"Not Sustainable"

Market Commentary – February 2011

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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 3.2% in the fourth quarter of 2010. This is higher than the third quarter measurement of 2.6%. Early in the recovery from the recession, GDP was boosted by businesses investing and rebuilding inventories. The driver of GDP growth now seems to be switching to consumer spending in a signal that the recovery is gaining traction. Consumer spending, which makes up about 70% of GDP, jumped 4.4% in the fourth quarter, the largest gain since the first quarter of 2006. The unemployment rate tumbled from 9.8% in November to 9.4% in December. While this is still much higher than the 4.4% to 5.0% range observed during 2007 (before the economy collapsed), it is a step in the right direction. What remains to be seen is whether the economy can continue growing at a rate significant enough to slash unemployment. In its press release on January 26, the Federal Open Market Committee (FOMC) noted that "employers remain reluctant to add to payrolls".

With monetary policy quietly at work in the background stimulating the economy, the spotlight is focused on fiscal policy. On January 26, the FOMC announced its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". It has maintained this range since December 2008, so the January 2011 decision is not shocking. We will likely hear more from the Fed near June as its purchase of $600 billion in Treasuries is scheduled to end. In the meantime, fiscal policy has been hogging the headlines. The Congressional Budget Office projects that the federal budget deficit will be $1.48 trillion in 2011 (9.8% of GDP). This is higher than the 2010 deficit of $1.29 trillion. The national debt is a bit more than $14 trillion. Politicians are willing to address non-security, discretionary spending (about 15% of the budget), but Medicare, Medicaid, and Social Security are critical. Inflation in healthcare costs and aging baby boomers will prove challenging in the coming years, and a spike in long-term interest rates could be the nail in the coffin regarding a potential U.S. default.

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 $95.84, which implies a price-to-earnings (P/E) ratio of 13.4 with the S&P 500 at 1286. The earnings yield (E/P) is currently 7.45%. Earnings estimates have been on the rise, contributing to a decline in P/E even though stock prices moved higher in January. The 10-year U.S. Treasury note yield has reached a plateau, currently at 3.38%. Generally speaking, there is still excellent value in stock prices.

While the rally in stock prices since September 2010 has been enjoyable, investors would be prudent to acknowledge that this pace of ascent is not sustainable. The S&P 500 jumped 2.3% in January, and this is on top of a 6.5% rise in December. Stocks sold off on relatively high volume on January 28. A high volume sell-off late in a rally suggests an upcoming period of consolidation. Our market breadth indicator peaked on December 30 and has been creeping lower ever since (although it remains barely in positive territory). There should be ample support from the 50 day moving average at 1250 and near the November high at 1225. On the upside, if the S&P 500 can break through resistance at 1300, the next major area of resistance would be around 1375.

We would view a mild pullback in stock prices as a healthy signal that the cyclical bull market has not yet ended. There was a rotation from small cap to large cap stocks in January, although mid cap stocks remained popular. Also, the value style tended to outperform growth in January. We favor large cap value as the core of a portfolio. Depending on the portfolio and the client's risk profile, we will look to incrementally add more stocks should prices decline further.