"Obsessed With News"

Market Commentary – July 2012

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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 1.9% in the first quarter of 2012. This reading is lower than the advance estimate of 2.2% and unchanged from the second estimate. The Federal Open Market Committee (FOMC) lowered its forecast for 2012 GDP to a range of 1.9% to 2.4% from a range of 2.4% to 2.9% predicted in April. This is a serious cut in a short amount of time. During the FOMC monetary policy press conference, Federal Reserve Chairman Ben Bernanke stated "the economy continues to expand at a moderate pace in the face of headwinds generated by the situation in Europe, a still-depressed housing market, tight credit for some borrowers, and fiscal restraint at the federal, state, and local levels."

Given its tempered economic outlook, the FOMC remained accommodative with its monetary policy announcements on June 20. The FOMC extended its "Operation Twist" program, originally set to expire in June, through December 2012. The Fed will therefore continue to sell short-term securities and use the proceeds to buy long-term securities, hoping to lower long-term interest rates and thus stimulate economic growth. Moreover, Chairman Bernanke stated "we're prepared to take further steps if necessary to promote sustainable growth and recovery in the labor market." The next announcement on monetary policy is scheduled for August 1.

Driven by crisis, countries in the euro zone are reluctantly inching toward a fiscal union to mirror their monetary union. Italian and Spanish banks have used cheap European Central Bank loans to fund purchases of Italian and Spanish sovereign debt. However, the falling value of sovereign debt, coupled with loan losses and depositor withdrawals, have raised questions of solvency for these banks. The Italian and Spanish governments have been stepping in to boost the balance sheets of their troubled banks, which in turn has further strained their sovereign debt since these countries are already fiscally stretched. To help combat this and other issues, the euro zone has approved the concept of a single supervisor to oversee banks in the 17 nations that use the euro. While details still need to be worked out, this decision, which was cheered by financial markets, moves Europe closer to a much-needed fiscal union.

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 $107.12, which implies a price-to-earnings (P/E) ratio of 12.7 with the S&P 500 at 1362. The earnings yield (E/P) of 7.86% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.66%. Earnings estimates for 2012 have been creeping lower as economic conditions appear increasingly tough. Still, there is tremendous value in current stock prices, especially given the interest rate environment.

Support held in June, and now the S&P 500 is pushed up against a resistance level. The 1360 area was a support level in March and April, and it is now being tested as resistance. Evidence suggests an upside resolution. First, volume spikes occurred on three solid up days for the S&P 500 in June. Second, the 200 day moving average supported stock prices in early June, and now that average is gently rising. Third, the lows on June 4 and June 25 form a pattern of "higher lows". Above 1360, the next resistance level is around 1425. Of course, it is possible that resistance near 1360 holds firm. Looking down, support exists around 1310 and 1280.

We attempt to remove emotion from our thought process by performing independent research, taking a balanced approach, and minimizing "all or nothing" investment decisions. Investors who get too wrapped up in the news run the risk of being "whipsawed" (getting in at the top and out at the bottom within a short period of time). This news-driven market requires discipline.