"Kick The Can"

Market Commentary – July 2011

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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 1.9% in the first quarter of 2011. This is higher from the second estimate of 1.8% and lower than the fourth quarter's reading of 3.1%. After lowering its forecast of 2011 GDP growth from 3.4%-3.9% to 3.1%-3.3% in April, the Federal Reserve now projects 2011 economic growth at 2.7%-2.9%. The Fed sees GDP growing by 3.3%-3.7% in 2012. Economists commonly view that the U.S. economy has entered a "soft patch". Fed Chairman Ben Bernanke recently commented that there is "an awful lot of uncertainty right now about how much of this slowdown is temporary, how much is permanent". Bernanke cited "weakness in the financial sector, problems in the housing sector, (and) balance sheet and deleveraging issues" as creating headwinds that are "more persistent than we had thought".

The Federal Reserve completed its $600 billion purchase of longer-termed U.S. Treasuries today, as scheduled. While the Fed has stopped new Treasury purchases, it will continue to reinvest principal payments as existing holdings mature. The Federal Open Market Committee (FOMC) announced on June 22 its decision to keep its benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". In a press conference following the FOMC announcement, Ben Bernanke pointed out that "when we begin to allow the portfolio to run off rather than reinvesting, that would be a first step in a process of exiting from our currently highly accommodative policies". The next scheduled FOMC decision on interest rates and quantitative easing will be announced on August 9.

"Kick the can", which is a colorful way to describe postponing the inevitable until some point in the future, seems to be a common economic theme these days in the U.S. and around the world. Politicians in Washington are kicking the can when they debate the best way to raise the nation's $14.3 trillion borrowing limit before the U.S. defaults on its debt on August 2. Raising the borrowing limit does not fix the problem that our government spends more money than it has coming in. Greece and the rest of the European Union kicked the can when the Greek Parliament approved a five-year austerity plan (cut spending and raise taxes) as a condition to receive new bailout money. Will this prevent a Greek default on sovereign debt in the future, or did this just prolong the agony? In terms of oil, the White House and International Energy Agency made a surprise announcement of their plan to release 60 million barrels of oil from their strategic reserves in order to lower the price of oil. What will happen to the price of oil when these 60 million barrels are eventually replaced in the strategic reserves?

Technical factors of the market are mildly 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 $101.19, which implies a price-to-earnings (P/E) ratio of 13.1 with the S&P 500 at 1321. The earnings yield (E/P) is currently 7.66%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 3.16%. Should the stocks we own reach their intrinsic values, the median P/E ratio would be 19.9. Of course, a spike in long-term interest rates would cause the fair value of stocks to fall.

It is always fascinating how scared the media becomes when the stock market has a normal, "healthy pullback". The S&P 500 fell to 1258 in mid-June, which represented an 8.2% correction from the high in early May. Indeed, strong support did exist at the 200 day moving average, which has gently risen to 1262. Volume on the bounce has been light on recent up days, but light volume is a hallmark of summer trading. Market breadth flipped back to positive territory today after turning negative on May 24. Major resistance is overhead at the early May high of 1370. Our short-term expectation is that stocks will trade in a range, but with a slight upward bias. Looking longer term, the secular bear market continues.