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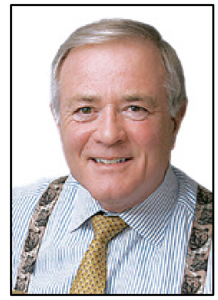

William Rutherford

Market rises closer to all-time high

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The equity market in the U.S. has continued the rally that began June 1, 2012. January's 5.1 percent increase for the S&P was the largest since October 2011. The Dow surpassed 14,000 for the first time since 2007. What's more, the market accomplished this in the face of a declining gross domestic product in the fourth quarter of 2012, when GDP dropped 0.1 percent instead of increasing as expected. Unemployment ratcheted up to 7.8 percent.

In response, the Federal Reserve said:

"Information received since the Federal Open Market Committee met in December suggests that growth in economic activity paused in recent months, in large part because of weather-related disruptions and other transitory factors. Employment has continued to expand at a moderate pace, but the unemployment rate remains elevated. Household spending and business fixed investment advanced, and the housing sector has shown further improvement. Inflation has been running somewhat below the committee's longer-run objective, apart from temporary variations that largely reflect fluctuations in energy prices. Longer-term inflation expectations have remained stable.

"Consistent with its statutory mandate, the committee seeks to foster maximum employment and price stability. The committee expects that, with appropriate policy accommodation, economic growth will proceed at a moderate pace and the unemployment rate will gradually decline toward levels the committee judges consistent with its dual mandate. Although strains in global financial markets have eased somewhat, the committee continues to see downside risks to the economic outlook. The committee also anticipates that inflation over the medium term likely will run at or below its 2 percent objective.

"To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the committee will continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month. The committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. Taken together, these actions should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

"The committee will closely monitor incoming information on economic and financial developments in coming months. If the outlook for the labor market does not improve substantially, the committee will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until such improvement is achieved in a context of price stability. In determining the size, pace and composition of its asset purchases, the committee will, as always, take appropriate account of the likely efficacy and costs of such purchases."

Political problems and financial strain in Washington continued. The European debt crisis subsided, but is not over. Nevertheless, with ample negatives to slow the market, equities rose. China engineered a soft landing after massive government support, and Japan started its own quantitative easing program.

A change in investor sentiment brought about the rally in U.S. equities. In December 2012, investors pulled a net $30.47 billion from stock funds, the most since July 2011 and the sixth highest withdrawal since that number has been tracked beginning in 1984.

However, in January 2013 that trend reversed and TrimTabs estimates $42.8 billion went into equity funds through Jan. 29. What happened to cause this change in sentiment? With gains very hard to come by in nearly every sector, equities began to look more appealing.

The money being invested into stock funds has not come from bond funds, as many had predicted. In fact, bond funds had $41 billion in inflows in January, according to Strategic Insight, much higher than the $27 billion averaged monthly last year. Apparently, investors still like bonds.

Indeed, the big loser in this rotation appears to be banks. More than $114 billion was pulled out of bank deposits the first week of the year, the biggest single week of withdrawals since 9/11, according to Bloomberg. Also, $30 billion more was withdrawn from retail money market accounts in January, according to the Investment Company Institute. People are getting tired of earning zero on their cash.

The change in attitude toward stock funds has been attributed to a number of factors, including the "January effect" of selling for tax reasons in December and then reinvesting in January.

With the housing market firming, people began to feel the wealth effect, and decided not to stay on the sidelines. Consumer confidence rose. Investors who worried on the sidelines did not experience positive results during the market climb from its depths March 9, 2009.

Meanwhile, manufacturing seems to be rebounding. The Institute for Supply Management index rose to 53.1 percent, from 50.2 percent in December, beating analysts' expectations. When the index is above 50 percent, it shows that manufacturing is expanding. Construction spending rose, and auto sales increased.

The Dow's all-time high is 14,164. On Feb. 1, the Dow closed up 149 points to reach 14,010. The volatility index closed below 13. With the Dow within 155 points of its all-time high, it is a fair bet that retail investors will notice. When the Dow and S&P exceed their highs, we can expect the psychological effect to be even greater. The Dow is selling at 13 times earnings versus 16 times in 2007. The market could still have room to run.

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