“Fiscal Woes”
Market Commentary – October 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 2.5% in the second quarter of 2013. This is the same as the second estimate and higher than the advance estimate of 1.7%. In September, the Federal Reserve updated its June projections of economic indicators. It now sees 2013 GDP in a range from 2.0%-2.3%, compared with the June forecast of 2.3%-2.6%. Growth is expected to be slightly stronger in 2014 with GDP ranging from 2.9%-3.1%, compared with the June forecast of 3.0%-3.5%. Overall, the economy is continuing on its path of slow growth.

On September 18, the Federal Open Market Committee (FOMC) announced the continuation of its $85 billion “quantitative easing” (QE) monthly bond purchase program. The stock market applauded this decision with the S&P 500 jumping 1.5% within the 60 minutes following the announcement. The FOMC maintains that future decisions to curtail QE will depend on data, especially unemployment (below 6.5%) and inflation (above 2.5%). With its September projection of economic indicators, the Fed sees unemployment at 7.1%-7.3% in 2013 and 6.4%-6.8% in 2014, and it forecasts inflation at 1.1%-1.2% in 2013 and 1.3%-1.8% in 2014. The next decision on monetary policy is scheduled for October 30.

The Fed’s use of loose monetary policy is helping to mask the pending disaster with U.S. fiscal policy. While news headlines are consumed with the question of whether the U.S. government will shut down on October 1 due to a lack of funding, the more important time frame to consider is the long-run. Last weekend, the cover of *Barron’s* was labeled “Budget Disaster”, with the main headline story arguing the need for the government to cut entitlement spending for the baby boomers. According to the nonpartisan Congressional Budget Office, the debt/GDP ratio is expected to spike from 73% today to 190% by 2038. Putting this in perspective, past spikes in this ratio resulted from the Civil War (less than 40%), World War I (less than 40%), and World War II (slightly above 100%). As of 1999, the ratio was only 38%. Past FOMC Chair Alan Greenspan had previously warned that loose monetary policy could bring price inflation and a decline in the value of the U.S. dollar. Not liking that they are being paid with depreciating dollars, bondholders would sell their bonds and thus fuel a surge in interest rates. High interest rates would make the U.S. government debt expensive to finance. Are the politicians in Washington D.C. up to the challenge of increasing revenue while decreasing expenses?

Technical factors of the market are 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 $114.86, which implies a price-to-earnings (P/E) ratio of 14.6 with the S&P 500 at 1682. The earnings yield (E/P) of 6.83% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.62%.

While 2013 thus far has been a wonderful year for stock prices, the lack of a significant correction this year is a cause for concern. The minute there is a brief pullback in stock prices (on the order of 5% or so), buyers swoop in to push stocks even higher. The S&P 500 is now hovering around its 50-day moving average (1680) as support. Looking up, resistance is at 1725 from the September high. On the downside, additional support should exist around the 200-day moving average (currently 1591 and rising) and near 1570 (June low).

It is troubling how the stock market still rallies when it expects the Fed to continue QE. The sustainability of the cyclical bull market would be more believable if the market rallied on favorable economic news. We hope that Congress does a better job of budgeting the same way individual households need to, and that the Fed can find a quiet exit. Meanwhile, our playbook remains steady.