"Unusually Uncertain"

Market Commentary – August 2010

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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. increased at an annual rate of 2.4% in the second quarter of 2010. Consumer spending, which makes up roughly 70% of GDP, rose a sluggish 1.6% in the second quarter. The stubbornly high unemployment rate of 9.5% is contributing toward consumers' reluctance to spend. Companies have been hesitant to hire, as they are watching costs to successfully generate profit growth in excess of sales growth. With 70% of the S&P 500 reporting second quarter results through July 29, earnings are 42% higher than a year ago while sales are only up 9%. Spending by state and local governments and inventory rebuilding juiced second quarter growth, but these factors should prove temporary.

Considering that this recession has had the deepest peak-to-trough contraction since the late 1940s and the recovery has been slower than usual, U.S. government projections for real GDP going forward are in danger of being too optimistic. Revised calculations spanning from the first quarter of 2007 to the first quarter of 2010 were released by the Bureau of Economic Analysis, showing that real GDP grew as follows: 1.9% in 2007, 0.0% in 2008, -2.6% in 2009, and 3.7% in the first quarter of 2010. The Federal Reserve recently trimmed its real GDP growth forecasts for 2010 from 3.2%-3.7% to 3.0%-3.5% and for 2011 from 3.4%-4.5% to 3.5%-4.0%. The White House's Office of Management and Budget projects 4% average annual real GDP growth between 2011 and 2014.

Federal Reserve Chairman Ben Bernanke described the current economic outlook as "unusually uncertain" and assured the Senate Banking Committee that the Fed remains "prepared to take further policy actions as needed". Bernanke reviewed three of the Fed's options to support economic growth. First, it could verbally emphasize its commitment to maintain low short-term interest rates. Second, it could encourage banks to lend more by cutting the rate banks earn on reserves stored with the Fed. Third, it could reinvest proceeds from maturing mortgage securities instead of trimming the Fed's balance sheet (which has ballooned from less than $1 trillion in mid-2008 to $2.3 trillion in July 2010). The next Federal Open Market Committee decision on interest rates is scheduled for August 10.

Technical factors of the market are mildly 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 $87.73, which implies a price-to-earnings (P/E) ratio of 12.6 with the S&P 500 at 1102. The earnings yield (E/P) is 7.96%, representing attractive value with the 10-year U.S. Treasury note at 2.91%. While each stock must be evaluated on a case-by-case basis, the stock market in general is offering excellent deals.

The positive divergence in market breadth we observed last month took hold and stock prices launched higher. We utilized stock market weakness in the first two days in July to buy stocks, depending on the client portfolio. Market breadth is currently positive with momentum to the upside, which works in favor of even higher stock prices in August. The S&P 500 is sandwiched between its 50 day moving average at 1081 and its 200 day moving average at 1114. Below the 50 day moving average, there should be ample support at 1065 and 1025. A breakout above the 200 day moving average would likely see a run to resistance at 1170 or 1210.

Our hypothesis is still that we are experiencing a cyclical bull market within a secular bear market. Mixed economic data and shaky consumer confidence will likely weigh on stock prices, while cheap stock valuations relative to interest rates should entice buyers. Companies are generally healthy and cash-rich, but growth is increasingly harder to find. Dividends and covered call premiums will continue to play strategic roles in helping investors earn a reasonable total return in a balanced portfolio.