

The Week

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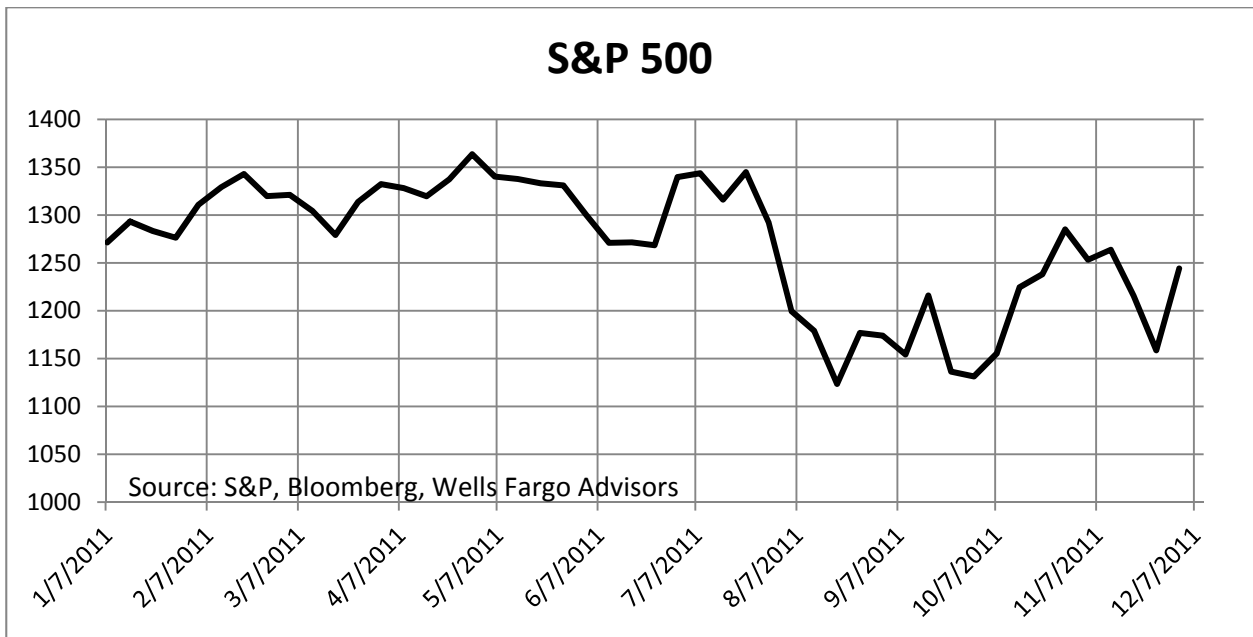
Stock market passes important test

A week ago, we said that the stock market was facing an important test. Sentiment was very negative and the stock market was testing important support levels after a remarkable advance in October. Those support levels held, and by the end of last week, the market had one of its biggest weekly gains since early 2009. This was an encouraging sign that the U.S. stock market may be more resilient than many investors expected.

As always, there were important reasons why sentiment was so negative and why the stock market sold off in late November. Likewise, there were reasons why the stock market rallied sharply last week. What is important to remember is that the underlying fundamentals normally determine the trend in the market. At this point, the fundamentals are still positive with the U.S. economy expanding and corporate profits growing. Nevertheless, investors are always watching to see if those fundamentals may change. That is why many investors are concerned that the problems in Europe could hurt the U.S. economy. Fortunately, that has not happened yet. The Euro zone may be

in recession, but the U.S. economy is still expanding.

The remarkable October stock market gains occurred after European policymakers announced steps to deal with their debt crisis. In addition, the October rally was fueled by better economic news in the United States. For example, there were more positive than negative earnings surprises, and consumer spending increased despite the drop in confidence last summer. As a result, investor sentiment turned positive in October. Of course it did not take much to dampen sentiment again, pushing the market back down to important support levels by the end of November.



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In late November, investors were worried that the efforts by European policymakers were inadequate and more needed to be done to contain the escalating debt crisis. In the United States, investors were also disappointed that the Super Committee could not reach a bi-partisan agreement to reduce the trajectory of the U.S. budget deficit. These problems could hurt the U.S. economy. Fortunately, the U.S. economic data continue to be more good than bad. At the same time, the problems in Europe got a temporary reprieve last week when the major central banks announced that they would provide more funding in the inter-bank market in order to prevent a possible liquidity crisis. By the end of last week, investor sentiment had responded positively to these developments, and the stock market had bounced sharply off important support levels.

Looking ahead, the added liquidity by the central banks should help but we believe it will not resolve the debt crisis. As the European debt crisis spread during the past few weeks, there were increasing concerns that European banks might not be able to get needed funds from other banks, which were holding back because of concerns that they might not be able to get funding. By extending loans in the inter-bank market, the central banks should ease the liquidity shortage caused by banks protecting their own liquidity needs. This should buy time for the European governments to try other measures to deal with their debt crisis.

This week, the leaders of the Euro zone countries will be meeting again to address the debt crisis. Investors will be watching to see if the governments with financial troubles will be willing to give up some control over their domestic economy in favor of more coordinated control by the central European authority. Of course, this would be a major change and might require the European countries to rethink the terms of their cooperation treaty. Obviously, these issues cannot be resolved in a week. The best investors may hope to see from this week's meetings might be more cooperation and less nationalism. Sometimes, it takes a crisis to force political changes. This is clear from the leadership changes in several troubled European countries during the past few months. It will be important to see if the new leaders can cooperate more or if national interests still override the interests of the overall European community.

The rebound in the stock market during the past week is an encouraging sign that investors think that some progress is being made to address the global economic problems. Unfortunately, there are no easy solutions. Therefore, investor sentiment may fluctuate as events unfold. In the meantime, seasonality is favorable for the stock market at this time of year, and the long-term fundamentals for the U.S. economy remain positive. Therefore, in the near term, the stock market may keep much of its recent gains after holding at important support levels in late November.

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