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Market Strategy

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October Market Outlook

September proved to be another volatile month for equity investors and commodity traders as the major equity market indices dropped for a fifth month in a row and major commodities – namely gold, silver and crude oil futures – saw huge declines. Investors in fixed income instruments enjoyed a modest rally during the month and ended the quarter with solid gains as intermediate and long-term Treasury maturities dropped to all-time low yield levels before moving back slightly by month-end. The third quarter ended with the stock and commodity markets posting their worst quarterly declines since 2009, while the bond market posted its best quarterly returns in three years.

During September, the financial markets acted in response to an around-the-clock stream of domestic and international news flow. Unfortunately, much of the news hitting the tape sent mixed or negative messages to investors, with most causing immediate market reaction. The European debt crisis remained the biggest market mover during the month. European Union members and the European Central Bank debated about the size of a potential bailout fund for troubled country sovereign debt (the European Financial Stability Facility), the need to build reserves in European banks holding that debt, and the conditions that Greece needs to meet in order to borrow from the fund in coming weeks. This drama has played out for most of 2011 and does not appear much closer to a lasting resolution than at the beginning of the third quarter. The back-and-forth situation in Europe continues to erode investor confidence in risky assets such as equities, commodities, and currencies, while attracting investor funds into perceived safe-haven, currency-friendly bonds.

The financial markets continue to react to a steady flow of somewhat discouraging news regarding the health of the U.S. economy. The Federal Reserve Open Market Committee met on September 21st and 22nd. At the conclusion of their two-day meeting, the committee announced "Operation Twist". This is a $400 billion balance sheet management plan for Federal Reserve assets intended to drive down intermediate and longer-term interest rates, thus providing a motivation for qualifying homeowners to refinance their mortgages at lower interest rates and to incentivize qualifying first time homebuyers to finance home purchases at all-time record low mortgage rates. The Fed announced that it expects to maintain its ultra-low short-term interest rate policy into 2013 as the economy continues to show "significant downside risks". The wording "significant downside risks" in its policy statement was a new insertion and triggered a widespread sell-off in the equity and commodities markets, erasing the decent gains seen between the end of August and mid-September. The Fed's downbeat assessment of the current state of the domestic economy and September's discouraging jobs report further elevated investor concerns regarding the possibility of the economy returning to recession.

Looking ahead, we anxiously await updated reports on the economy in early October in the form of the ISM (Purchasing Managers) Indices and the October employment report that we expect to show at least some non-farm jobs growth. Economic data released in late September continues to show the economy plodding along just above stall speed. We also await the launch of third quarter earnings reporting season around mid-month. While the economic data points to a recent slowdown in domestic and global economic growth, we have only a few signs that major companies have seen or acknowledge their domestic or global business is slowing. Coming into the end of September, there had been very few third quarter earnings warnings for investors, thus we are looking for a significant number of companies, once again, to meet or slightly beat third quarter revenue and earnings estimates published by Wall Street analysts. We do not expect to see many companies lift fourth quarter revenue or earnings guidance.

From a valuation perspective, the stock market remains undervalued versus the bond market with the dividend yield for the S&P 500 sitting around 2.3% while the yield on the 10-year Treasury note currently stands at 1.8%. The Price-to-Earnings ratio for the S&P 500 based on estimated 2012 operating earnings sits at 10.8x. Our estimate of fair value based on continuation of the current interest rate environment and modest earnings growth over the next three to five years is 15.0x. Put another way, equity investors appear to be discounting a sharp rise in interest rates over the next two to three years, or foresee a very deep near-term recession. While both are plausible, we believe the probability of either occurring is low. Near-term, we expect to see the recent above average day-to-day price volatility in the stock market continue, but we are also looking for some slightly encouraging economic data to renew investor confidence over the next couple of months, which could drive stock prices higher during the fourth quarter.

Bond investors should rest easy even though yields for most Treasury issues are at or near all-time low levels. This is due to the Federal Reserve essentially manipulating the Treasury market in order to keep interest rates as low as possible for as long as possible with a current timeline extending into 2013. We have a concern for potential new buyers of Treasury bonds or bonds with very low yields and maturities longer than 10 years. We believe interest rates will rise several percentage points from their current levels when the Federal Reserve finally decides to remove its restraints on rising rates as the economy eventually begins to accelerate or inflation pressures build. If this occurs within the next three to five years, it is conceivable that the yield on a 10-year Treasury note could rise from its current 1.8 percent level to 4 or 5 percent or more, consequently triggering a 20 to 25 percent decline in the value of these low coupon, long maturity bonds when that happens. Thus, we caution investors needing fixed income exposure to be very cautious in rolling over maturing bonds or certificate of deposits.

Investors holding top quality bonds with attractive coupon interest rates and maturities less than 10 years should not worry about significant price erosion in the event interest rates rise. We do not expect to see interest rates materially rising until the Fed reverses course and begins to raise interest rates on short-term funds. Most likely, that will not occur until 2013 at the earliest. We are not advocating selling high quality bonds with attractive yields based on cost, but warn investors seeking to roll over cash from maturing bonds or new cash coming into their portfolios to be very selective and careful when evaluating new bond investments.

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