"Breakout Pending"

Market Commentary – September 2012

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The second 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 1.7% in the second quarter of 2012. While higher than the advance estimate of 1.5%, this level still represents anemic growth. About a week ago, the non-partisan Congressional Budget Office (CBO) warned of a recession in the first half of 2013 if Congress fails to avoid almost $500 billion in tax hikes and spending cuts scheduled for January, dubbed the "fiscal cliff". The CBO sees GDP shrinking by 2.9% in the first half of 2013, followed by weak growth of only 1.9% in the second half. Fiscal cliff news is not all negative, however. The CBO forecasts that higher taxes and reduced spending would slice the U.S. budget deficit from an expected $1.1 trillion in 2012 to $641 million in 2013. With the election approaching quickly in November, debate surrounding the fiscal cliff should escalate in the coming months.

Stock market bulls continue to seek clues that the Federal Reserve's monetary policy will include a third round of bond purchases, known as "quantitative easing" or "QE". When the Federal Open Market Committee (FOMC) made its scheduled monetary policy announcement on August 1, they reiterated that the Fed is ready to act, if necessary. According to minutes from that meeting, "additional monetary accommodation would likely be warranted fairly soon unless incoming information pointed to a substantial and sustainable strengthening in the pace of the economic recovery." In a speech at the Federal Reserve's annual retreat in Jackson Hole, Wyoming, Chairman Ben Bernanke expressed concern about three factors weighing on economic growth: the housing market; credit and financial market strains, especially due to the European debt crisis; and uncertainty about U.S. fiscal policy. The Fed is sitting on the fence about whether to implement a third round of QE: should they wait for a more severe financial crisis? The next Fed decision on monetary policy is scheduled for September 13.

Economists are engaged in a heated debate over the effectiveness of Federal Reserve monetary stimulus in recent years, especially the controversial QE programs. Similar to the side effects associated with prescription medications, there are potential consequences for stimulating the economy. One of the biggest concerns is inflation down the road. Is monetary stimulus worth the cost? At the retreat in Jackson Hole, Bernanke stated that "central bank securities purchases have provided meaningful support to the economic recovery." The Fed estimates that its $2.3 trillion in QE bond purchases has lowered long-term interest rates by 0.8 to 1.2 percentage points, raised GDP by 3%, and increased employment by 2 million jobs. It also seems to have supported stock prices. The value of QE will be proven over time, when we can look through the crystal-clear review mirror.

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 $107.54, which implies a price-to-earnings (P/E) ratio of 13.1 with the S&P 500 at 1407. The earnings yield (E/P) of 7.65% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.56%. Earnings estimates have been trending lower, which makes expectations more reasonable.

The S&P 500 is pushed up against resistance, bracing for a pending breakout. Resistance around 1425 has indeed proven firm, as the S&P was not able to pierce that level on a closing basis during August. At the same time, support has formed just below 1400. The stock market appears to be building potential energy, which will likely be transferred into kinetic energy with a news event (Federal Reserve, European debt crisis, global growth, etc.) acting as a catalyst. Heavy support exists between 1300 and 1375. Overhead, the next major resistance should be around 1500. A balanced portfolio is already positioned for a variety of outcomes: stocks rising, falling, or trading sideways. Investors should stay true to their risk profile, and not be risk-loving during rallies and risk-averse during declines.