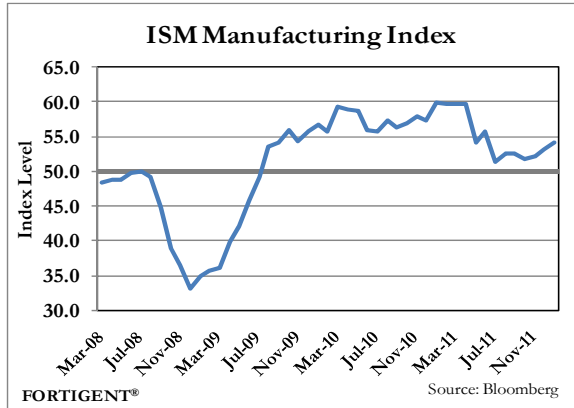


The Institute for Supply Management (ISM) released two important reports on business conditions last week – its manufacturing and non-manufacturing indices.

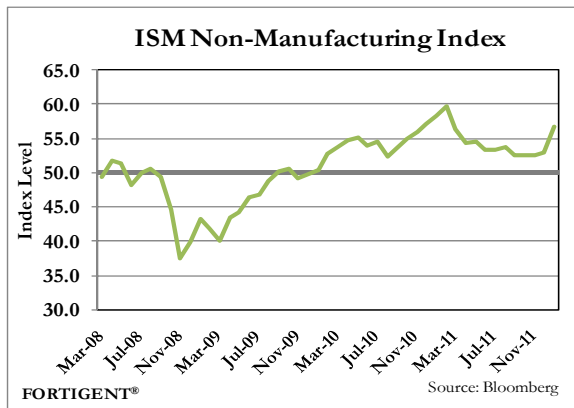
The manufacturing PMI, released Wednesday, remained well above the expansion/contraction line of 50. The headline index increased from 53.1 to 54.1 in January, and seven of the 10 component indices improved from the month prior. The new orders index, in particular, had a solid

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gain of three points, to reach 57.6. New orders typically portend future growth, so this is a welcome sign for the US manufacturing sector.



On Friday, ISM released its non-manufacturing index. Though less heralded than its manufacturing counterpart, ISM's non-manufacturing report is an important barometer for the US economy, given the larger size of the service sector. It was a positive sign, then, that the headline index surged 3.8 points to 56.8. Economists had expected a minimal gain in the series.

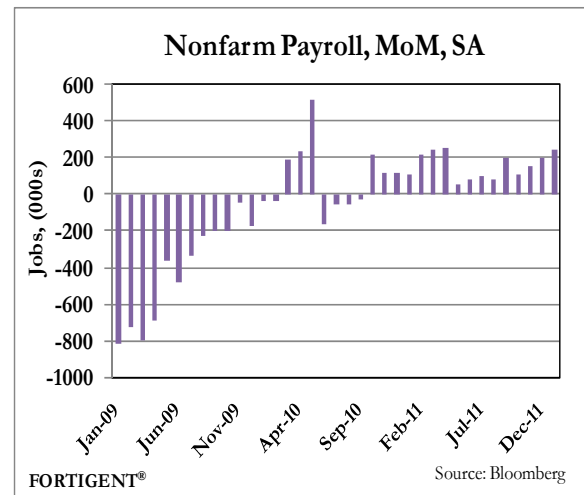


Encouragingly, growth in the index was broad-based as seven of the 10 component indices improved from the prior month. Notably, the employment and new orders indices had the largest increases, gaining eight and five points, respectively. The

employment index had previously been in contractionary territory, so January's bump brings it more in line with other positive measures of the US labor market.

Unlike recent months, ADP's employment report on Wednesday set a negative stage ahead of Friday's government report. The private payroll processor reported a monthly gain of 170,000 jobs in January – in line with consensus expectations – but included a negative revision of 33,000 to December's previously reported gain.

Friday's job report did not disappoint though. The Bureau of Labor Statistics (BLS) reported nonfarm payrolls increased by 243,000 in January, more than 100,000 above consensus estimates. Gains in the prior two months were revised upward by 60,000 jobs. Additionally, the BLS revised its estimate of total nonfarm employment upward by 162,000 as part of its annual benchmarking process.



In the household survey, the unemployment rate declined unexpectedly to 8.3%. The improvement was driven primarily by a drop in the number of unemployed, as opposed to a fall in the labor force. The broader measure of unemployment known as U-6, which

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includes people marginally attached to the labor force and part-time workers who would prefer to be full-time, also edged down to 15.1%.



The underlying composition of Friday's jobs report was very positive. Gains in the payroll report were broad-based, with large advances occurring in professional and business services, leisure and hospitality, and

manufacturing. Additionally, average hourly earnings grew by 0.2%, and the average

workweek edged up to 34.5 hours, both positive indicators of labor market health.

Critics are pointing to seasonal adjustment factors as a potential cause of this month's impressive jobs report. January is typically a weak month for jobs as seasonal workers are removed from corporate payrolls. The non-seasonal data is therefore adjusted upward to reflect this pattern. However, with less turnover in the job market due to uncertain economic conditions, it is possible the BLS' seasonal adjustments may be overstating month-to-month job gains (and conversely, losses).

The data may have its flaws, but it is difficult to deny the momentum occurring in the labor market. Sharp improvement in alternative measures like initial jobless claims, the ADP payroll estimate, and the employment components of the ISM reports paint a positive picture for America's employed. There is certainly room for that to continue, as the US job market is still 5.7 million jobs below its pre-recessionary level.

CORPORATE EARNINGS HIT A ROUGH PATCH

Another week of earnings reports is in the books, and based on recent market actions, all indications are that corporate America is in fantastic shape. Underlying the improvement in market sentiment is a largely disappointing earnings season.

On the surface, the news is positive and with slightly more than half of the S&P 500 companies reporting, the earnings growth rate is 5.8%. Unfortunately, once you exclude the outsized impact of AIG and Apple, the earnings growth rate falls to 1.0%. That is in stark contrast to the first three quarters of 2011, when growth rates, excluding Apple, were running in the mid-teens.

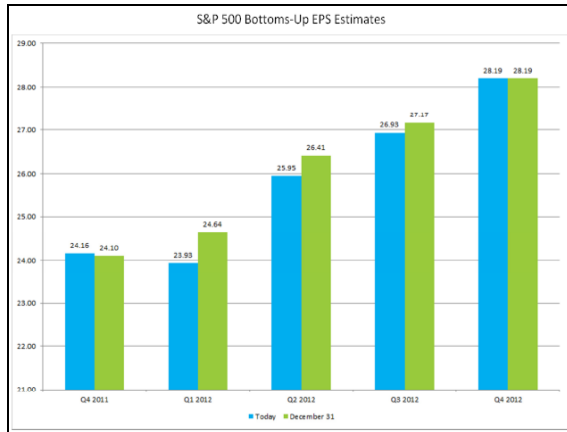
Jonathan Golub, strategist at UBS, attributes the sudden weakness to headwinds such as foreign growth, dollar strength, and energy prices.

Some analysts believe the recent trend higher in equity markets is due in part to optimism about corporate earnings in the back half of 2012. They may be right, but the picture looks shaky in the meantime.

For the first quarter, analysts actually believe bottoms-up earnings per share (EPS) will fall to \$23.93, from current fourth quarter estimates of \$24.16. Earnings growth resumes in the second and third quarter, but analysts are ratcheting down those

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expectations as well given weakening corporate earnings guidance.



Source: FactSet Earnings Insight

The good news comes later in the year, specifically in the fourth quarter. Based on current projections, analysts are still expecting \$28.19 bottoms-up EPS. That is unchanged from December 31 and shows some amount of confidence that an acceleration of

corporate growth will happen towards year-end.

For the first, second, and third quarters of 2012, analysts expect earnings growth of 0.4%, 7.2% and 4.7%, well below recent trends. For the fourth quarter, though, growth jumps back to 16.3%.

According to FactSet, a primary headwind for many companies last quarter was weaker sales in Europe, less favorable exchange rate environments, and malaise about the economic outlook. United Technologies, for instance, noted, “We expect FX (foreign exchange) to be a significant headwind in the first half of 2012.” Similarly, Xerox pinpointed Europe as the “largest factor” in its technology revenue drop.

One of the major unknowns in the outlook is what direction will the US economy take in 2012. Recent data has painted an optimistic picture, particularly in stressed areas such as the labor markets. Should the US continue to show improvement, companies would clearly benefit. If the situation in Europe worsens, dragging down growth in the US, an already weak outlook will grow weaker.

THE WEEK AHEAD

This week is relatively light on economic data in the US, with Friday’s release of the trade balance headlining the week’s items. After reaching a record high in the fall, exports have softened in the past few months – likely the result of a weaker Europe. Consumer credit and consumer sentiment reports are also on tap.

Earnings season kicks into high gear with reports due from BP, Coca-Cola,

GlaxoSmithKline, Toyota, UBS, Walt Disney, UBS, BHP Billiton, Cisco Systems, News Corp, Sanofi, Credit Suisse, Diageo, PepsiCo, Rio Tinto, and Alcatel Lucent, among others.

Rate announcements are due from the ECB, the Bank of England, Australia, Poland, Serbia, South Korea, Indonesia, and Peru. Neither the ECB nor the Bank of England is expected to adjust their key lending rates.



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