“Two Steps Forward, One Step Back”
Market Commentary – November 2012

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The advance 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 2.0% in the third quarter of 2012. This compares with 1.3% in 2012 Q2, 2.0% in 2012 Q1, and 4.1% in 2011 Q4. While growth of the U.S. economy has been steady, the pace has been slow. Moreover, there are several headwinds that could impede growth in the months ahead: a controversial U.S. political election, the U.S. fiscal cliff (combination of spending cuts and tax hikes scheduled for January 1, 2013), Europe’s recession, and China’s slowing growth. In October, the International Monetary Fund’s World Economic Outlook report warned that “risks for a serious global slowdown are alarmingly high.”

With a variety of accommodative stimulus tools already in place, financial markets yawned at the Federal Open Market Committee (FOMC) monetary policy statement on October 24. The third round of quantitative easing, known as “QE3”, is currently in place, as the Fed is buying $40 billion in mortgage-backed securities each month with no end date given. “Operation Twist”, where the Fed extends the average maturity of its Treasury securities by selling short-term securities and buying long-term ones, is scheduled to last through the end of 2012. In addition, the Fed Funds rate is projected to be in a range of 0% to 0.25% through mid-2015. With the patient (i.e. the U.S. economy) heavily medicated, it is now a matter of waiting for the effects of the medication to kick in. The Fed hopes that higher asset prices will cause consumers and businesses to feel confident and spend, thus driving economic growth. The next FOMC announcement is scheduled for December 12.

Whoever wins the U.S. election on November 6 will inherit a difficult hand of cards. Monetary policy can buy time (at a cost), but the major problems we face are fiscal in nature. In the long-run, the U.S. economy will have a more stable platform from which to grow if the U.S. federal government balances its budget and slowly pares debt over time. In the short-run, however, the process of balancing the budget is painful, since it involves raising taxes and cutting spending. These actions could throw the economy into a recession. If only the economy would grow, it would make balancing the budget and reducing debt easier. That’s the catch-22: growth is anemic. One way out of this dilemma is to encourage businesses to spend by *permanently* lowering their effective tax rates (including the repatriation of U.S. multinational companies’ foreign-earned profits), simplifying the tax code, reducing government regulation, lessening the burden of healthcare on employers, and developing domestic sources of energy (especially natural gas). Expanding companies would hire, which would in turn fuel consumer spending. These solutions are not accomplished overnight. Patience is needed.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $110.54, which implies a price-to-earnings (P/E) ratio of 12.8 with the S&P 500 at 1412. The earnings yield (E/P) of 7.83% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.69%. Analyst estimates have been trending lower in recent months. S&P 500 operating EPS for 2013, projected near $119 in April 2012, are now expected to be $114.20. Lower expectations make it easier for companies to beat.

The S&P 500 continues its healthy, self-correcting pattern that we could describe as “two steps forward, one step back”. Resistance proved tough at 1465. Support around 1425 was pierced, but 1410 has been holding up well. Looking below, the 200 day moving average is at 1378 and climbing. There is also plenty of support around 1360. In recent months, the stock market has corrected modestly before overheating too much; this is bullish. News headlines have been negative and investor sentiment has been bearish. Just when it looks like the market must move in the “obvious” direction, isn’t it curious how it often does the opposite? A balanced portfolio helps investors to profit from this paradox.