"Catching Its Breath"
Market Commentary – September 2009

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The second estimate of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. fell by 1.0% in the second quarter of 2009. Consumer spending makes up about 70% of GDP. It will be difficult for consumers to increase spending given their high debt, poor credit, and the weak labor market. Unemployment was 9.4% in July and is expected to peak above 10%. Rising foreclosures of home and commercial real estate loans are weighing on the economy. Still, the Federal Reserve noted that "economic activity is leveling out". Moreover, many economists are forecasting positive GDP growth in the third quarter of 2009. It appears that the recession may have ended, but the economy cannot be considered healthy. The patient is stable but still sick.

Investors are curious how the Federal Reserve will reign in its accommodative policies as it tries to prevent inflation without throwing the economy back into recession. The Federal Open Market Committee (FOMC) kept its benchmark Fed Funds rate at a target range of 0% to 0.25% on August 12 and continues to expect to keep it in this low range "for an extended period". Futures markets do not see the Fed Funds rate at 0.5% until May 2010. The Federal Reserve is also maintaining its commitment to buy up to $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt by the end of 2009. It expects its purchase of $300 billion in Treasuries to be complete by the end of October. Perhaps before the Fed raises interest rates, it will first pull back its other tools implemented to encourage economic growth. The next FOMC decision on interest rates will be September 23. As a side note, President Obama nominated Ben Bernanke to a second four-year term as Chairman of the Federal Reserve. This nomination eliminates a source of uncertainty for the market.

The Federal Deposit Insurance Corporation (FDIC), which insures U.S. bank deposits, has had 84 banks fail thus far in 2009 with more bank failures imminent. The FDIC list of "problem banks" is at the highest level in 15 years with 416 banks falling short of capital, asset quality, and liquidity levels. Assets at these troubled banks are $299.8 billion. The FDIC has only $10.4 billion remaining in its insurance fund, but it also has an untapped $500 billion line of credit with the Treasury Department.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. As of August 19, 2009 with 470 of the S&P 500 companies having reported second quarter earnings, actual operating earnings per share (EPS) are 17.7% below second quarter of 2008 results. Trailing 12-month operating EPS is $39.98, while Standard & Poor's forecasts operating EPS for the next 12 months to be $64.32 (15.9 price-to-earnings ratio). Earnings are on the rise.

The S&P 500 chugged ahead by 3.3% in August, but it now seems to be pausing to catch its breath. Our market breadth indicator peaked on August 5 and has been easing back since then. This divergence is the result of fewer stocks leading the market higher, suggesting the possibility of a mild pullback. Of 209 industries spanning the entire stock market, 75.6% of them are in a strong uptrend. Studying our historical records, which date back to December 2001, this statistic has only been above 60% one other time (January 2004). While the rally since March 9 has been powerful, a pause would be healthy. The S&P 500 should have support between 920 and 945 from the early May and late June highs.

Our working hypothesis is that while the stock market may take a brief rest, the overall rally is not yet complete. As the market proceeds higher, it will battle increasingly stronger currents. There is plenty of resistance overhead. In August, some of our portfolios were called out of a couple of positions, forcing us to "sell high". The discipline of selling high is one of the subtle benefits of selling covered calls. We are seeking new opportunities to sell more calls expiring between October and December. Should the market pull back, we would look to buy stocks. Portfolio modifications are made incrementally.