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“Bear Market Bounce”

Market Commentary – August 2008

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According to the advance reading of Gross Domestic Product (GDP), the value of goods and services produced in the U.S. grew 1.9% in the second quarter. Shrinking imports and expanding exports boosted GDP, while a decline in business inventories weighed it down. The Bureau of Economic Analysis also reported updates to previously released calculations: GDP grew 2.9% in 2005, 2.8% in 2006, 2.0% in 2007, and 0.9% in the first quarter of 2008. Interestingly, the 2007 fourth quarter reading was lowered from positive 0.6% to negative 0.2%. While the National Bureau of Economic Research defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months,” others define it as two consecutive quarters of contracting GDP. A recession has not yet been declared, but the U.S. economy is teetering on the edge.

The Federal Open Market Committee (FOMC) is expected to leave its benchmark Fed Funds rate at 2.0% when it meets on August 5. According to Federal Reserve Chairman Ben Bernanke, “accurately assessing and appropriately balancing the risks to the outlook for growth and inflation is a significant challenge for monetary policymakers.” The Fed now sees 2008 GDP growth in a tepid range of 1.0%-1.6%, while they expect inflation to simmer at 3.8%-4.2%. Bernanke sees “significant downside risks” due to high commodity prices, tight credit, job losses, and falling home prices. Futures markets have not fully priced in a 25 basis point rate hike until February 2009.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. One year ago, the S&P 500 was at 1459 with earnings of $83.15, implying a price-to-earnings (P/E) ratio of 17.5. Today, the S&P 500 is 13% lower at 1267 while earnings have tumbled 27% to $60.39. Since earnings have dropped more than stock prices, the P/E ratio has actually increased to 21.0. Normally, a low P/E ratio hints that stock prices are cheap, while a high P/E ratio suggests that stock prices are expensive. Our hypothesis is that the horrible earnings reported by financial firms in recent quarters are a temporary phenomenon. Many of the major banks are suffering huge losses as they write down assets from loans expected to turn sour. Unless these banks are all destined to fail, which is highly unlikely, such write-downs are not sustainable in the long run and thus temporary. Although we consider stocks to be fairly priced, we maintain that they are more attractively priced than they were a year ago.

Support around 1280 for the S&P 500 failed, and now past support is acting as resistance. In July, the S&P 500 consolidated between 1200 and 1280. A favorable technical development is that the pattern of lower lows, the definition of a downtrend, has stopped. As well, our market breadth indicator bottomed on July 15 and will likely turn positive on August 1. There is plenty of resistance overhead: 1280 from the March lows, 1380 from the 200 day moving average, and 1425 from the May peak. Still, the market seems to be building for a bear market bounce. Volume on the bounce will be the key in determining how strong the rally is. Stocks rising on light volume would suggest short covering, which is bearish. If stocks rise on heavy volume, however, that would indicate a sign of market health as real money from the sidelines is put to work.

Market volatility is creating interesting opportunities for our cash liquidity. Bear markets give investors who have cash the chance to buy stocks when they are cheap. According to our calculations, there are plenty of individual stocks currently “on sale”. These may be added incrementally to our portfolios. It is critical, however, to maintain a balance of cash and stocks. Keeping a balance makes portfolio management less about predicting and more about planning.