The Week

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Help from overseas

The U.S. economy has weathered many problems during the past year and has proven more resilient than many investors expected. The good news is the U.S. economy could benefit if inflation subsides this year. That's because several of the foreign countries that raised interest rates to fight inflation early last year could cut interest rates early this year if inflation decreases as the global economy slows down.

The latest U.S. economic data show consumer sentiment continues to recover from the shock to confidence last summer. Equally important, small business sentiment is also improving, potentially setting the stage for more job creation in the months ahead. The U.S. economy still faces many problems, but conditions do not seem to be as bad as many investors feared six months ago.

Unfortunately, things do not look this good overseas. Several countries in Europe already appear to be in recession, making it even harder for them to pay their debts. Consequently, nine European countries had their credit ratings downgraded by Standard and Poor's credit rating agency last week. Of course, this news was not unexpected, and investors did not overreact. In fact, most of the major European stock markets rallied on the first day of trading after the announcement. This shows that investors are taking bad news relatively well, suggesting that a lot of disappointing news is already priced into the European stock markets.

The initial positive European stock market response to the debt downgrades may also indicate that investors are anticipating that something good could come after all this bad news. For example, the debt downgrades could make European policymakers more resolute in their efforts to find a way to restrain future government deficits. Moreover, slower economic growth may also dampen inflation this year, opening the door for policymakers to cut interest rates further.

The European Central Bank already cut interest rates twice late last year and could cut interest rates one or two more times early this year if inflationary pressures moderate. Even the Chinese monetary authority could cut interest rates during the next few months if Chinese economic growth slows down and inflation subsides.

Here at home, the U.S. stock market continued to trend higher during the past week. U.S. investors seem to be focused more on the health of the U.S. economy rather than on the problems in Europe or the economic slowdown in Asia. Obviously, not all the U.S. economic news is positive, but more economic reports have been "good" rather than "bad" recently. Therefore, the stock market seems to have a positive bias, and the underlying character of the market is looking better this month.

Investors seem to be less defensive as sentiment improves. The more volatile cyclically-sensitive sectors of the U.S. stock market have been doing better this month than the less volatile defensive sectors. If the defensive sectors were leading the way in the latest market advance, the risk of a prolonged downturn would probably be greater than it is when the cyclically-sensitive sectors are leading the way.

Looking ahead, the recovery in the U.S. stock market is probably due for a correction at some point in the next week or two. A slow and steady advance, as we have seen during the past few weeks, can make market participants a bit complacent. When that happens, unexpected bad news can lead to some profit taking. Nevertheless, we believe the longer-term fundamentals still favor modestly higher stock prices in 2012. If inflation subsides and foreign central banks cut interest rates this year as we expect, stocks are likely to do

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better than they did last year when rising inflation and interest rate hikes aggravated the European debt crisis and depressed investor sentiment. Fortunately, sentiment has improved during the past few months because economic conditions and the global stock markets appear to be stabilizing as investors look beyond all the negative news of the past year.