"Bad News Is Good News"

Market Commentary – July 2013

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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 1.8% in the first quarter of 2013. This is lower than the advance estimate of 2.5% and the second estimate of 2.4%. In June, the Federal Open Market Committee (FOMC) revised its March forecast of GDP. It now sees 2013 GDP in a range from 2.3%-2.6%, compared with the March projection of 2.3%-2.8%. Interestingly, it bumped up its forecast for 2014 from a range of 2.9%-3.4% to 3.0%-3.5%. The FOMC anticipates 2013 unemployment to be 7.2%-7.3% (above its target of 6.5% or lower) and 2013 inflation to be 0.8%-1.2% (below its 2% level of concern). Overall, the economy is moving in the right direction, albeit slowly.

The FOMC is gingerly revealing clues regarding the inevitable end to its incredibly accommodative monetary policy. During a press conference on June 19 following the announcement of Fed monetary policy, Fed Chairman Ben Bernanke tried to keep his statements balanced. "The fundamentals look a little better to us," he said, citing improvements in the housing sector. On the other hand, "the main headwind to growth this year…is federal fiscal policy, which the Congressional Budget Office estimates is something on the order of 1 ½ percentage points of growth." It appears that interest rates are going to be low for a significant period to come, and the first action of Fed will be the slowing of asset purchases (i.e. Quantitative Easing, or "QE"). Bernanke indicated that if current forecasts of economic data come true, assets purchases could be reduced by late 2013 and eliminated around mid-2014. The 10-year U.S. Treasury note yield shot up from around 2.20% to 2.35% and the Dow Jones Industrial Average shed 1.3% within 60 minutes of this comment.

With the financial markets currently addicted to monetary stimulus, bad news is good news. If economic data in the coming weeks and months suggests lighter economic growth or higher unemployment, the Fed would likely continue its $85 billion monthly bond purchases. Stocks would probably rally and bond yields would fall on such news. This behavior is ironic. After all, it would seem more intuitive that negative economic data is bearish for the financial markets. In the long-run, this is true; the stock market thrives on robust economic growth. In the short-run, however, liquidity created by the Fed is driving stocks. At some point, there will be a transition to more "normal" times, where good news is good and bad news is bad. This transition period will likely be choppy for the financial markets.

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 $115.83, which implies a price-to-earnings (P/E) ratio of 13.9 with the S&P 500 at 1606. The earnings yield (E/P) of 7.21% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.48%. Note how the Treasury yield has spiked from 1.68% on April 30 (only two months ago). This may be the beginning of the bond market bubble bursting. Meantime, expected EPS for the S&P 500 jumped up from $112.47 last month. Corporate earnings make up 12.4% of U.S. GDP, a post-World War II high.

This correction may have some more bite before it has shaken out the weak investors. For the first time since November, the S&P 500 has significantly pierced the 50-day moving average. It is now testing the 50-day as resistance. This is a logical place for the stock market to take its next leg down. Meanwhile, the 200-day moving average, currently 1510, is steadily marching higher. After peaking at 1669 on May 21, a pullback for the S&P 500 to an area between 1510 and 1550 would be healthy. We anticipate buying incrementally into such weakness, especially with cash raised over the past couple of months. Perhaps the stock market has finally begun anticipating life after the Fed. The death of the secular bear market may coincide with the stock market's eventual recognition that good news is good.