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quarterly investment outlook

A strong first quarter in stocks, but investors shouldn't ignore the dark clouds

By Tomoeh Murakami Tse
Washington Post Staff Writer
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NEW YORK -- Consumer confidence is rising. Corporate dividends are coming back. Markets continue to thaw.

Wall Street bankers are busier selling more stocks and bonds, and on Friday, a monthly employment report from the Labor Department showed that the country added 162,000 jobs in March -- the biggest monthly gain in three years.

In short, things are looking up. During the first three months of the year, major stock indices added another 5 percent to last year's double-digit gains, their fourth consecutive quarter of positive performance.

Carmine Grigoli, chief investment strategist at Mizuho Securities USA, says this is just the beginning. He expects the Standard & Poor's 500-stock index to rise another 12 percent by midsummer.

"The momentum and breadth of the market's recent advance, together with a revival in corporate stock purchases, seems to point to a powerful new bull market phase," he wrote in a note to clients last week.

So should retail investors, who have largely sat on the sidelines as equities soared, finally plunge back into the stock market?

Not so fast, say the bears, and they are still out there. They are quick to note that the March job gains were helped by temporary hiring for the 2010 Census. This camp is urging more caution now that asset prices have gone up further.

While acknowledging the improvement in the economy and excesses rung out from the financial system, these analysts argue that at its core, the same old problems loom: Individual debt, corporate debt, government debt.

David Levy of the Jerome Levy Forecasting Center said that even though upturns in the post-World War II period have lasted for several years, that won't be the case this time.

"Unsustained debt -- that's really what's different this time," he said.

For example, he pointed to household debt that, while recently improved, exceeds income. According to Federal Reserve statistics, the financial sector, which includes companies and government-sponsored enterprises, still has outstanding debt that is 119 percent the size of the gross domestic product. In 1990, that ratio was 46 percent.

"What this means is the private sector cannot function the way it normally does," Levy said. "This is a tremendous difference from any other cycle we've had since the 1930s. The idea we're going to jump-start the economy, and then it'll kind of kick in and drive itself -- that doesn't work here. . . . Next year is very much a question mark in my mind."

Levy added that he has invested his money primarily in Treasurys. He said "more financial trauma, no inflation and a lot of overblown fears about what is going to happen to yields make them attractive."

Many analysts warn that investors of Treasurys and other bonds may be in for a rude surprise when interest rates, which are at historical lows, eventually head back up, possibly later this year. In general, bond prices take a tumble when interest rates rise, and they rally when rates fall. The central bank, which has dramatically expanded its own balance sheet as it sought to rehabilitate the economy, has kept its short-term interest rates low as part of those efforts.

Going forward into the second quarter, investors will watch the Fed carefully and the pace of its pullback from its various interventions in the credit markets. Last week, the Fed ended its $1.25 trillion program to purchase mortgage-backed securities, an effort aimed at lowering interest rates on home loans.

Axel Merk, portfolio manager of the Hard Merk Currency Fund, suggested investors stay away from U.S. stocks, which he thinks are already overvalued, and buy the euro, which has been depressed by the recent turmoil that emanated from Greece.

"We're pouring all of this money into the economy. Sure we can get some growth out of it, but it's a very expensive growth," he said, adding that the economy still faces headwinds from the housing and commercial real estate markets in particular. "The implication of that is we need all of this stimulus to keep things going. And if we withdraw this stimulus . . . we will plunge right back down, which means the Federal Reserve won't do that."

Despite lingering worries, companies are expected to report solid profits when they start reporting quarterly earnings later this month. That could give stocks another boost, at least for the short-term.

Although concerns over heavy U.S. borrowing and stability of the global economy prompted a pullback across various assets in February, investors returned to mount a spring rally.

For the quarter, the Dow Jones industrial average of 30 blue-chip stocks gained 429 points, or 4.1 percent, to close at 10,857. The Standard & Poor's 500-stock index rose 4.9 percent, to 1169. The index, a broader measure, has now recovered 73 percent from its lows in March 2009, but is still off 25 percent from its all-time high reached in the fall of 2007.

The tech-heavy Nasdaq composite index, meanwhile, returned 5.7 percent, helped by large gains by a few companies such as Apple. The index stood at 2398 at quarter's end Wednesday.

"It was a great quarter," Howard Silverblatt, senior index analyst at Standard & Poor's, referring to the recovery in the corporate dividend.

Silverblatt said 72 companies in the S&P 500 index had raised dividends -- collectively worth $5 billion -- during the first quarter, including eight companies with "enough chutzpah, enough belief in their earnings ability, to initiate dividends."

Last year, S&P 500 companies slashed dividends by $38 billion.

As is often the case when investors are expecting a recovery, mutual funds that invest in the more volatile shares of smaller companies fared better than those that invest in larger, more stable companies. The value funds that buy small company stocks gained 9.5 percent, while value funds that invest in large firms rose 5.8 percent for the quarter, according to Lipper, a data company that tracks mutual funds. Large-cap growth funds returned 4.2 percent, while small-cap growth funds gained 7.3 percent.

Gains in world equity funds, hurt by the turmoil in the European markets, were more muted than U.S. diversified equity funds; international funds returned an average of 2.3 percent, compared with domestic funds' average gains of 5.7 percent, Lipper said. European and China region funds each had losses, though of less than 1 percent. Markets in Europe were dragged low by the debt crisis in Greece, which set off concerns about the indebtedness of other governments in the region. Chinese equities retreated as that country's central bank took steps during the quarter to tighten lending to companies and individuals to slow down the economy and curb inflation.

Among the sector funds, those that invest in stocks of financial services and consumer services companies rose the most, with each gaining more than 11 percent for the three-month period. Those were sectors that were beaten down during the recession. Funds that invest in commodities -- generally considered tied to the economies of emerging markets such as China -- were among the worst performers. Commodities funds and utilities funds each declined about 2 percent.