Miracle Mile Advisors Research, February 2012

The Macro Perspective: Ahead of the Pack

Market cycles have been driven almost exclusively by macro forces over the past several years. A wave of globalization fueled this trend on a large scale for the previous decade, but recently it has intensified and lifted the co-movement amongst stocks – and even between different asset classes – to historical highs. In current market parlance, investors are trading with either a "risk on" or "risk off" stance where most markets move in synch. Stock pickers lament that good companies get ravaged along with the bad when the broad equity market is falling, and low-quality stocks rally along with the cream of the crop when it is rising. In both environments, active managers have found it very difficult to beat their benchmark indexes. According to Morningstar, 2011 was the worst year for equity mutual funds since 1997. Only 17% of roughly 4,100 large cap equity funds beat their benchmarks last year.

Complicating matters further for active managers is the volatility of the last few years. Investors remember well the gut-wrenching days of 2008 and 2009, but it may come as a surprise that compared to 2010 and 2011 those earlier years were more straightforward from a macro perspective. The ISM Manufacturing Index, a reliable leading economic indicator of the economy, declined through most of 2008, bottomed late in the year, and then rose throughout most of 2009. The equity market largely followed suit. It was not a pleasant experience while equities headed south, but the signals for decline and recovery were there for macro investors to read.

The picture changed significantly in 2010 and 2011. In ***each*** of these years equities had three distinct market phases. This volatility made successful stock picking nearly impossible. In our opinion, the intervention of Federal Reserve policy contributed to these choppy waters. Economic improvement stalled in mid-2010 and equities also took a breather from their post-recession recovery. The Fed then stepped in with an additional round of stimulus. This action helped renew the rally temporarily, but it also sparked a global inflationary spiral. As the U.S. dollar sank, food and energy prices rose and eventually choked off economic growth. This led global equity markets to another stall in mid-2011. Inflation pressures cooled by late last year, however, and the current recovery began.

The good news is that the present economic backdrop looks much more constructive than it did over the last two years, yet many investors remain unconvinced. Below we discuss why these rough market conditions have left most investors too bearish, and the reasons we believe a smoother, macro-driven path for markets lies ahead.

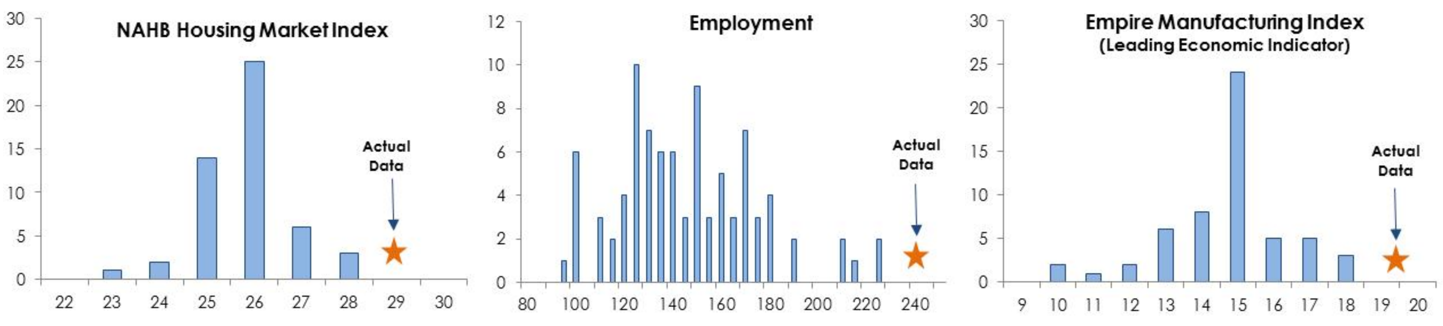
Chasing the Wrong Tail

The one-two punch of a sharp market decline followed by extreme volatility has left investors delirious. Those who were burned badly in 2008 still may be gathering the strength to step back in the ring, but those who have stuck it out may feel even more bruised and battered. Bloomberg News recently reported that 48 percent of investors are holding more than 5 percent of their assets in cash while a year ago only 30 percent of investors held over 5 percent. The recent improvement in economic data, as well as the equity rally in place since the fall, should have prompted *less* investors to hold cash instead of more.

We believe that the severity of the credit crisis has changed investor psychology at a fundamental level. This is not shocking; its impact took many by surprise and now investors are on high alert for the next extreme event ("tail event"). The steady stream of media attention focused on the potential candidates for another Black Swan event[1] also contributes to the fear mentality. The bearish mantra in late-2011 centered on a "European meltdown" and the many reasons equities could not rise into headwinds from Greece. Meanwhile, the S&P 500 has gained 9% year to date and more than 20% from its October cyclical low. Now the naysayers have shifted from "all news is bad news" to "the good news can't last." Oil prices have become the villain *du jour* and the debate has shifted to the magic number at which energy inflation will stamp out growth.

We concur that the risk of a tail event is real, but we believe that a *positive* event is more likely than a *negative* one given the current economic backdrop. In fact, we are observing far more positive "surprises" than negative ones every day in economic data releases. The graphs below highlight just a few examples of how drastically Wall Street economists and strategists are underestimating the strength of the economy. In each of these cases – including the much-watched housing and employment areas – *every single professional forecast* came in below the actual data report. Unfortunately these pessimistic predictions get more coverage than the actual results, and the fear feeds on itself. This fear, however, is the foundation for the "wall of worry" that the market has been climbing year to date.

Forecasts of Wall Street Economists and Strategists for Recent Economic Data Releases



Source: Bloomberg, Wolfe Trahan & Co., NAHB, BLS.gov, Federal Reserve Bank of New York

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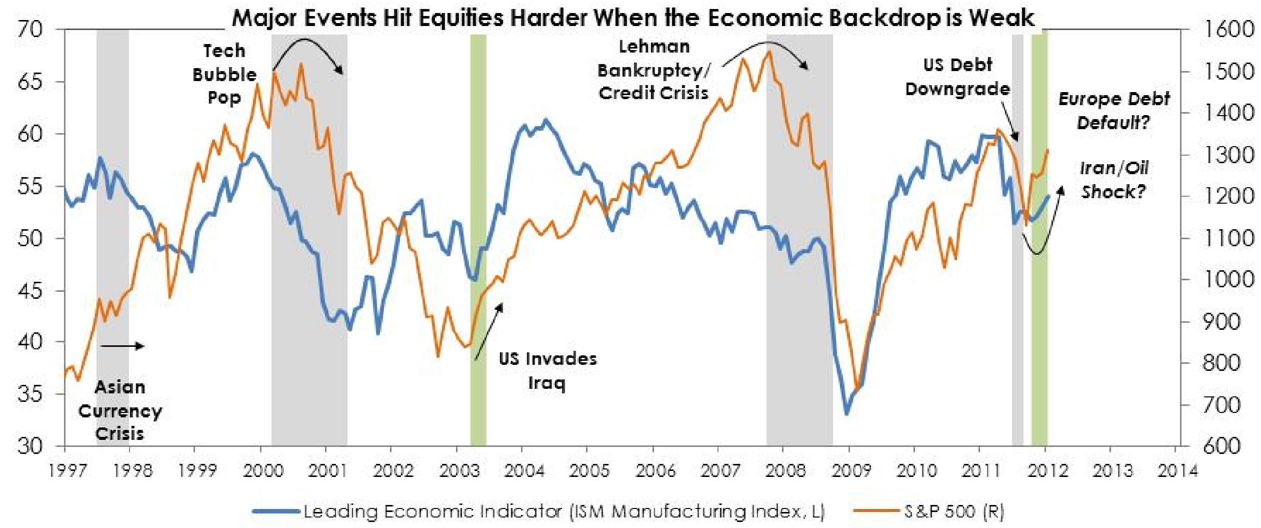
[1] The term "Black Swan event" was popularized by author Nassim Taleb in his book, "The Black Swan: The Impact of the Highly Improbable" and refers to a highly improbable, unpredictable event that has a significant impact.

The risk that an exogenous event could occur is always present, but the severity of the market's reaction is tied to the economic backdrop. When the business cycle is in an expansionary phase and leading indicators are rising, the markets tend to be much more resilient in the face of negative events. The opposite is also true; a tail event can trigger a market reversal against a poor economic backdrop. The graph below shows several negative historical periods and how the S&P 500 Index reacted to them. In the cases where leading indicators were falling – Asian Currency Crisis in 1997, Tech Bubble Pop in 2000, Lehman Brothers Bankruptcy in 2007, and the U.S. Debt Downgrade by Standard & Poor's in 2011 – the equity market turned down. However when the United States invaded Iraq in 2003, the economy was improving and the equity market was not shaken. Today, both leading indicators and the equity market are in an uptrend, and as long as this trend continues it should provide a safety net to some degree for potentially adverse events. In fact, we believe that this safety net is working now as the market continues to rally despite the ongoing and unresolved Greek debt problems.

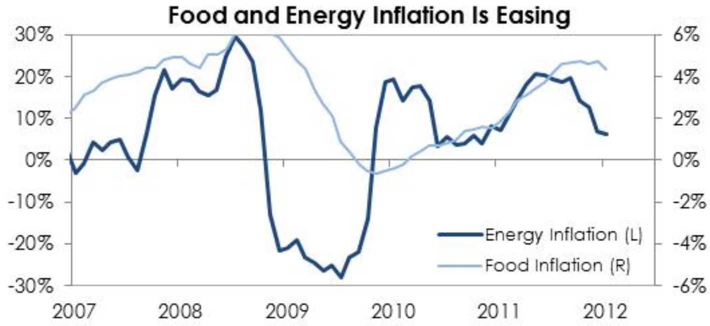


Best in Show

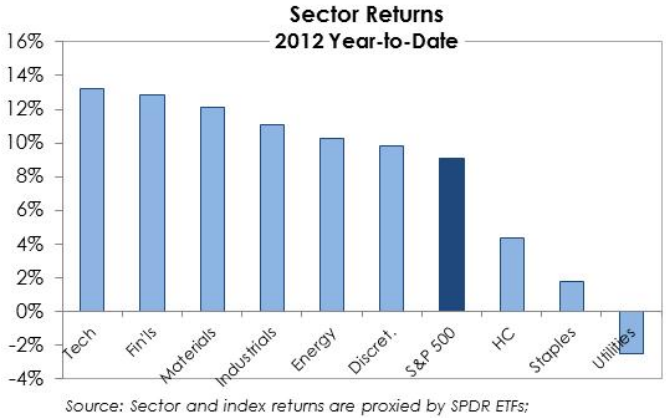
Our most highly-regarded objective at Miracle Mile Advisors is to *protect* the wealth our clients have earned, so when we increase our risk exposure to attain growth the decision is not taken lightly. When we believe the downside risk outweighs the potential reward we do not hesitate to shift toward more conservative allocations and assets, but now is not one of those periods.

Economic data continues to surprise on the upside – all five of the leading economic indicators released for February have shown improvement – and most inflation data, which tend to forecast a turn in these indicators, continue to indicate growth ahead. Despite a similar pattern in the equity market, when we scratch below the surface this year does not look like a repeat of 2010. Housing, employment, credit growth, and consumer confidence are all improving while last year they were stagnant or deteriorating.

The global backdrop is much more positive today than it was a year ago as well. World central banks are lowering interest rates instead of raising them since they no longer need to fight the demon of inflation. Oil prices have risen due to both improving growth prospects and fears of a conflict with Iran, but overall food and energy price inflation in the U.S. has been declining since October which provides some buffer room. Consumer confidence is still rising as well, signaling that the average American is not yet feeling a pinch from gasoline prices.



Sector leadership in equities also points to a healthy market. Year to date, the sectors associated with improving economic growth are leading the pack. Miracle Mile Advisors holds Opportunistic positions in the sector ETFs for Technology, Materials and Energy – all of which are outperforming the broad index in 2012. The defensive sectors which held up best during the difficult markets of 2011 – Health Care, Utilities, and Consumer Staples – all are significantly underperforming the S&P 500. A shift in leadership away from growth-oriented sectors like Materials and Technology and toward defensive sectors like Utilities would be an early signal that weakness in the broad equity market could lay ahead.



Barking Up the Wrong Tree

The macro perspective makes a solid case for continued strength in equities but yet many investors do not buy the bullish story. What will make them change their tune? We think their skepticism is rooted in a bottom-up investment process. Investors who ignore macro trends and focus on stock-specific stories are waiting for an improvement in earnings before fully jumping on the bandwagon. This type of strategy destines an investor always to be late to the game since earnings are backward-looking indicators.

The official 2011 fourth quarter earnings season came to a close a little over a week ago, and it was one of the weakest in years. This may partially explain stock pickers' skepticism about the health of the market rally, but we expect this tide to turn in the coming quarters. Bloomberg News reports that the number of negative earnings pre-announcements for the first quarter of 2012 has fallen. Company management is usually anxious to get ahead of a negative earnings result by pre-announcing weakness to the market, so an absence of negative guidance on earnings could bode well for results in the coming quarter.

The market also is signaling that earnings improvement could be near. We have seen an expansion of the price-to-earnings multiple (P/E) as the market rallied over the last several months. Historically a higher P/E ratio is followed by an improvement in earnings per share growth over the next six months. If this relationship holds, we can expect better earnings seasons in the next few quarters and a higher likelihood of bottom-up stock pickers shifting toward a more bullish stance. More cash entering the equity market could mean more gains in the months ahead.

Source: Wolfe Trahan & Co.

The fact that much of Wall Street disagrees with our optimistic view does not worry us at all. In truth, we find it encouraging. The periods when everybody is on the same side of the ship are when one needs to worry about tipping over. Despite a positive backdrop there are always risks to the markets. We monitor changes in the data very carefully to differentiate between a major shift in outlook and a temporary pull back. We currently believe a pull-back would be a buying opportunity and remain fully invested at our target asset allocations.

February 29, 2012

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