"Digesting A Bubble"

Market Commentary – November 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. grew at an annual rate of 2.0% in the third quarter of 2010. Consumer spending, which accounts for approximately 70% of economic activity, rose at an annual rate of 2.6% (the highest since late 2006). Businesses helped growth by rebuilding inventories and cautiously retooling, while weak residential construction and strong imports hurt GDP. The economy is expanding, but the recovery is sluggish. Moreover, economists agree that the economy needs to grow faster in order to lower unemployment, which currently stands at 9.6%. With the Bush tax cuts set to expire in 2011, a tightening of fiscal policy will create headwinds in the short run.

All eyes will be on the Federal Open Market Committee (FOMC) on November 3 as they will announce their plans for interest rates and quantitative easing. With the benchmark Fed Funds rate already at a record low target range of 0% to 0.25%, the Fed needs to reach deeper into its toolbox. By purchasing U.S. Treasury securities and thus boosting their prices, the Fed can lower long term interest rates. The hope is that lower long term interest rates would encourage more investment and spending and thus create jobs. This form of monetary stimulus is known as quantitative easing. It is unclear how much the Fed would buy, but it is expected to be on the order of a few hundred billion dollars and would allow flexibility in purchase quantities based on perceived effectiveness. Possible side effects from this action, including future inflation or a new asset bubble, are being debated by market participants.

Investors need to be patient while the economy digests the bursting of the real estate bubble. President Obama recently said "as we continue to dig out from the worst recession in 80 years, our mission is to accelerate that recovery and encourage more rapid growth so that businesses…can continue to prosper and we can get the millions of Americans who are still looking for jobs back to work". This is easier said than done. Fiscal and monetary policies are catalysts, but it takes time for bubbles to be digested. When bubbles burst, prices do not typically rebound sharply. After a long basing process, prices *slowly* start to climb in a stair-like fashion. To quote Nelson Kjos from The Renaissance Poet of Wall Street and Main Street, "Growth always wins over gloom and doom, but not always in the short term. And the short term could turn into many months or many years."

Technical factors of the market are mildly 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 $91.10, which implies a price-to-earnings (P/E) ratio of 13.0 with the S&P 500 at 1183. The earnings yield (E/P) is 7.70%, representing attractive value with the 10-year U.S. Treasury note at 2.61%. Looking at equity valuations, there is excellent potential for upside with stock prices.

Nearby resistance overhead and pending tax hikes could cause some investors to take some profits by selling winning positions. The S&P 500 faces resistance at 1210 from the April high earlier this year. Above that, the next resistance is around 1300. The S&P 500 has risen 13.8% from its low of 1040 in late August. Stock prices have come a long way in a short time and are due for a mild correction. Some investors may sell stocks to realize capital gains with the long-term capital gains tax rate scheduled to increase from 15% to 20% in 2011. Plus, we are also entering the season of tax-loss selling. The election on Tuesday may be a "sell the news" event. Any pullback, however, should be mild. There is significant price support for the S&P 500 at 1125, coupled with the 200 day moving average at 1123 and the 50 day moving average at 1132. Note that the 50 day moving average has crossed above the 200 day moving average, which is a bullish technical indicator. A minor retreat in stock prices can be bought with confidence, subject to an investor's risk profile. No matter how much conviction an investor has in a stock market decision, there must always be a plan for things not going as anticipated.