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The Markets

The latest U.S. economic data show consumer sentiment continues to recover from the shock to confidence last summer. Equally important, small business sentiment is also improving, potentially setting the stage for more job creation in the months ahead. The U.S. economy still faces many problems, but conditions do not seem to be as bad as many investors feared six months ago.

Unfortunately, things do not look this good overseas. Several countries in Europe already appear to be in recession, making it even harder for them to pay their debts. Consequently, nine European countries had their credit ratings downgraded by Standard and Poor's credit rating agency last week. Of course, this news was not unexpected, and investors did not overreact. In fact, most of the major European stock markets rallied on the first day of trading after the announcement. This shows that investors are taking bad news relatively well, suggesting that a lot of disappointing news is already priced into the European stock markets.

The initial positive European stock market response to the debt downgrades may also indicate that investors are anticipating that something good could come after all this bad news. For example, the debt downgrades could make European policymakers more resolute in their efforts to find a way to restrain future government deficits. Moreover, slower economic growth may also dampen inflation this year, opening the door for policymakers to cut interest rates further.

The European Central Bank already cut interest rates twice late last year and could cut interstates one or two more times early this year if inflationary pressures moderate. Even the Chinese monetary authority could cut interest rates during the next few months if Chinese economic growth slows down and inflation subsides.

Here at home, the U.S. stock market continued to trend higher during the past week. U.S. investors seem to be focused more on the health of the U.S. economy rather than on the problems in Europe or the economic slowdown in Asia. Obviously, not all the U.S. economic news is positive, but more economic reports have been "good" rather than "bad" recently. Therefore, the stock market seems to have a positive bias, and the underlying character of the market is looking better this month.

Investors seem to be less defensive as sentiment improves. The more volatile cyclically-sensitive sectors of the U.S. stock market have been doing better this month than the less volatile defensive sectors. If the defensive sectors were leading the way in the latest market advance, the risk of a prolonged downturn would probably be greater than it is when the cyclically-sensitive sectors are leading the way.

Looking ahead, the recovery in the U.S. stock market is probably due for a correction at some point in the next week or two. A slow and steady advance, as we have seen during the past few weeks, can make market participants a bit complacent. When that happens, unexpected bad news can lead to some profit taking. Nevertheless, we believe the longer-term fundamentals still favor modestly higher stock prices in 2012. If inflation subsides and foreign central banks cut interest rates this year as we expect, stocks are likely to do better than they did last year when rising inflation and interest rate hikes aggravated the European debt crisis and depressed investor sentiment. Fortunately, sentiment has improved during the past few months because economic conditions and the global stock markets appear to be stabilizing as investors look beyond all the negative news of the past year.

Index Performance Statistics – January 17

Index	Close	Day Change	Day % Change	% YTD Change	52 Wk % Change
DJIA	12422.06	-48.96	-0.39	1.67	5.38
NASDAQ	2710.67	-14.03	-0.51	4.05	-1.62
S&P 500	1289.09	-6.41	-0.49	2.50	-0.32

Source: Bloomberg
**Price return — does not include dividends*

Fed Officials Open to Additional Easing as They Monitor Risks of Economy

Federal Reserve officials are staying open to further monetary easing this year as they monitor risks that threaten to move the economy further away from their mandate for stable prices and full employment. Atlanta Fed President Dennis Lockhart told reporters Jan. 9 that he hadn't closed out "the option" for more stimulus, while New York Fed President William C. Dudley said in a Jan. 6 speech that it's "appropriate" to evaluate whether the Fed could do more to boost growth. Both are voting members of the Federal Open Market Committee.

Among the possible triggers for action, according to Ethan Harris, co-head of global economic research at Bank of America Merrill Lynch in New York: a slump in U.S. gross domestic product caused by a European recession, a more rapid slide in U.S. inflation than anticipated, and deteriorating U.S. payroll growth. "The labor market has a special role," said Harris, who doesn't expect the Fed to move at next week's meeting. "They are looking for a real healing process there" because job growth "helps drive the housing market, it helps drive the banking system with its bad debt issues, and, obviously, it helps the consumer."

Fed Chairman Ben S. Bernanke and his fellow policy makers will publish their latest economic forecasts after their meeting on Jan. 24-25. For the first time, they will reveal their own predictions for the benchmark federal funds rate, as well as "qualitative information" regarding their expectations for the $2.9 trillion Fed balance sheet that could provide hints on further easing.

Last Week

Bulls showed a fighter's chin as the market absorbed jabs by the bears. Stocks advanced this week on growing optimism in the global economy. A slowdown in Chinese imports boosted hopes for a soft landing, sparking speculation of fiscal and monetary easing by the world's second largest economy. Investors shook off Alcoa's (AA $9.93) earnings miss to kick off fourth-quarter reporting season with encouragement from the aluminum maker's top-line results and outlook. The Fed's Beige Book survey suggested the U.S economy continues to expand. Good vibes from meetings with German Chancellor Merkel and French President Sarkozy and successful Italian and Spanish bond auctions helped soothed sovereign debt fears. The bulls hung on to a slim lead after getting sucker punched by JP Morgan's disappointing profit tally and a report S&P was going to downgrade the credit ratings of several European countries.

Next week's pace will pick up as we receive another round of economic data. When the market opens after the long weekend, focus will be on scheduled releases on inflation, housing and manufacturing. Inflation is expected to remain tame with both producer and consumer prices rising 0.1%. On the housing front, we receive updates on starts, building permits and existing home sales. Industrial production, capacity utilization and regional reports from New York and Philadelphia are projected to show a modest improvement in manufacturing activity.

Earnings season hits the speed bag with scheduled releases from 48 S&P 500 companies and 6 Dow components. JP Morgan's profit tally could foreshadow what to expect from next week's releases by Citigroup (C $31.60), Bank of America (BAC $6.79) and Goldman Sachs (GS $101.21). Focus will also be on tech with bellwethers Google (GOOG $629.31), International Business Machines (IBM $180.55), Intel (INTC $25.75) and Microsoft (MSFT $27.99) scheduled release results. Other notable companies due to grace the tape with profit tallies include Freeport McMoRan (FCX $42.45), Schlumberger (SLB $69.70), General Electric (GE $18.93), Johnson Controls (JCI $35.10) and Consolidated Edison (ED $58.98).

Weekly Focus – Think about it

"You have a class of investors and you have a class of speculators. The speculators historically haven't been big enough to cause the investors to doubt the long-term vision of stock."
~ Jim Cramer

Best Regards,

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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.

* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.

* Bloomberg is the source for any reference to the performance of an index between two specific periods.

* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

* This commentary should not e consider individual investment advice and you should consult your financial professional before making any investment decision.

* You cannot invest directly in an index.

* Past performance does not guarantee future results.

* The Markets prepared by Gary Thayer, Chief Macro Strategist, Wells Fargo 1/17/12.

* Fed Officials Open: Craig Torres, Bloomberg 1/17/12.

* Last Week cited from Dean Meehan, Market Analyst, Wells Fargo Advisors 1/13/12.

* The opinions expressed here reflect the judgment of the authors as of the date the report and are subject to change without notice.

* This report was prepared by VSR Financial Services, Inc. Wealth Management Department.