

The Week

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Worth Noting

- The U.S. equity market bounced nicely last week, following the end-of-quarter sell-off.
- One factor helping the market was the International Monetary Fund (IMF) forecast for stronger economic growth this year.
- Unfortunately, emotions still appear to be driving the equity markets more than fundamentals. In particular, investors seem to be worried more about losing money than missing an opportunity to make money. This suggests that the market may need more time to work off the excesses from the 80 percent, 13-month rally from March 2009 until April 2010.

Market Bounces

After spending several days in the Rocky Mountains last week, crossing the continental divide several times, I was reminded that there is often a fine line between things flowing one way versus the other. In the mountains, the water flows east or west from the divide. In the markets, sentiment can seem to change its flow from one way to the other just as easily.

Last week, the equity markets finally rallied after falling sharply at the end of the second quarter. Sentiment was very negative at the end of June, with the equity markets making a new low for the correction that began in April. More important, the equity markets also dropped below the February correction low. We have been saying for several months that if the equity markets declined below the February low, it could signal a longer and deeper correction that could last through the summer. Last week's rally in the equity market does not change that view.

The decline in the equity market since April is not because the economy is contracting again. Rather, it is because investors are nervous that the economy may not be doing as well as they thought earlier this spring. In other words, the market has been declining because investor sentiment has shifted and is now flowing more to the negative side than the positive side.

The good news is the economy is still growing. In fact, last week, the IMF increased its forecast for global economic growth this year from the 4.2% rate projected in April to 4.6% now. In particular, the IMF increased its growth forecast for both the United States and China. This is a positive sign that the global economy is still on track to recover further from the 2008-2009 global recession.

However, the IMF cautioned that policymakers need to do more to keep the economy on its current track. Problems in Europe could hurt other countries and dampen the recovery. Nevertheless, the global economy is doing better not worse, despite investors' fears to the contrary.

The latest IMF report is also consistent with our view that the probability of a double-dip recession is low. According to the IMF director of research, a relapse into recession is "very unlikely". Of course, that does not mean that investors will not worry about a double-dip. It is

only natural for the flow of sentiment to swing from positive to negative after the dramatic 80% rally in 2009 and early 2010.

Last week, the stock market recovered very quickly after dropping below important support. This is an encouraging sign that the market is not in a free fall as many investors feared at the end of June. However, it is too early to say that the decline that began in April is complete. That's because sentiment is still the driving force in the market right now. Another round of bad news and investors may quickly forget that the IMF has raised its forecast for global growth.

The big problem for the equity market is confidence not the direction of the economy. The economy is growing. However, investors are worried that the economy could fall back into recession, causing the market to drop like it did in 2008. At this point, we think there is more downside risk in the equity markets, but we do not expect a repeat of 2008, unless some unexpected event changes the direction of the economic flows.

Investing is always a tug of war between hope and fear. Investors hope that their assets will appreciate in value as the economy recovers. However, they also fear that asset prices could drop instead. After the 80 percent rally from the March 2009 low, investors are probably more fearful than hopeful.

We continue to believe that the equity markets will be volatile this year. More important, we believe there is further downside risk. That's because investors seem to fear another big drop in the market more than they expect the equity prices to rally again. Consequently, people are still more likely to sell on bad news than buy on good news. Longer term, our year-end target for the S&P 500 remains 1100-1140.

Latest International Monetary Fund (IMF) projections – World Economic Outlook (WEO)						
	Projections				Difference from April 2010 WEO projections	
	2008	2009	2010	2011	2010	2011
World Output	3.0	-0.6	4.6	4.3	0.4	0.0
Advanced Economies						
	2008	2009	2010	2011	2010	2011
Advanced Economies	0.5	-3.2	2.6	2.4	0.3	0.0
United States	0.4	-2.4	3.3	2.9	0.2	0.3
Euro Area	0.6	-4.1	1.0	1.3	0.0	-0.2
Emerging and Developing Economies						
	2008	2009	2010	2011	2010	2011
Emerging and Developing Economies	6.1	2.5	6.8	6.4	0.5	-0.1
Central and Eastern Europe	3.1	-3.6	3.2	3.4	0.4	0.0
Developing Asia	7.7	6.9	9.2	8.5	0.5	-0.2
Middle East and North Africa	5.3	2.4	4.5	4.9	0.0	0.1
Western Hemisphere	4.2	-1.8	4.8	4.0	0.8	0.0

Source: International Monetary Fund

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