"Addicted To Stimulus"

Market Commentary – October 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 1.3% in the second quarter of 2012. This is down from 2.0% in 2012 Q1 and 4.1% in 2011 Q4. According to the Standard & Poor's/Case-Shiller 20-city index, home prices have risen 5.9% year-to-date in 2012, which is the strongest clip since 2005 when the index jumped by 10.2%. Following gains of 2.0% in 2010 and 0.4% in 2011, the recent strength in housing is a favorable sign. However, with Europe in recession, growth slowing in China, a controversial U.S. election in November, and the looming U.S. fiscal cliff, there is plenty to worry about.

Concerned about the headwinds facing the U.S. economy and unemployment at a stubbornly high 8.1% rate as of August, the Federal Open Market Committee (FOMC) announced its third round of quantitative easing, dubbed "QE3", on September 13. The Fed plans to buy $40 billion in mortgage-backed securities each month. Contrary to QE1 and QE2, QE3 purchases do not have a specific end date. In addition, the Fed plans to continue "Operation Twist" (buy longer-term securities and sell an equal amount of shorter-term securities) through the end of 2012 and keep the Fed Funds rate in a range of 0% to 0.25% through mid-2015, rather than late-2014. Stock prices jumped on the news. The Fed hopes that the wealth effect consumers feel from higher asset prices will translate into more robust spending, which will in turn help fuel economic growth.

A structural change in the jobs market, rather than strong economic growth, is nudging the unemployment rate lower: baby boomers retiring. The participation rate ("PR"), which is the ratio of the labor force to population, has fallen over the past four years from around 66% to 63.5% in August 2012 (the lowest level since 1981). Lower PR means that there are fewer people in the labor force relative to population. The smaller labor force implies that there are more jobs to go around, and therefore fewer people are unemployed. One of the causes for the secular decline in PR is older baby boomers leaving the workforce. Population increased by 3.7 million people from August 2011 to August 2012. During this time, the labor force increased by 1 million and those "not in the labor force" rose by 2.7 million. Digging into this 2.7 million figure, the U.S. Bureau of Labor Statistics website shows that for those ages 55 and older, the number of people "not in the labor force" who also "do not want a job now" increased by 1.9 million. It appears that most of the increase in those not in the labor force is due to baby boomers entering retirement. This structural change will likely persist for years to come.

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 $107.47, which implies a price-to-earnings (P/E) ratio of 13.4 with the S&P 500 at 1441. The earnings yield (E/P) of 7.46% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.64%.

Having broken through resistance levels, the S&P 500 continues to exhibit a healthy, self-correcting pattern. Old resistance around 1425 should prove to be future support, as well as areas around 1400. The 200 day moving average is at 1359 and trending higher. A decline to these areas would be viewed as normal. Resistance overhead should be found near 1465 and 1500.

As the saying goes, "don't fight the Fed". Monetary policy is very accommodative these days, which bodes well for stocks while the party is going. Investors are addicted to economic stimulus. The hint of such news causes stocks to jump. It is important to remember that at some point, there will likely be unintended consequences of current monetary and fiscal policies. In the meantime, a balanced approach helps investors to keep emotions to a minimum.