"Belt-Tightening"

Market Commentary – November 2011

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The advance 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 2.5% in the third quarter of 2011. This is higher than 0.4% in 2011 Q1 and 1.3% in 2011 Q2 and suggests that the economy is not yet dipping into recession. Consumer spending has been fairly steady since the GDP started expanding again in 2009 Q3, contributing an average of +1.6 percentage points to the final GDP reading each quarter. Business investment, however, has been more volatile. From 2009 Q4 to 2010 Q2, business investment added between +2.9 and +3.5 percentage points to GDP. From 2010 Q3 to 2011 Q3, however, business investment added only an average of +0.4 percentage points to GDP. Looking at data over the past two years, consumers are spending at a slow but steady pace and businesses are holding back on spending. While the economy is growing and is technically out of recession, it will take stronger growth than we have seen in 2011 to dent the 9.1% unemployment rate.

According to the minutes from their September 21 meeting, members of the Federal Open Market Committee (FOMC) see "significant downside risks to economic growth". The minutes noted that "with growth slow, the recovery (is) more vulnerable to adverse shocks". They added that "risks included the possibility of more pronounced or more protracted deleveraging by households, the chance of a larger-than-expected near-term fiscal tightening, and potential spillovers to the United States if the financial situation in Europe were to worsen appreciably". Since the FOMC met in September, European leaders have agreed to a general plan where private holders of Greek sovereign debt would voluntarily accept a 50% write-down in the value of their Greek bonds, European banks would boost their capital ratios, and the European Financial Stability Facility (EFSF) would guarantee the debt of some euro-zone countries. While financial markets reacted favorably to this news, critics of the plan insist that the details remain to be seen. The next FOMC decision on monetary policy will be announced on November 2.

Consumers are tightening their financial belts by deleveraging. *The Wall Street Journal* recently reported that according to the Federal Reserve Bank of New York, "total household debt – through payment or default – fell by $1.1 trillion, or 8.6%, from mid-2008 through the first half of 2011". In the short run, headwinds are generated when consumers opt to pay off debt or save money instead of spend it. In the long run, however, healthier household balance sheets will lead to the future ability of consumers to spend. Deleveraging is a smart move, especially in a secular bear market.

Technical factors of the market are mildly 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 $104.84, which implies a price-to-earnings (P/E) ratio of 12.0 with the S&P 500 at 1253. The earnings yield (E/P) is currently 8.37%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 2.18%. Despite higher stock prices in October, valuations are still attractive.

We expect stock prices to take a breather in November following a monster rally in October. The S&P 500 briefly pierced support at 1120 before finally bottoming intraday at 1075. Buyers seeking value, along with those covering short positions, fueled a 16.6% jump in the S&P 500 from the bottom. Resistance near 1220 surrendered to buying pressure as the S&P 500 motored ahead to 1285. Since 1220 acted as resistance on the way up, technicians would regard a pullback to that area as a logical place for support. Moreover, the 50 day moving average, now at 1189 and rising, will likely act as additional support. Our market breadth indicator is at an extreme positive reading, where it has historically reversed to the downside. We interpret these signals as a "buy the dip" scenario rather than "sell the rally", subject, of course, to an individual investor's risk profile.