JOHNSON
INVESTMENT COUNSEL

E-Updates

Market Index	January Change	Year to Date
Standard & Poor's 500	-3.6%	-3.6%
Dow Jones Industrial Average	-3.3%	-3.3%
Russell 2000 (small company)	-3.7%	-3.7%
MSCI EAFE (international)	-4.4%	-4.4%
Barclays Intermediate Gov/Credit Index	1.4%	1.4%
3 Month Treasury Bill	0.0%	0.0%

A Chill Returns in January

January is often viewed as a barometer for the rest of the year, and the S&P 500's 3.6% decline in the month was not an encouraging start. In 44 of the last 60 years, the direction of the market in January predicted the market direction for the rest of the year. According to Ned Davis Research, when January has been up, the February through December gain has averaged 12.32%. When January has been down, the rest of the year return has averaged -0.79%. Of course, no indicator is consistently predictive, and the January Barometer has missed some big turning points in its history. For example, in January 2009, the market fell 8.6%, only to gain 35.0% for the rest of 2009.

After such a strong recovery in 2009, some profit-taking may have been overdue. In most cases, areas of the market that performed well last year struggled in January. International stocks fared worse than U.S. stocks, as the U.S. dollar strengthened and commodities dropped. High quality stocks outperformed low quality stocks. The two best performing sectors in 2009, Technology and Materials, were the two worst performing sectors in January 2010, each down more than 8%.

Policymakers Grab the Spotlight

Mid-month, investors were socked with a series of headlines from around the world that helped trigger selling. Rising worries about the creditworthiness of sovereign debt raised default risks, as Greece's fiscal deficits grabbed the spotlight. The "PIIGS" - Portugal, Ireland, Italy, Greece, and Spain - are among those European countries with the most burdensome debt levels, but the interconnectedness of global markets makes this a shared risk. China is dealing with a different risk - potentially too much growth. Government officials there began to send signals suggesting a tighter monetary policy and an intention to control economic growth through moves to raise capital requirements for banks and tighten lending standards. Amid these global developments, our domestic bonds rose, as the U.S. market and dollar benefitted from a flight to quality.

U.S. politics also had a big impact on the markets in January. Scott Brown, a Republican, won the Massachusetts Senate seat derailing the President's health care plan. The Democrats loss of a "filibuster proof" majority in the Senate has the potential to greatly change the direction on many areas that affect investors in this mid-term election year. Health Care was the only sector with a positive stock return in January, up 0.5%, upon the realization that any bill that does pass will likely have a relatively mild impact. On the heels of this setback, President Obama introduced a more populist proposal: levy a fee on major banks to recoup the TARP bailout money and enact legislation to limit the size and scope of banks. While it remains to be seen what will become law, the large banking stocks sold off on this threat. Lastly, after some protest from a few Senators, Ben Bernanke was reconfirmed as the Federal Reserve chairman as expected.

Underneath these policy issues, economic data and earnings news continued to support a business recovery. The January unemployment rate dipped down to 9.7% and 4th quarter GDP rose 5.7%, the best growth since 2003. So far, the majority of companies that have reported 4th quarter earnings have exceeded forecasts. However, expectations have gotten increasingly high by investors, which has limited the market's response to such good news. At a price earnings ratio of 14.5 times projected earnings, the market appears near fair valuation, which indicates that future returns are likely to be driven by earnings growth and dividends.

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