"Recharging The Batteries"

Market Commentary – March 2011

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 2.8% in the fourth quarter of 2010. This is lower than the advance estimate of 3.2%. The Federal Reserve recently upped its forecast for 2011 GDP growth from 3.0%-3.6% to 3.4%-3.9%. It still sees long run GDP growth in the 2.5%-2.8% range. Unemployment fell to 9.0% in January, the lowest level since April 2009, but it is well above the Fed's long term forecast of 5.0%-6.0%. Robust economic growth is the key to bringing down the unemployment rate to more normal levels.

While the risk of deflation has been a concern since the economy collapsed in 2008, recent movement in energy prices suggests that inflation hawks may also need to worry. Inflation is best when it is not too low and not too high. The Federal Reserve predicts the 2011 price index for personal consumption expenditures (PCE), which includes the volatile food and energy categories, in a tame range of 1.3%-1.7%. This forecast may need to be revised higher. Recent global unrest, especially in oil-rich Libya, has contributed to a spike in the price of oil. The Light Sweet Crude Oil index peaked at $146 per barrel in July 2008, hit a trough at $33 per barrel in January 2009, and is once again near $100 per barrel. If high oil prices are sustained, they will weigh on economic growth like an extra tax.

In the long run, famous investor Warren Buffett revealed last weekend in his annual letter to Berkshire Hathaway shareholders that he is bullish on the future of the United States. Mr. Buffett pointed out that "Money will always flow toward opportunity, and there is an abundance of that in America." He cautioned investors that the "prophets of doom", who are worried about America's problems, have ignored an important factor: "Human potential is far from exhausted, and the American system for unleashing that potential – a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War – remains alive and effective."

Warren Buffett's annual letter contained an excellent section titled "Life and Debt", where he cautioned against the downside of leverage and praised the importance of cash liquidity. On the topic of cash, Mr. Buffett wrote: "Having loads of liquidity…lets us sleep well. Moreover, during the episodes of financial chaos that occasionally erupt in our economy, we will be equipped both financially and emotionally to play offense while others scramble for survival." Exactly.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $96.19, which implies a price-to-earnings (P/E) ratio of 13.8 with the S&P 500 at 1327. The earnings yield (E/P) is currently 7.25%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 3.41%. Earnings estimates continue to creep higher, but they are doing so at a pace slower than the ascent of stock prices. As a result, stocks valuations have become slightly less attractive.

Despite continued strength in stock prices, we maintain that stocks are in need of a consolidation period to recharge the batteries. The S&P 500 plowed through resistance at 1300 in early February and ultimately marched higher to 1343. A pullback on high volume at the end of February suggests a period of consolidation may be ahead. Major support levels exist at 1300, the 50 day moving average at 1291, and the November high at 1225. On the upside, resistance is around 1345 and 1375. A news catalyst would likely trigger a sell-off. Aside from global events, a possible catalyst could include news of fiscal policy out of Washington D.C. or state government spending. Our hypothesis is that investors would utilize a pullback to put more capital to work, providing a level of support to stock prices.