January 2010 Market Review

The stock market got off to a lousy start in 2010. The S&P 500 lost 3.6% in January; the Russell Midcap, 3.3%; and the small-cap Russell 2000, 3.7%. This was a typical January, in that investors took profits in the previous year's winners, while past losers rebounded from tax-loss selling in December.

The January selloff occurred despite strong fourth-quarter earnings reports. About three-fourths of the large-cap companies that have reported beat earnings estimates, and about two-thirds exceeded revenue estimates. News on the economy has also been generally good. Fourth-quarter real GDP grew at an annual rate of 5.7%, exceeding expectations. Annualized growth in end demand was only 1.8%, while reduced inventory liquidation contributed 3.4%, and improvement in the trade balance added 0.5%. Data for January show that the pickup in production is continuing. Auto production was up 22% from the December level, and the Institute for Supply Management's survey of manufacturing rose to 58.4%, its highest level since 2004.

The shape of the current recovery is different from the norm and is likely to remain so. Consumer spending is weaker than it normally would be, while the industrial sector is stronger. Spending on capital equipment, which normally lags in a recovery, grew at a real rate of 13.3% in the fourth quarter. The pattern is likely to persist because consumers need to rebuild their savings, and the decline in the dollar has made U.S. manufacturing competitive in world markets. Because of this structural shift in the economy, increases in payroll employment are likely to be smaller than normal relative to the growth in GDP.

The weakness in stocks probably reflects increasing concern about future monetary policy. China, which has been the most important driver of global recovery, has tightened bank lending in response to signs of inflationary pressure. In the United States, tightening by the Federal Reserve is not likely before the second half of the year, but investors anticipate such changes well in advance. While stocks are likely to encounter some more bumps in the road this year, we continue to think that a strong recovery in corporate earnings will support positive returns.

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February 3, 2010

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