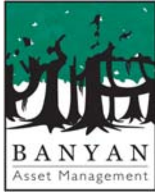

"Accumulating Stocks"

Market Commentary – September 2008

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The preliminary reading of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. grew 3.3% in the second quarter. The preliminary reading was revised higher from the advance reading of 1.9% announced last month. The relatively robust growth is attributed to strong exports on the back of the weak U.S. dollar and increased consumer spending due to the tax rebates issued in the spring. However, the strong rally in the U.S. dollar over the past 6 weeks, coupled with a slowing global economy, should cause exports to slow in the quarters ahead. Also, the economic boost from the tax rebates was a one-time shot, the benefits of which have already been felt.

Inflation in consumer goods and services has soared to the highest level in 17 years. The Producer Price Index (PPI), a measure of inflation in wholesale costs, rose 9.8% in July versus a year earlier. This is the biggest jump since June 1981. The Consumer Price Index (CPI), a measure of inflation in consumer goods and services, rose 5.6% in July versus a year earlier. The last time CPI was this high was in January 1991. The expensive prices of commodities and other inputs are creeping into the prices of finished goods. The presence of inflation is pressuring the Federal Reserve to raise interest rates.

The Federal Open Market Committee (FOMC) kept its benchmark Fed Funds rate at 2.0% on August 5, and it is expected to leave it alone again when it meets on September 16. According to the FOMC meeting minutes, "tight credit conditions, the ongoing housing contraction, and elevated energy prices are likely to weigh on economic growth over the next few quarters." The minutes add "over time, the substantial easing of monetary policy, combined with ongoing measures to foster market liquidity, should help to promote moderate economic growth." Futures markets are anticipating a period of rate hikes, but these will be moderate and over extended periods of time. The Fed Funds rate is expected to be 2.05% in December 2008, 2.33% in May 2009, 2.53% in August 2009, and 3.06% in February 2010. For now, though, the Fed is on hold as it struggles with slow economic growth and high inflation.

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. With the S&P 500 at 1283 and earnings at $51.83, the price-to-earnings (P/E) ratio is 24.8. Since high P/E ratios indicate an expensive market, one may be tempted to conclude that stock prices are too high. Our hypothesis, however, is that today's earnings are temporarily low. One year ago, S&P 500 earnings were $85.11. Over the past year, earnings have plummeted 39% (largely the result of the write-offs from financial institutions due to the collapsing real estate market and credit crunch). Once real estate stabilizes and banks stop taking huge write-offs, which will eventually happen, earnings should jump back up. Factoring in our assumption that today's earnings are an anomaly, we consider stocks to be a better value than they were a year ago.

The market continues its consolidation after rallying from the lows hit in mid-July. The S&P 500 has gyrated in recent weeks between 1260 and 1300. Volume has been light during the consolidation, which hints at a breakout coming soon. Our market breadth indicator turned positive on August 1 and barely slipped into negative territory again on August 29. The percentage of industries in a strong downtrend peaked at 56.5% on July 19 and is now only 8.1%. A breakout would likely be accompanied by high volume, giving confirmation to the strength of the move.

While each client's situation is unique, we have generally been accumulating stocks in our portfolios over the past several months. There are some fantastic buys in the stock market these days – high quality companies with strong fundamentals temporarily "on sale". There are also some interesting opportunities to bottom-fish for stocks overly depressed by the recent market turmoil. We continue to make our investment decisions incrementally, and we are keeping cash on hand in case the historically volatile months of September and October present even cheaper prices for stocks.