The final reading of Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., shows that the U.S. economy grew 1.0% in the first quarter. So far, the U.S. economy has maintained positive economic growth and has stayed out of recession. Still, the economy is facing difficult challenges:

- Inflation is present in fuel and food prices and threatens to spread to other areas of the economy. The Producer Price Index, a measure of inflation in wholesale products, is up 7.2% since May 2007. The Consumer Price Index, which measures inflation in consumer products and services, is up 4.2% since May 2007. The price of oil has skyrocketed to over $140 per barrel.
- Unemployment spiked to 5.5% in May, the highest since late 2004.
- Home prices in 20 major U.S. cities, as measured by the Case-Shiller national index of single-family homes, tanked a record 15.3% in April versus a year earlier.
- The Conference Board’s Consumer Confidence Index fell to 50.4 in June, the lowest level since February 1992. Higher fuel and food prices, as well as the weak housing market, are weighing on the U.S. consumer.

The Federal Open Market Committee (FOMC) held its benchmark Fed Funds rate steady at 2.0% following its meetings on June 24 and 25. The Fed wrote “although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased.” The Fed is caught between a weakening economy and simmering inflation. To encourage economic growth, they would like to keep interest rates low. Low U.S. interest rates relative to the rest of the world, however, encourage foreign investors to put their money where interest rates are higher. This decreases demand for the dollar, which increases the price of oil and other imports. With the European Central Bank expected to raise its key interest rate target from 4.0% to 4.25%, the Fed may have to raise rates soon to fight inflation. Futures markets have fully priced in a 25 basis point increase in the Fed Funds rate by November 2008. The next FOMC meeting will be on August 5.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. The price-to-earnings (P/E) ratio of the S&P 500 is 20.6. S&P 500 earnings per share reported a year ago were $83.39, compared with $62.28 today. Financial companies have weighed heavily on earnings results, as well as other companies that are struggling with the weak economy. Earnings comparisons for the rest of 2008 will be challenging, but the stage is being set for potentially explosive earnings growth in 2009 and beyond.

The S&P 500 is testing the lows from March around the 1280 level. Given the weakness seen over the past several weeks, a bounce is likely. A key parameter will be the volume on such a bounce. If volume is heavy and the S&P 500 can rally back to approximately 1350, we would interpret that as a bullish change of character. If volume on the bounce is light, however, that would have a bearish connotation. Our market breadth indicator turned negative on June 3 and has been gaining momentum to the downside. The next support level for the S&P 500 is 1230, followed by 1180.

Cash liquidity is providing a degree of defense in this volatile market environment. While we have added more stocks to our portfolios in recent months, we have not exhausted our buying power. The primary bear market continues to roar. We must respect it and let the market run its course. Ironically, those who make a decision to go to 100% cash are taking considerable risk. Such investors will likely miss the market when it does eventually turn around. Our expectation is that the stock market will curiously head higher before the economic news improves. In the meantime, we patiently maintain our approach of balancing cash with a diversified portfolio of undervalued stocks.