"Fiscal Cliff Bungee Cord"

Market Commentary – January 2013

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The third 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 3.1% in the third quarter of 2012. This is higher than the advance estimate of 2.0% and the second estimate of 2.7%. An examination of the components of GDP growth (consumer spending + investment + net exports + government spending) uncovers what is driving it. Consumer spending, which historically makes up about 70% of GDP, contributed only 1.12 percentage points to the 3.1% growth rate. Investment contributed 0.85 of a percentage point, but digging deeper reveals that 0.73 of a percentage point was created by the building of inventories; this is not sustainable. On a favorable note, 0.31 of a percentage point of investment was generated by residential investment, suggesting that housing is contributing to economic growth. Net exports added 0.38 of a percentage point to GDP growth, but this number tends to be volatile around the zero level. Finally, government spending grew by 0.75 of a percentage point, which is not sustainable given the government's stretched fiscal condition. In conclusion, yes, the economy is growing, but the sources of growth are not indicative of a strong situation.

Politicians in Washington D.C. have waited until the midnight hour to strike a deal regarding the fiscal cliff. As of this writing, it appears that the Senate has come up with a fiscal deal. However, the House of Representatives still needs to approve it. It remains to be seen how much economic damage was caused by the inability of politicians to reach a deal earlier. Fourth quarter GDP results, to be released in late January, will tell the story. It seems reasonable to expect the effects to be similar to a "bungee cord", where the economy dips in the fourth quarter of 2012, but then springs back in the first quarter of 2013. This, of course, assumes that a budget deal is officially signed very soon.

The Federal Reserve has used accommodative monetary policy to juice the economy and partially offset short-term negative effects of the fiscal fiasco. In December, the Fed announced the end of Operation Twist and the expansion of QE3 to include a monthly purchase of $45 billion of long-term Treasury securities (in addition to the monthly purchase of $40 billion in mortgage-backed securities). Coupled with a Fed Funds rate at an ultra-low range of 0% to 0.25% that is now pegged to unemployment (>6.5%) and inflation (<2.5%) guideposts, the Fed is stimulating the economy and the financial markets.

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 $108.35, which implies a price-to-earnings (P/E) ratio of 13.2 with the S&P 500 at 1426. The earnings yield (E/P) of 7.60% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.76%. The ability of stock prices to meander higher while analyst estimates have trickled lower suggests that valuations are cheap.

A gently-sloped uptrend has characterized the S&P 500 since April 2012. "Backing and filling" has prevented stock prices from overheating, creating a bullish self-correcting mechanism. Support below should be expected around the 50-day moving average at 1411, the 200-day moving average at 1390, and the November low around 1350. Looking up, resistance from the September highs should be strong around 1465. Above that, the S&P 500 would be poised to attack its all-time closing high of 1565.

There have been many opportunities over the past year for investors to throw in the emotional towel and give up on stocks. Ironically, 2012 turned out to be a solid year for stocks. Scary headlines can cause emotional investors to make wrong decisions. To help combat emotion, it pays for investors to make their financial situation "anti-fragile": eliminate leverage, allocate investment dollars between stocks and cash in a balanced fashion, emphasize fortress-like corporate balance sheets, and buy stocks at a discount to intrinsic value on short-term weakness.