"Stretched"

Market Commentary – March 2013

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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 0.1% in the fourth quarter of 2012. This compares to the advance estimate of a contraction of 0.1% reported last month. As of February, the Congressional Budget Office (CBO) projects GDP will grow at only 1.4% in 2013 while factoring in the effects of recent tax hikes and spending cuts. Without these recent tax hikes and spending cuts, the CBO believes GDP would have grown by approximately 3% in 2013. By 2014, the CBO sees GDP rebounding with growth of 3.4%. In the short-run, the $85 billion in automatic spending cuts, known as "sequestration" and set to go into effect on March 1, will likely weigh on GDP. The long-term effects may not be as dreadful as feared. Sequestration will help narrow the gap between government revenue and spending, thus improving the country's fiscal situation.

While Congress and President Obama play a game of "fiscal policy chicken" in the media, the Federal Open Market Committee (FOMC) has bought some time with its ultra-accommodative monetary policy. The benchmark Fed Funds rate will remain in a range of 0% to 0.25% while unemployment is greater than 6.5% (current: 7.9% in January 2013) and projected inflation in one to two years is expected to be less than 2.5% (current: as of December 2012, projected by the Fed to be between 1.3% and 2.0% in 2013 and 2014). In addition, through its quantitative easing program, the Fed is buying $45 billion of long-term Treasury securities and $40 billion of mortgage-backed securities each month (no end date given). As Fed Chairman Ben Bernanke told Congress this week, "keeping long-term interest rates low has helped spark a recovery in the housing market and has led to increased sales and production of automobiles and other durable goods". The FOMC's next announcement on monetary policy is scheduled for March 20.

Technical factors of the market are 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 $111.22, which implies a price-to-earnings (P/E) ratio of 13.6 with the S&P 500 at 1515. The earnings yield (E/P) of 7.34% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.89%. While stock valuations overall are attractive, there are some companies trading at rich valuations; beware. Some investors seem willing to pay high prices for companies that exhibit growth in our low-growth world. Growth is desirable, but only if the price is right.

After a strong push higher, it would be healthy for stocks to pull back in price for a month or two. The S&P 500 is up 12% from the low on November 15. This is a significant move in a short amount of time, and a correction phase is in order. Between April and June 2012, the S&P 500 dropped 9.9%. Between September and November 2012, the S&P 500 pulled back 7.7%. A correction along these lines would be favorable, as it would help ground the emotions of bulls. Even a consolidation to the 1465 level on the S&P 500 would be favorable. However, if the market marches higher without pausing to rest, the eventual correction will likely be steeper and more painful.

In portfolios where we utilize options, we have been actively selling covered calls in recent weeks. These call options expire in either April or June. This is a fantastic environment for covered calls. If the market pulls back or flattens out, we will steadily earn the call option premiums as time value melts away. This income stream will be added to our already robust dividends being earned. If the market continues higher, we will (happily) be called out of the underlying stocks. There is something wise about selling into strength. When it looks safe to swim in the ocean, you need to look out for sharks. We are still operating under the hypothesis that the stock market is experiencing a cyclical (short-term) bull market within a secular (long-term) bear.