"Market On Steroids"

Market Commentary – February 2013

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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. fell at an annual rate of 0.1% in the fourth quarter of 2012. Just as the third quarter's growth rate of 3.1% was not as strong as it looked, the fourth quarter contraction of 0.1% is not as bad as it seems. Analysis of the components of GDP (consumer spending + investment + net exports + government spending) uncovers that the fourth quarter was interestingly the opposite of the third quarter. Consumer spending, which is the most important driver of GDP growth, added 1.52 percentage points (on par with readings over the past two years). Investment deducted 0.08 of a percentage point, with a reduction in inventories weighing down investment by 1.27 percentage points (temporary). Notice that residential investment is quietly plugging away, contributing 0.36 of a percentage point to GDP growth. Net exports weighed on GDP by 0.25 of a percentage point (nothing to worry about). Finally, government spending penalized GDP by 1.33 percentage points, of which national defense spending lowered GDP by 1.28 percentage points. While fiscally-strained government spending is a glimpse of things to come, its effect can be offset by robust consumer and business spending. Removing the "temporary" factors that lowered fourth quarter GDP, it seems that the economy is exhibiting lethargic growth rather than hinting recession.

In a statement released on January 30, the Federal Open Market Committee (FOMC) revealed that "growth in economic activity paused in recent months, in large part because of weather-related disruptions and other transitory factors". The "transitory factors" likely refer to the fiscal cliff debate that consumed headlines toward the end of the fourth quarter. It is important to remember that while politicians in Washington D.C. did reach a last-minute fiscal deal, there are still serious concerns with our government's finances. Meantime, the Fed is using ultra-accommodative monetary policy to keep the wind at the economy's back. The benchmark Fed Funds rate will remain in a range of 0% to 0.25% while unemployment is greater than 6.5% (current: 7.8% in December 2012) and projected inflation in one to two years is expected to be less than 2.5% (current: as of December 2012, projected by the Fed to be between 1.3% and 2.0% in 2013 and 2014). In addition, through its quantitative easing program, the Fed is buying $45 billion of long-term Treasury securities and $40 billion of mortgage-backed securities each month. No end date has been given for the quantitative easing program.

Technical factors of the market are 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 $112.21, which implies a price-to-earnings (P/E) ratio of 13.4 with the S&P 500 at 1498. The earnings yield (E/P) of 7.49% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.99%. Note that the EPS estimate jumped up from $108.35 last month, which is helping to drive stock prices higher without excessively stretching valuations. Interestingly, the 10-year Treasury yield is creeping higher, too.

The uptrend for the stock market remains in place as the pattern of higher highs and higher lows continues. Now that the S&P 500 has broken through resistance around 1465, it is reasonable to expect a pullback to test old resistance as new support. Technicians will eye this level as a favorable entry point for new positions. Our market breadth indicator appears ripe for a rollover. Following such a strong rally, a mild pullback would be a healthy sign that the bullish self-correcting mechanism is still in place.

Our hypothesis continues to be that the stock market is experiencing a shorter-term cyclical bull market within a longer-term secular bear market. Fed policy is acting as a steroid for the financial markets. It will likely take a long time for the economy to truly heal. Plus, as signs of economic healing become evident, monetary policy will become more restrictive. We already know that fiscal policy needs to be reigned in, too. We expect this tug-of-war between the news and policy to cause choppier markets.