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Charting a Course for the Future

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Market Outlook

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The stock market has been mired in a trading range all summer. Two months ago we forecast "the market (S&P 500) to remain range-bound between 1050 and 1150 through the remainder of the current quarter, providing investors the opportunity to position for what we believe will be a breakout to the upside that will challenge the April highs before year-end." The lowest closing value for the S&P 500 since that prediction was 1047 in the month of August, and the highest was 1148 in the month of September. We briefly exceeded the 1150 level on the last day of the quarter, which we interpret as an indication that a new leg up in this bull market will soon be underway. The Dow Jones Industrials (+7.7%), Standard & Poor's 500 (+8.8%) and Nasdaq Composite (+12%) all finished September with tremendous gains. Technology led sector performance with a gain of 12.1%, while the utility sector was the worst performer, posting a gain of just 2.6% (source:Bloomberg.com).

There are two primary camps of thought prevailing today: one believing that the economy will fall back into recession, the stock market will again decline into bear market territory and a deflationary period will take hold; the other believing that we will avert such an onerous scenario, but will still remain jailed in a prolonged period of very slow growth, low interest rates and minimal investment returns under the burden of enormous government and consumer debt. The latter view has been coined the "new normal." We believe both camps are wrong. Our analysis has consistently led to a far more optimistic outlook dating back to the birth of this bull market in early 2009.

Economic growth decelerated during the first half of this year. As a result, economic forecasters gradually reduced estimates for real (inflation-adjusted) growth to what is now a consensus of just 2% for the second half of the year. The improvement is expected to be a modest 2.5% in 2011. Such tepid growth, should it occur, would not support the level of job creation we need to bring down the unemployment rate. Consumer spending and business investment would likely slow as the effects of economic stimulus subside--a scenario consistent with the "new normal" view. We believe the stage has instead been set for an upside surprise in the months ahead. Domestic growth has been much stronger than pundits, politicians and the public are willing to acknowledge. The headline numbers that serve as lagging indicators are depressing, but this is what the media and the majority of the public focus on, which is why sentiment is so discouraged. We expect real growth will average 3-4% in the second half of this year and well into 2011, driven by a steady pace of real consumer spending growth, a continuation of the surge in business investment and a gradual improvement in the trade deficit.

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Consider the fact that nominal consumer spending has already surpassed the highest level achieved in the previous expansion, with measures of consumer confidence and sentiment at dismally low levels and the unemployment rate at 9.6%. What happens when confidence improves and the unemployment rate declines as recent trends would dictate? Combining the increases in wages with the number of hours worked over the past year reveals that compensation has risen at a rate of 4%. With the savings rate approaching 6%, there is plenty of room for consumption to increase as confidence improves, and to allow consumers to continue repairing balance sheets.

We expect businesses to continue to invest and spend at an accelerated pace financed by the surge in profits and record levels of cash that sit on corporate balance sheets. The durable goods report for August, which included an upward revision to the July number, showed orders increasing in every major category with the exception of the transportation sector. In addition, it is likely Congress will support the Obama administration's recent proposal to allow corporations of any size to fully expense, rather than depreciate, the equipment they purchase between now and year-end 2011. This would serve to bolster capital spending, which we already believe will be a significant contributor to economic growth.

We believe increased levels of consumer spending and business investment will result in more significant payroll job gains following the mid-term elections, yet we don't view the current employment numbers as negatively as does the consensus. In the past two recoveries, payroll job growth has led the household number, so it makes sense to focus on payrolls to measure economic strength. Private payroll gains have averaged nearly 100K per month this year, which is modest by historical standards, but household employment gains, which include small business and the self-employed, tell a much different story. The surge in household employment by 891K in August brings the average monthly gain closer to 300K for this year. It appears that household employment is leading payroll employment in this recovery. We expect the payroll numbers that investors focus on to catch up with the household numbers in the months ahead. A leading indictor to this improvement will be a decline in the four-week average of unemployment claims below the 450K level, which we expect to see in the fourth quarter.

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Trade has been a drag on economic growth over the past year, but in our view that is about to change. Our imports should slow as the inventory rebuilding cycle matures, while we see growth in the developing world re-accelerating, which should boost our exports. The trade deficit, which subtracted a record 3.5% from economic growth in the second quarter, should be a net contributor to growth in the second half of this year and in 2011. In June we opined that "efforts by China and other developing countries to slow their own economies may come to an end." In August we advocated that "the PRC will implement measures to stimulate the economy in the months ahead." Last month we learned that August industrial production in China rose a stronger-than-expected 13.9%. This makes us more confident that global growth is re-accelerating. Further confirmation comes from the steady rise we have seen in the CRB Commodity Index, led by the price of copper, as well as the decline in value of the dollar.

As optimistic as we are about the economic fundamentals, we have learned the hard way that stock market performance can be as significant a determinant of those fundamentals as it is a reflection of the same. It is for this reason that we are even more confident in our bullish outlook based on our interpretation of statements made by the Federal Reserve following its September meeting. Chairman Bernanke indicated that the Fed would employ another round of quantitative easing as early as its November meeting, should economic activity and employment growth not accelerate. The Fed also openly expressed concern for the first time, perhaps as cover for such a policy move, about the risk of deflation. Quantitative easing occurs when the Federal Reserve purchases Treasury debt or other debt securities held by banks in exchange for dollars, thereby increasing the money supply. Those opposed to such measures argue that quantitative easing has no direct impact on economic growth. Just because a bank has more liquidity on hand doesn't mean it will lend more, nor would lower long-term interest rates resulting from bond purchases necessarily spark loan demand. We have no argument here, but we think the opposition doesn't fully appreciate Chairman Bernanke's true intentions.

We know that an increase in the money supply has historically lifted stock prices and weakened the dollar. We believe that is exactly what Chairman Bernanke wants to do, though it would be central bank sacrilege to openly say so. Another significant rise in stocks prices would likely trigger what is known as the wealth effect, which in turn could start a positive feed-back loop that achieves the Fed's ultimate goal—faster rates of economic and employment growth. As stock prices rise, so do consumer confidence and spending. As consumer confidence and spending rise, business confidence and spending follows. Businesses then hire more workers. A weakening dollar increases profits for multi-nationals and our competitiveness in global trade. As the unemployment rate falls, home prices begin to rise again, and stocks continue to move higher. This is the loop.

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We believe the Fed's informing investors of its intentions at the September meeting is designed to have a positive effect on financial markets between now and November. The Fed hopes that stock prices will rise and the dollar will weaken in anticipation of further quantitative easing to such a degree that the wealth effect takes hold. There is the possibility that the economic and employment numbers improve to such a degree that the Fed holds off on further quantitative easing. If we don't see measurable improvement in the numbers, which is more likely, we believe the Fed will announce another round of bond purchases. Either way, the deck is stacked in favor of the bulls.

We believe the recent breakout above the 1150 level on the S&P 500 to be significant. Investors have been digesting the gains we saw from the March 2009 lows for five months, and we suspect this breakout indicates a new leg up is approaching. We want to be fully invested in stocks at this time, but it is still critical in this new era of man against the machine to be selective on entry points for new investment. The computerized trading that accounts for nearly two-thirds of the volume on the exchanges has no investment outlook other than the handful of seconds that occupy each trade. This has dramatically increased volatility. A move of 5-10% in the market averages in either direction can occur in a matter of days, with complete disconnect from real world fundamentals. Pundits then rationalize these market moves by grasping for data points that support their respective confirmation biases. We refuse to be sucked into the high-frequency vortex, and we work relentlessly to fend off our own biases each day. October is not likely to be a repeat performance of September, and a temporary pullback in prices to digest the record monthly gains in September would be welcome, but we are confident that any pullback will be a final opportunity to purchase common stock within the summer trading range. We expect the S&P 500 to close above the 1150 level in coming weeks, challenge the April high of 1217, and exceed it before year-end. ■