"Welcome Back, Fear!"

Market Commentary – June 2012

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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 1.9% in the first quarter of 2012. This reading is lower than the advance estimate of 2.2%. Economists are becoming worried that a global slowdown is on the way, led by the fiscal disorder in Europe. Countries in northern Europe, especially Germany, are facing the tough decision of whether to help pay for the fiscal negligence of their southern European neighbors (Greece, Italy, Spain, and Portugal). Will certain countries leave the euro zone? Can the euro survive even though the countries do not share fiscal policy? Serious questions are being asked, which has spooked global financial markets. Of course, the situation is Europe is chronic and did not develop only recently. It is fascinating how the U.S. markets ignored negative news out of Europe earlier this year, and now they are mesmerized by it.

The "Bernanke put" is in place as the Federal Open Market Committee (FOMC) observes developments in the global economy. According to the minutes of the FOMC meeting on April 24-25, "strains in global financial markets, though generally less pronounced than last fall, continued to pose a significant risk to the outlook, and the possibility of a sharp fiscal tightening in the United States was also considered a sizable risk." With the Bush tax cuts set to expire at the end of 2012, the fiscal cliff of higher taxes and lower government spending could weigh on domestic GDP. Moreover, politicians in Washington could cause a situation similar to that seen in August 2011, which sent markets (temporarily) spiraling. If economic conditions continue to deteriorate, the FOMC will consider a third round of quantitative easing ("QE3"). QE3 would likely provide some downside insurance to the financial markets, similar to a "put option" (hence the phrase, "Bernanke put"). The next FOMC decision on monetary policy is scheduled to be announced on June 20.

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 $108.30, which implies a price-to-earnings (P/E) ratio of 12.1 with the S&P 500 at 1310. The earnings yield (E/P) is 8.27%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 1.58%. In a flight to quality, investors are bidding the price of Treasuries so high that yields are being pushed down to rock-bottom levels. It is difficult to argue that bond prices do not represent a bubble. Stocks are not at bubble valuations. Of course, the fact that a stock is cheap does not mean it cannot get cheaper. However, the "margin of safety" increases as valuations become more attractive relative to earnings power.

While May was a rocky month for the stock market, support levels are currently being encountered. When support for the S&P 500 failed at 1360, the next level of support that held was at 1290. Since then, the index has been trading sideways between 1290 and 1330 as a base is being formed. Strengthening the 1290 support level is the 200 day moving average, which is currently 1284. Also, there should be strong support around 1260. On the upside, resistance should be encountered around 1360, which was a prior support level that failed. Market breadth worsened with the downturn, but our market breadth indicator is in an area where it historically has reversed to the upside.

It is healthy that fear has returned to the financial markets after observing extreme bullishness earlier in 2012. Fear presents opportunities to buy stocks at lower prices. This is exactly what we have been doing. Depending on the client's risk profile, we have been incrementally buying companies with strong balance sheets, solid cash flow, and attractive valuations. We also sold a few stocks that are no longer in our universe. Our covered calls have worked out well this year. Some expired worthless in May, meaning that we successfully captured the premiums. We also had a couple of stocks called away, which is a mechanical way to "sell high". Should stocks drop further, we would look to buy more.