"Fatigued"
Market Commentary – April 2010

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The third estimate of Gross Domestic Product (GDP) indicates that the output of goods and services produced by labor and property located in the U.S. grew by 5.6% in the fourth quarter of 2009. This is a downward revision from the second estimate of 5.9%. According to the Federal Open Market Committee (FOMC) in their March 16 press release, "economy activity has continued to strengthen and…the labor market is stabilizing". They added that "household spending is expanding at a moderate rate but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit". Overall, the Federal Reserve expects the economic recovery to be "moderate for a time", with inflation remaining under control.

On March 16, the FOMC announced its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". Futures markets anticipate a gently rising short-term interest rate environment, forecasting the Fed Funds rate to be 0.5% by December 2010, 1.0% by May 2011, and 2.0% by February 2012. The next interest rate decision will be announced on April 28. In the meantime, Treasury rates have been migrating higher. The 10-year Treasury note yield climbed from 3.6% to over 3.8% in March, and the rising wedge technical pattern suggests a spike above 4% may be coming soon. This is a risk for stock prices and could cause the next stock market correction.

With government balance sheets stretched thin, it is questionable how much longer investors will finance government debt with low interest rates. Greece is learning this the hard way, with market forces demanding a 5.9% coupon on a new seven-year bond (more than twice the rate that Europe's safest credit risk, Germany, needs to pay). In the U.S., the Federal Reserve's balance sheet has ballooned to more than $2.3 trillion in assets, more than twice pre-recession levels. The Fed's decision to stop at the end of March the $1.425 trillion program to buy mortgage-backed securities and debt will help contain the balance sheet, but it may also lead to higher mortgage rates and a slower housing market. Individual states need to be mindful of their debt situation, as well. As of now, all 50 states have investment-grade credit ratings, with the lowest being California. The last state to default on its bonds was Arkansas during the Great Depression. Still, if states continue on their current path, investors may require higher rates of return to compensate for additional perceived risk.

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. Standard & Poor's forecasts operating earnings per share (EPS) over the next 12 months for the S&P 500 to be $78.12, implying a price-to-earnings (P/E) ratio of 15.0 with the S&P 500 at 1169. The earnings yield (E/P) is 6.68%, which represents attractive value with the 10-year U.S. Treasury note at 3.83%. Still, it is appropriate to note that the strong stock market rally in March has caused the earnings yield to drop from 7.04% last month.

Stock prices are overbought on a short-term basis following an exuberant March and appear ripe for a correction. The common belief on Wall Street was that the passage of the health-care reform bill would cause the stock market to tank. Indeed, the opposite happened, as the S&P 500 propelled to its highest level since September 2008. However, upward price momentum seems to be running out of steam. Our market breadth indicator peaked on March 18 and has been gently declining since then (albeit deep in positive territory). Moreover, 68.9% of industries are in strong uptrends, which is not sustainable. Corrections are normal and should be embraced, not feared.

It takes discipline to not chase stock prices higher; at the same time, it also takes discipline to maintain stock market exposure in a cyclical bull market. This conundrum has resulted in our portfolio activity being lighter than normal in recent months. While we have been enjoying the rising tide in stock prices, we are also patiently waiting for opportunities to buy on weakness.