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Raising Our 2012 S&P 500 Trading Range

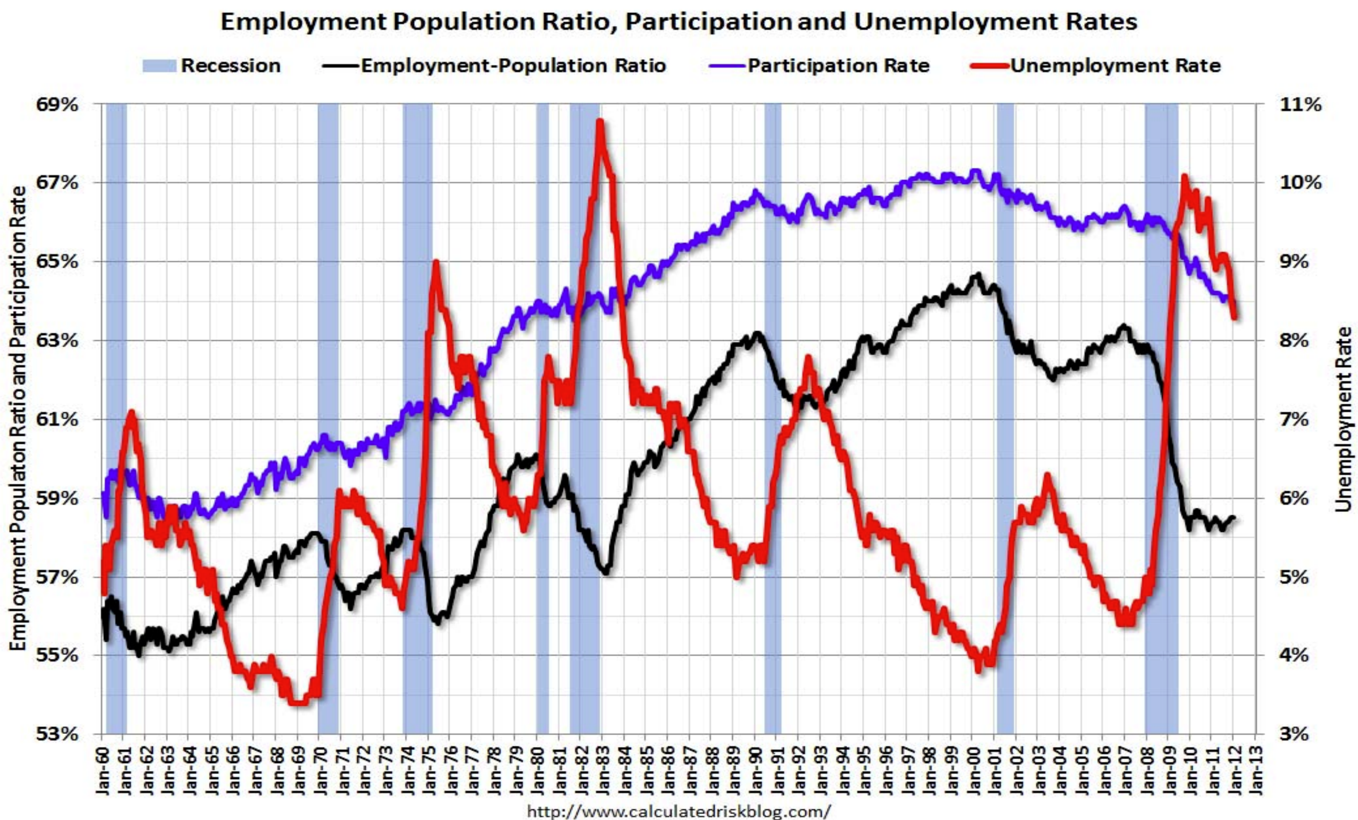
• We are raising our trading range for the S&P 500. Our new range for the rest of the year is 1250 to 1500 and represents approximately a 5% increase in our upper end target and a 12% increase in the lower end from the range we published in our 2012 Outlook. We believe the money printing by the European Central Bank (ECB) and its success in both stabilizing the banking system and lowering Italian and Spanish bond yields has reduced the downside risk for stocks. We are also encouraged by data from around the world that shows modest growth and a clear pick-up in economic momentum. There will likely be setbacks both politically and economically, but we believe investors should not be defensively positioned and should be adding to portfolios from cash on a systematic basis, and especially on pullbacks.

• Leadership in the financial markets has changed from last year, when higher yielding more defensive stocks outperformed. In 2012, stocks are being led higher by emerging markets, small caps, and large-cap technology — the MSCI Emerging Markets Index is up 16% year to date, the Russell 2000 is up 12%, and the Nasdaq 100 is up 11%. At the same time, long-term Treasury bonds have fallen 1.7%. We believe some of the extraordinary monetary policy support by the world's central banks, led by the Federal Reserve and the ECB, is beginning to filter through to the real economy, judging by the job growth acceleration reported last week.

• With the Fed effectively extending its zero-interest rate policy through 2014, the ECB about to engage in another long-term refinancing operation at the end of February, and with commodity inflation still decelerating, we think an improving macroeconomic environment is validating investors' rising risk appetites. In the coming weeks, we think upside to 1400 is achievable for the S&P 500, but as in all bull markets, there will be a setback at some point. Our new trading range implies that any setback will be less than 10% from current levels. Although crowd sentiment is becoming more optimistic, investor positioning remains defensive and valuations attractive. In short, extraordinary central bank actions are preventing the financial world from falling apart, and the real economy seems to be finally responding. Thus, the rally in risk assets should persist as economic and earnings growth follow through. We believe our portfolios are positioned to benefit from our more positive outlook.

• January nonfarm payrolls rose by 243,000, the greatest amount since April last year, and the prior two months were revised higher by 60,000 bringing the three-month average to 201,000. The unemployment rate also fell more than expected to 8.3%, in part due to the falling labor participation rate. Purchasing Managers Indexes (PMIs) from around the world were another positive. The US January manufacturing PMI rose one point to 54.1 in and the service PMI was up 3.8 points to 56.8, while global indexes rose to 51.2 and 53.2, respectively, and both from below 50. (Above 50 indicates expanding activity, below 50 indicates contraction.) The US PMIs' employment components suggest further private employment growth of around 200,000 next month. Moreover, ongoing declines in initial jobless claims, whose four-week moving average has fallen to 375,000, down 13.4% from a year ago, suggest year-over-year GDP growth will be over 2% this quarter (from 1.6% prior).

THE WEEKLY CHART: FALLING PARTICIPATION RATE HELPS LOWER UNEMPLOYMENT RATE



In the recent strong employment report the labor-force participation rate (the blue line in the chart, which shows the percentage of the working age population that either have a job or are actively seeking employment) fell to 63.7%, its lowest level since the early 1980s (it peaked just above 67% in the late1990s). A study by the Federal Reserve Bank of Chicago estimates that half of the participation rate's decline over roughly the last decade can be attributed to retiring baby boomers. Slate Columnist Matthew Yglesias points out that the falling participation rate may just reflect a structurally lower US employment/population ratio (black line in the chart), which has fallen back to early-1980 levels at 58.5% from a peak of 64% in 2000. He noted that the employment/population ratio in Germany (with with world-envyingly low unemployment rates) has rarely been over 55%.

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