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Market Outlook

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The bulls have long been overdue for a rest given the torrid pace of the rally that began last March. September, which has historically been the worst performing month of the year for the stock market, provided a golden opportunity for a correction, yet the markets refused to cooperate. The Dow Jones Industrials (+2.3%), Standard & Poor's 500 (+3.6%) and Nasdaq Composite (+5.6%) all finished the month of September with substantial gains. Industrials led sector performance with a gain of 6.6%, while healthcare was the worst performing sector, posting a gain of less than 1% (source:Bloomberg.com).

We could not summon a more supportive environment for financial markets. The negative numbers that the bears cling to are all lagging indicators, while the positive ones are all either leading or coincident. As the dollar continues to weaken, Treasury yields are falling, inflation is non-existent and credit spreads have collapsed. Stock, bond and commodity prices are rising in concert, and home values have registered their third consecutive month-over-month increase. Liquidity is still abundant and investor sentiment is cautious at best.

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Critical to sustaining the market's current uptrend through year-end will be a continuation of the improvement in housing and employment data. There are reasons to be optimistic on both fronts. With home prices still depressed and mortgage rates below 5%, home affordability is at record highs. The S&P/Case-Shiller home-price index recently reported its largest monthly gain in nearly four years (for July) as the trend in sales of existing and new homes continues to improve. Some have argued that the numbers are skewed because the majority of sales have been foreclosures. When the $8,000 tax credit for first-time home buyers ends in November, sales will slide and home prices will decline again. Yet further analysis of the monthly data reveals that the percentage of sales attributable to first-time home buyers has steadily declined from March through July. We believe that the incremental rise in home prices will continue, which will support a further improvement in sales.

We are anticipating further declines in weekly unemployment claims and in the number of jobs lost each month, with the expectation that there will be job gains by year-end. Corporate profits have risen dramatically over the past six months, despite the lack of economic growth, primarily due to the reduction of labor costs. As profits have risen, business confidence has gradually improved, which is a precursor to hiring new employees. Now that the economy is expanding again, revenues will start to rise and companies will be forced to hire new workers to meet demand for goods and services.

There is no better evidence of the improvement in business confidence than the flurry of acquisitions and strategic investments announced around the world last month. This is an indication that financial markets remain undervalued, despite their meteoric rise since March. Regardless, individual investor sentiment remains guarded, as shown by the net redemptions from equity mutual funds in recent weeks. The consensus of leading economists is equally as reserved in their expectations for corporate earnings and economic growth in the year ahead. This caution is significant because it is the dichotomy between perception and reality that determines the potential for market returns moving forward. We believe the vital signs for the economy indicate that the consensus of investors and economists are still too pessimistic.

As the gap between perception and reality closes in the months ahead, we will need to more closely monitor some major headwinds that have the potential to steer this bull market off course. One major concern is that once the inventory cycle has run its course and the benefits from the economic stimulus plan end, the artificial prosperity we enjoyed from debt-induced consumer spending over the past decade will not be there to support economic growth. At this stage, we are not concerned.

Household wealth rose in the second quarter for the first time in two years as the amount of consumer debt continued to decline, and retail sales are on track to increase in the third quarter, even when we subtract the boost in auto sales from government subsidies. Consumer spending will undoubtedly level off next year as the savings rate rises, but even if its contribution to economic growth is negligible, we see an offsetting factor that few are acknowledging. In previous recoveries our imports of goods rose dramatically as our exports to trading partners declined, leading to an increase in the trade deficit that detracted from growth. This was in large part due to the indebtedness of developing countries and their lack of domestic consumption. Today developing countries are leading the recovery because they avoided the leverage that encumbers growth and have realized the emergence of their own middle classes. As a result, our exports are rising faster than our imports, which is narrowing the trade deficit and contributing to growth. We believe this new development, should it sustain itself long-term, has the potential to offset the decline in domestic consumer spending as the savings rate rises.

Another concern is inflation. The government's prudent response to the bursting of the credit bubble has been to inflate our way out of it by increasing the money supply, lowering short-term interest rates to zero, and borrowing and spending even more. Opponents of this policy point to the weakening of the dollar that has resulted and the inflationary pressures they believe will follow. The nominal rate of inflation, which includes energy, is set to soar over the next few months, but not for the reasons just mentioned. Energy prices plunged in the fourth quarter of last year, which means the year-over-year comparison used to determine the headline inflation rate will show a substantial increase as we enter the fourth quarter of 2009. We expect this to raise concerns, but they are misguided. The Federal Reserve focuses on the core rate of Personal Consumption Expenditures (PCE) when determining inflation risks and monetary policy. This inflation gauge measures the average increase in prices for all domestic personal consumption and accounts for changes in spending habits caused by price changes. This figure is forecasted to decline over the next year by leading economists, which will substantially ease the need for the Federal Reserve to withdraw liquidity and tighten monetary policy to the extent that it thwarts the rise in asset prices.

Fearful memories are persistent in people's minds. Many of us know someone who lived through the Great Depression and was permanently changed as a result. This apprehension is pervasive today in light of the dramatic downturn in the economy and financial markets last year. Fed Chairman Bernanke offered his expert opinion just days ago that the recession is "likely over." The market is up nearly 58% from the lows in March leading up to his conclusion. Our message has always been that the markets look forward 6-12 months. The financial media will continue to get lost in the day-to-day minutia, with its central focus on reporting what will attract the most viewers, as opposed to truly informing investors. We will continue to focus on incoming data that is forward looking (leading indicators) and allow this information to dictate our investment strategy. In our May Outlook we established a year-end target of 1200 for the S&P 500. Over the past five months our confidence in this forecast has only increased as the arguments for sustainable growth continue to outweigh the potential headwinds. ■

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