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June 13, 2013

Gleanings

A Monthly Chart Presentation and Discussion Pulling Together the Separate Disciplines of Economics, Fundamentals, and Quantitative Analysis

What Does the Stock Market Know that Investors Don't?

- Some of this month's slides were sent to me by a particularly bright financial advisor who put into pictures what I have been saying with words. Said slides show there have only been four broad bases of over 12 years for the D-J Industrials since 1900. Each time the Dow has broken out of one of those Brobdingnagian bases we have been in a new secular bull market.
- The characteristics of the market, when it breaks out of a base that exceeds 12 years in length, is different. Investor behavior reflects an underlying distrust, or disinterest, and is characterized by underinvestment in equities. This results in a rebound that is relentless, providing little opportunity to buy on pullbacks.
- Studying those individual bases, and the subsequent upside breakout, shows that the equity markets have had substantial rallies from those breakout points. It also shows that such breakouts come when investors remain worried, and therefore underinvested, about pretty much the same things both in the past and the present.
- In my recent discussions with portfolio managers (PMs) outside of this country it is interesting that, for the first time in a decade, all of them want to increase their exposure to U.S. equities. While the rotation out of bonds and into stocks has not begun in earnest yet, the rotation out of non-U.S. stocks into U.S. stocks is alive and well.
- As for the recent rise in interest rates, there have been two previous occasions when the monthly on the 10-year T Note has risen by 20% or more. In the two previous times, stocks have rallied. We'll see if that correlation plays this time since there has been another 20% delta recently. One correlation, however, that has derailed recently has been the dollar/stock market. Since last week, the dollar fell 2%, but the S&P 500 rallied 0.87%. That could be a hint that the July point of stock vulnerability I have talked about is coming.

Please read domestic and foreign disclosure/risk information and Analyst Certification beginning on slide 28.

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A History of Big Bases

- Dow Jones Industrial Average
- 1900-2013

Dow Jones Industrial Average 1900-2013

Source: Bloomberg 50-day moving average 200-day moving average

Big Bases Since 1900

There have been four bases that exceeded 12 years

- 1906 to 1924—18 years
- 1929 to 1955—26 years
- 1966 to 1982—16 years
- 2000 to 2013—13 years

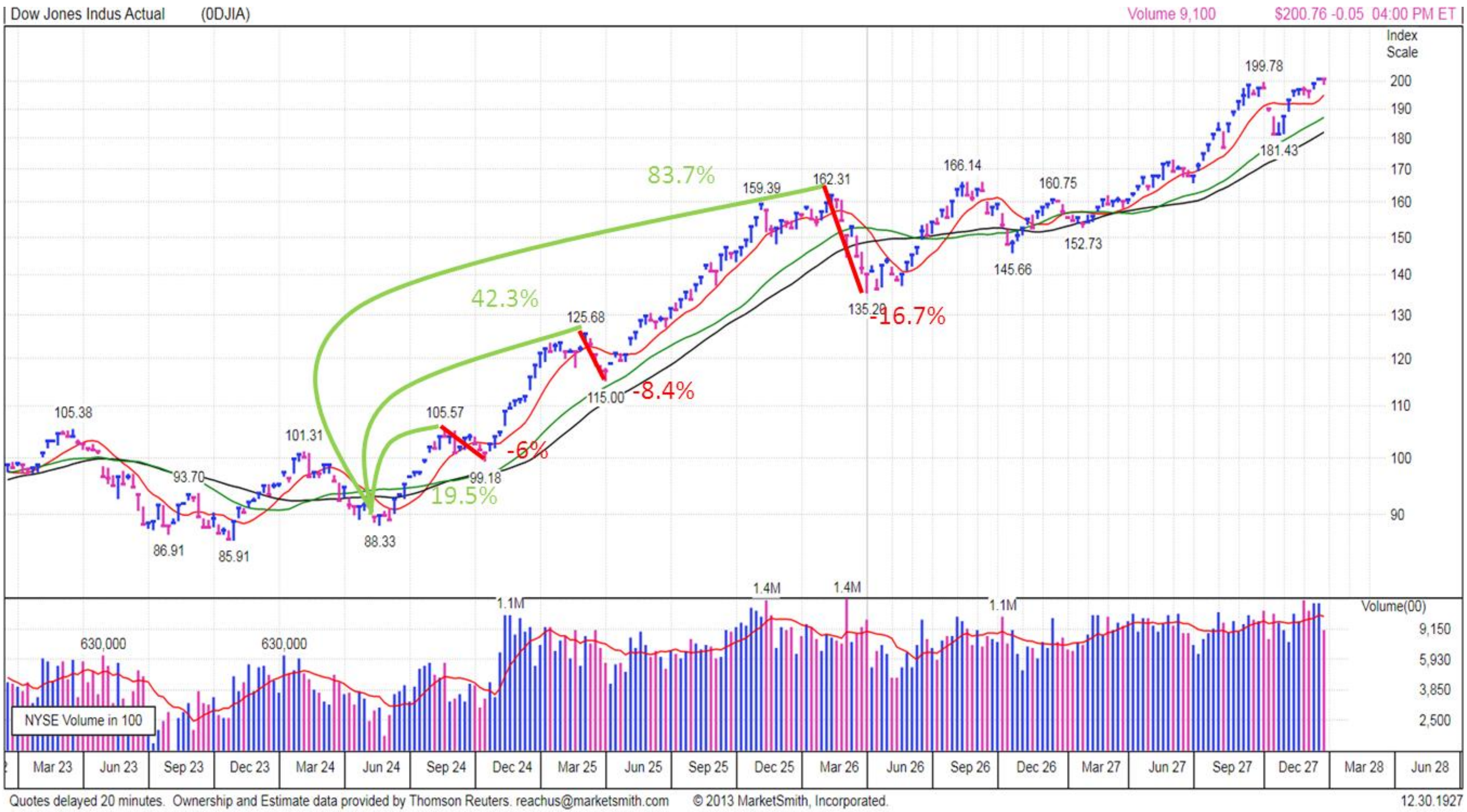
Breakouts from Big Bases

The characteristics of the market when it breaks out of a base that exceeds 12 years in length is different.

Investor behavior reflects an underlying distrust or disinterest and is characterized by underinvestment in equities.

This results in a rebound that is relentless, providing little opportunity to buy on pullbacks.

1906 to 1924 Base Breakout



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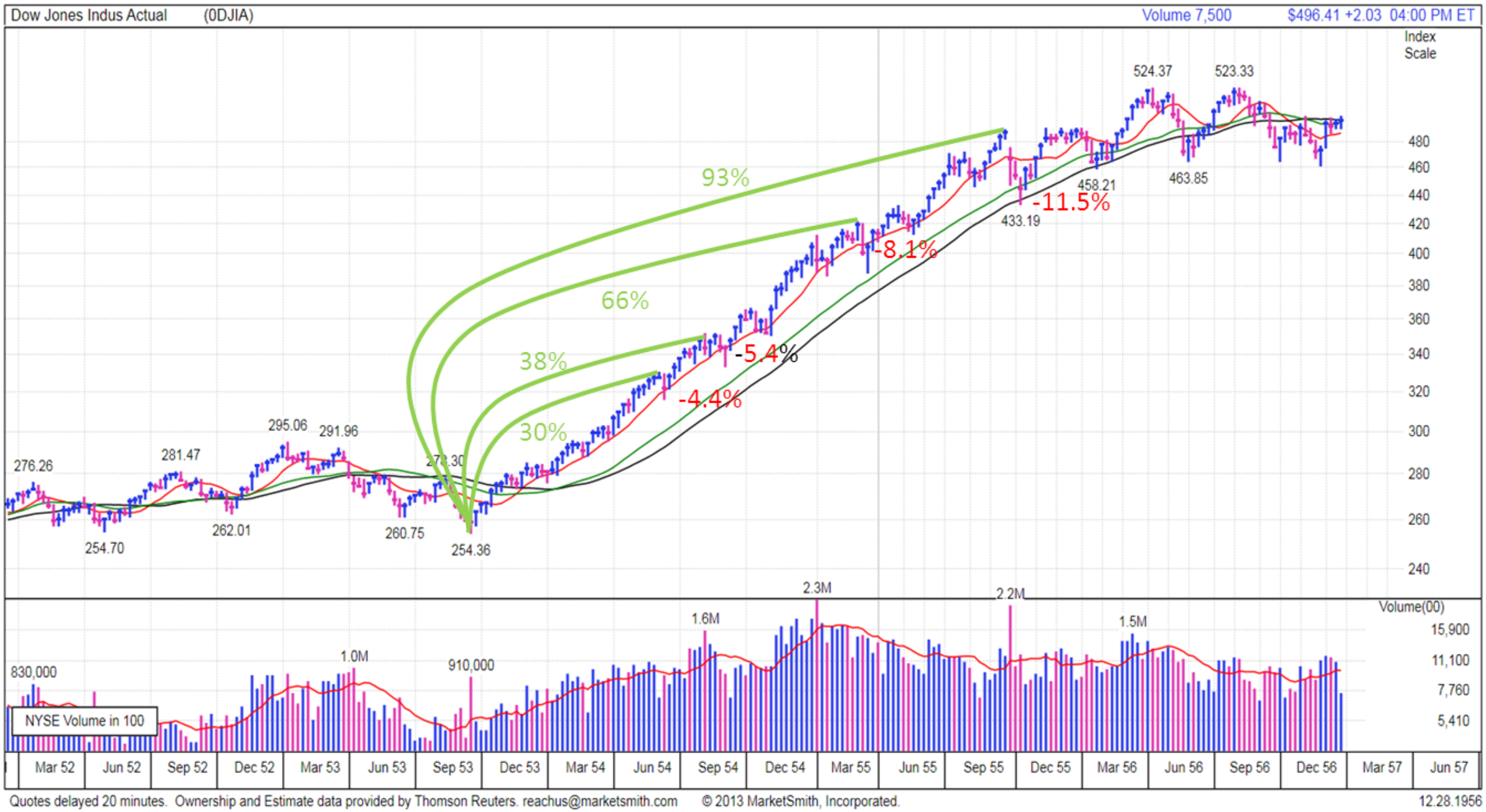
1929 to 1955 Base Breakout



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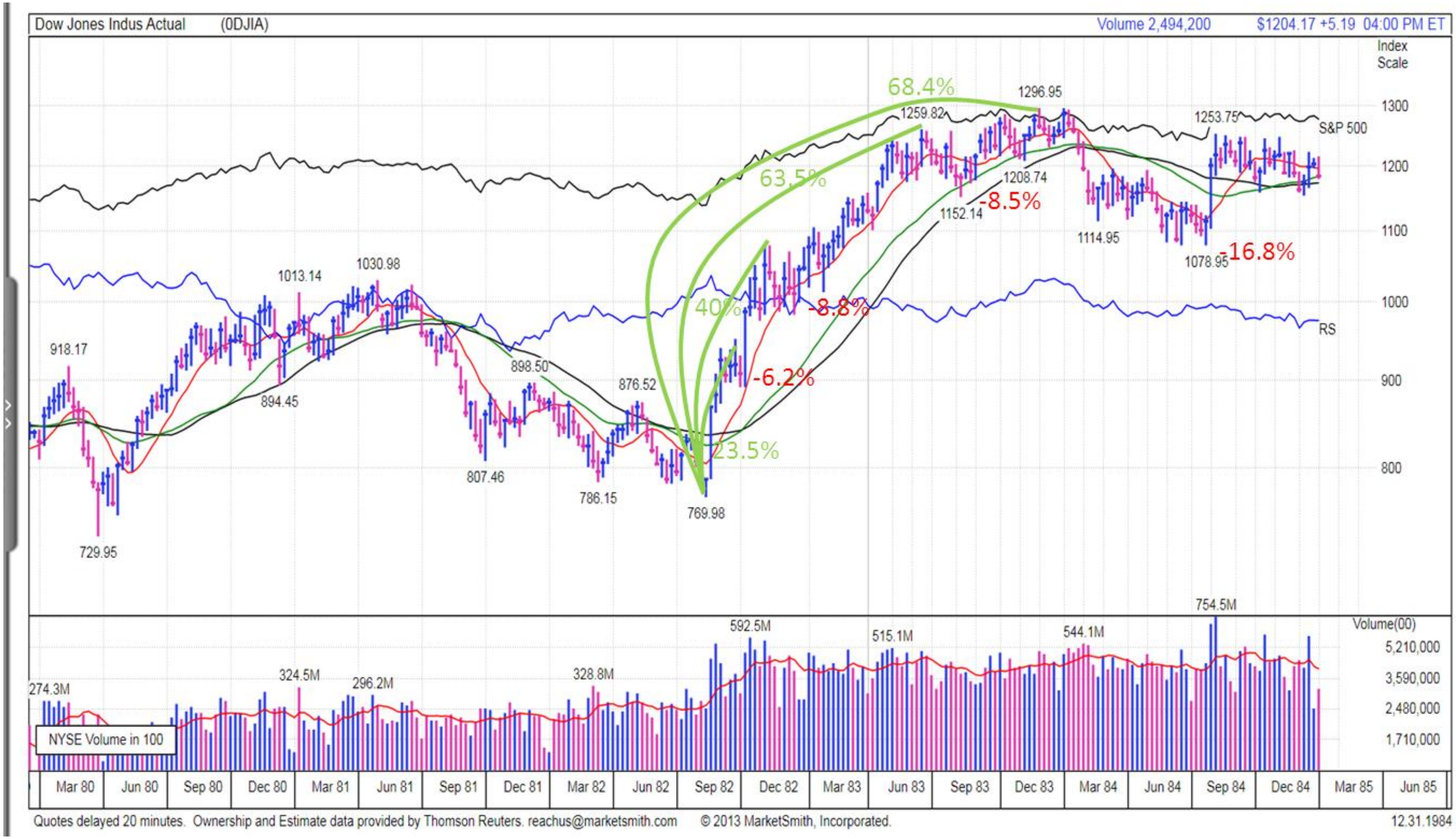
1966 to 1982 Base Breakout



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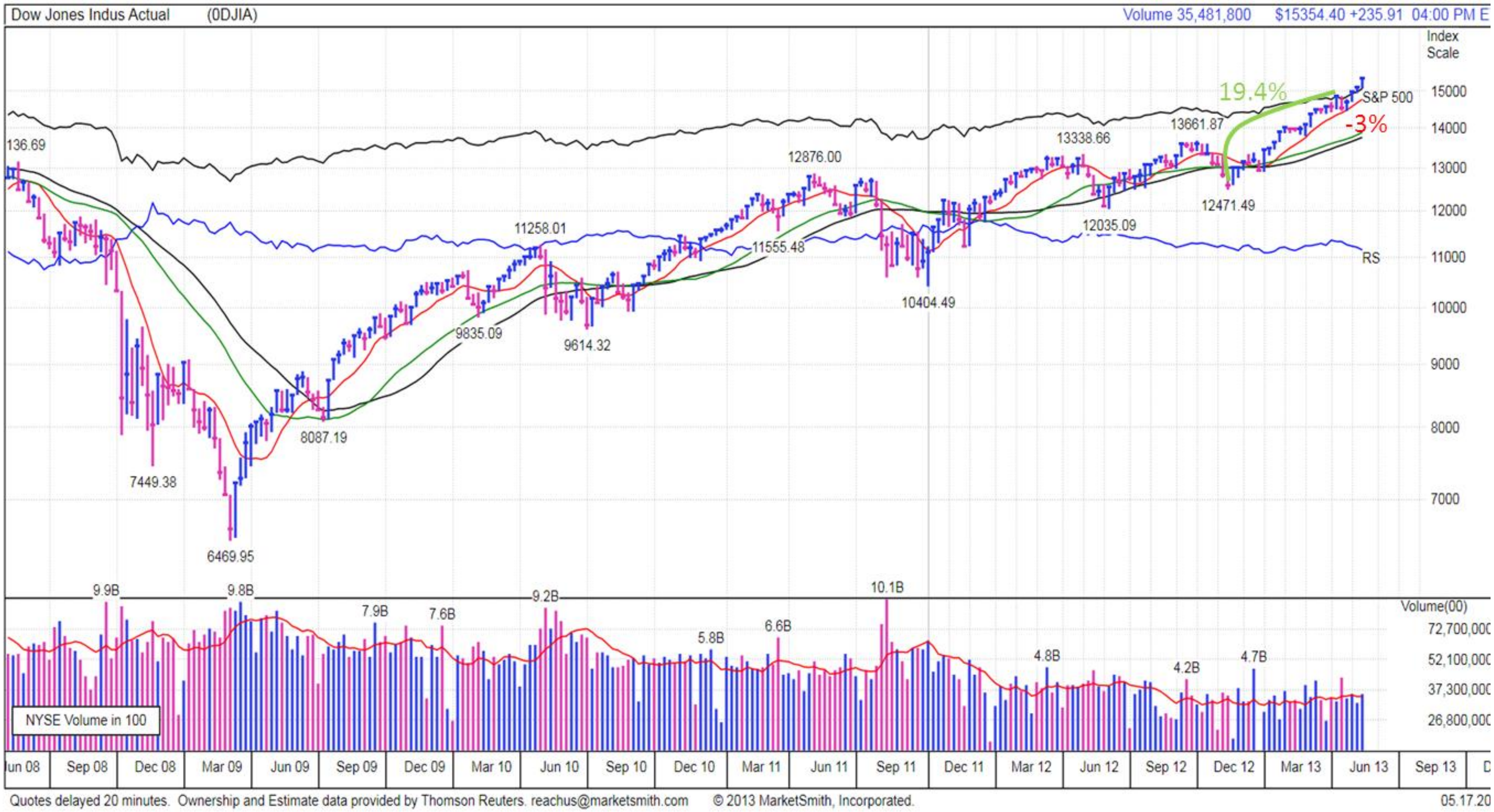
2000 to 2013 Base Breakout



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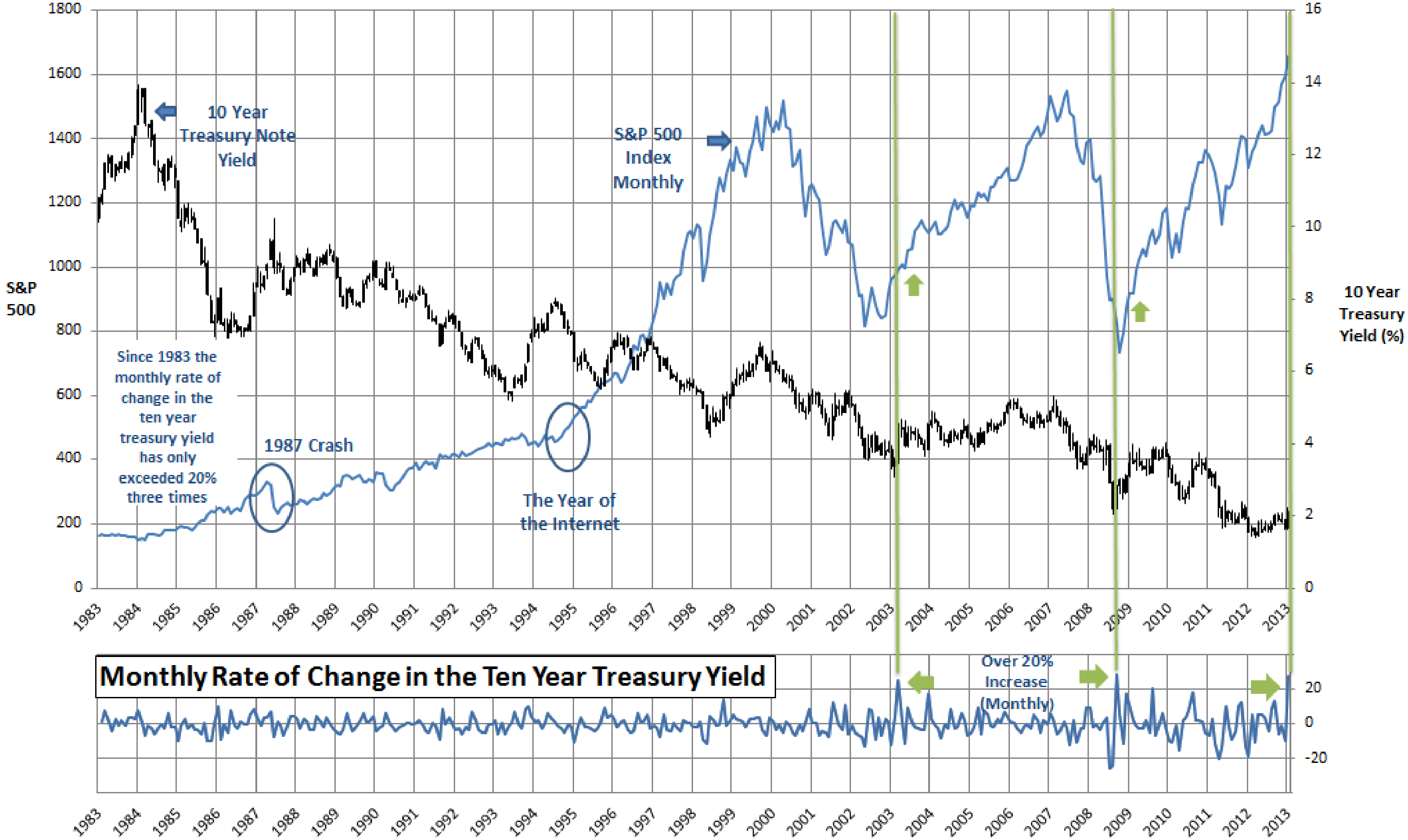
Common Fundamental Characteristics

- Rebound from high unemployment (age 20-35)
- High government interest payments on debt
- Low investor allocation to equities
- Extremely high/low interest rates (alternates)

Conclusion

- Breakouts from 10+ year bases are very rare
- The current breakout is the fourth since 1900
- Don’t mess it up!

10-year Treasury Note Yield vs. the S&P 500 Index



Source: Factset

S&P 500 vs. U.S. Dollar Index

Source: Factset

S&P 500 vs. U.S. Dollar Index

Source: Factset

Scott Brown

Economic Indicator	Status	Comments
Growth		Real GDP is expected to have slowed in 2Q13. Expectations for growth in 3Q13 have declined somewhat. However, growth is expected to pick up in 4Q13 and into 2014.
Employment		Job growth has trended at a moderately strong pace. However, we aren't making up much of the ground that was lost in the labor market during the recession. Youth unemployment and long-term unemployment remain unacceptably high.
Consumer Spending		A mixed bag. Wealth gains from the stock market and housing are supporting spending at the high end. Stagnation in inflation-adjusted wages and lagged effects of the payroll tax increase are restraining spending growth at the lower end of the income scale .
Business Investment		Corporate profits have remained strong, providing fuel for business fixed investment. However, recent figures on capital spending have been generally soft.
Manufacturing		Mixed across industries, with strength in autos and construction-related industries, but generally a bit soft. Weak global demand has dampened U.S. exports. Employment and industrial production have been soft in recent months.
Housing and Construction		Sales and construction activity should continue to improve. However, the recent increase in mortgage rates won't help. It will take some time before the supply chain fully recovers.
Inflation		The PCE Price Index rose 0.7% over the 12 months ending in April (+1.1% ex-food & energy), well below the Fed's 2% target. The soft global economy has put downward pressure on commodity prices. Wage pressures remain mild. Inflation expectations are well-anchored.
Monetary Policy		The Fed will continue to purchase $85 billion per month in long-term Treasuries and mortgage-backed securities, but is expected to taper the pace in the months ahead (September, most likely). Short-term interest rates are expected to remain exceptionally low until mid-2015.
Long-Term Interest Rates		Long-term interest rates have risen sharply in recent weeks, but the increase is at odds with the economic outlook (which has grown a bit softer in the near term). The markets are putting too much emphasis on a possible tapering of Fed asset purchases.
Fiscal Policy		Sequester cuts are spread out over time (no cliff effect), but will subtract from overall economic growth this year and next. The outlook for the deficit has improved considerably in recent months. The federal debt ceiling will not be binding until after Labor Day (perhaps October).
The Dollar		Likely range-bound in the near term. The U.S. economy is expected to outpace Europe (a plus for the dollar), but easier monetary policy is a negative.
Rest of the World		Global growth has been relatively soft, but is expected to improve in 2014. Europe remains in recession, which won't help China's export engine.

Long-Term Interest Rates

- Long-term interest rates will rise as the economy recovers, but they shouldn't rise so much that they jeopardize the recovery
- The recent increase in long-term interest rates is puzzling
  - The near-term economic outlook has gotten a bit worse
  - Inflation has been trending lower
  - The government is borrowing significantly less
- It's the total QE purchases that matter, not the monthly pace
  - There was no significant rise in long-term rates after QE1 and QE2 ended
  - There hasn't been a huge change in the outlook for total QE3 purchases
    - ($500 billion is roughly equivalent to 20 basis points in 10-year Treasury yield)
- Markets are confused about "tapering" and the impact of QE3
  - Mixed comments from Fed officials have fueled the market confusion
    - The Fed is not "confused" – rather, there is a range of views
    - "Substantial improvement" means different things to different Fed officials
  - The pace of Fed asset purchases should vary with the economic outlook, but it's not a mechanical process for the Fed
  - Lower Treasury borrowing implies a technical decrease in the pace of QE3

Long-term interest rates have risen sharply over the last few weeks, even as the economic outlook has softened.

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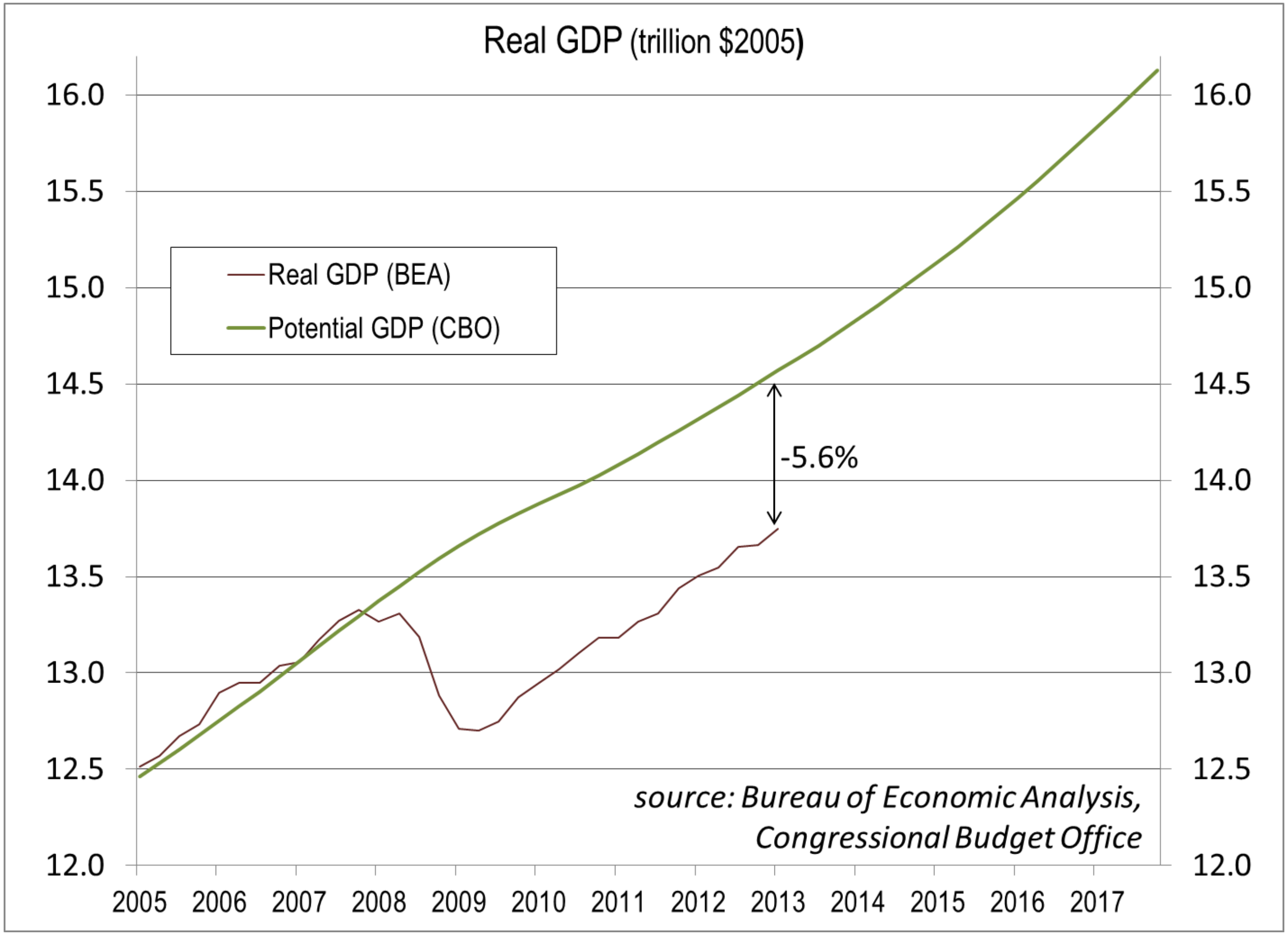
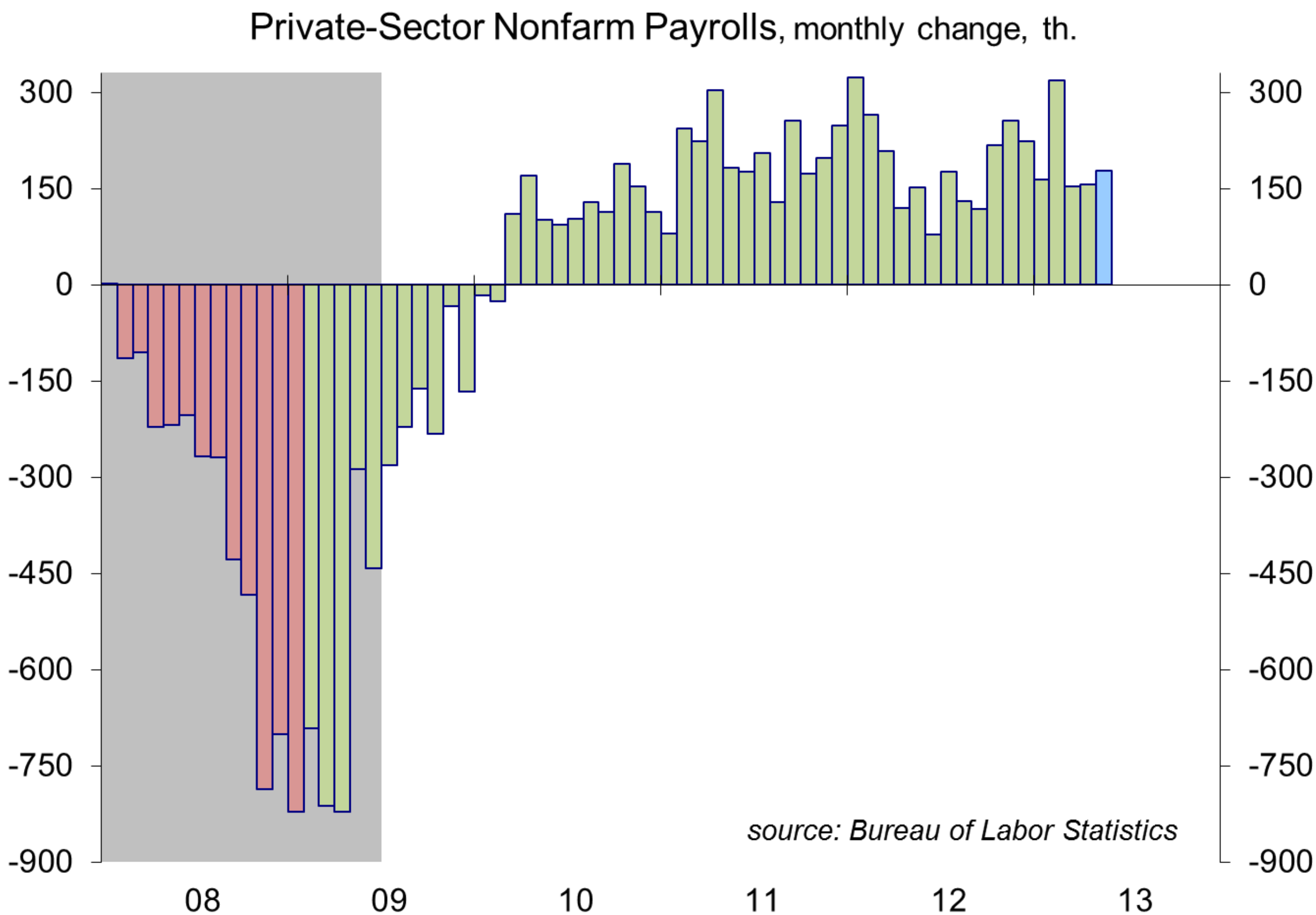
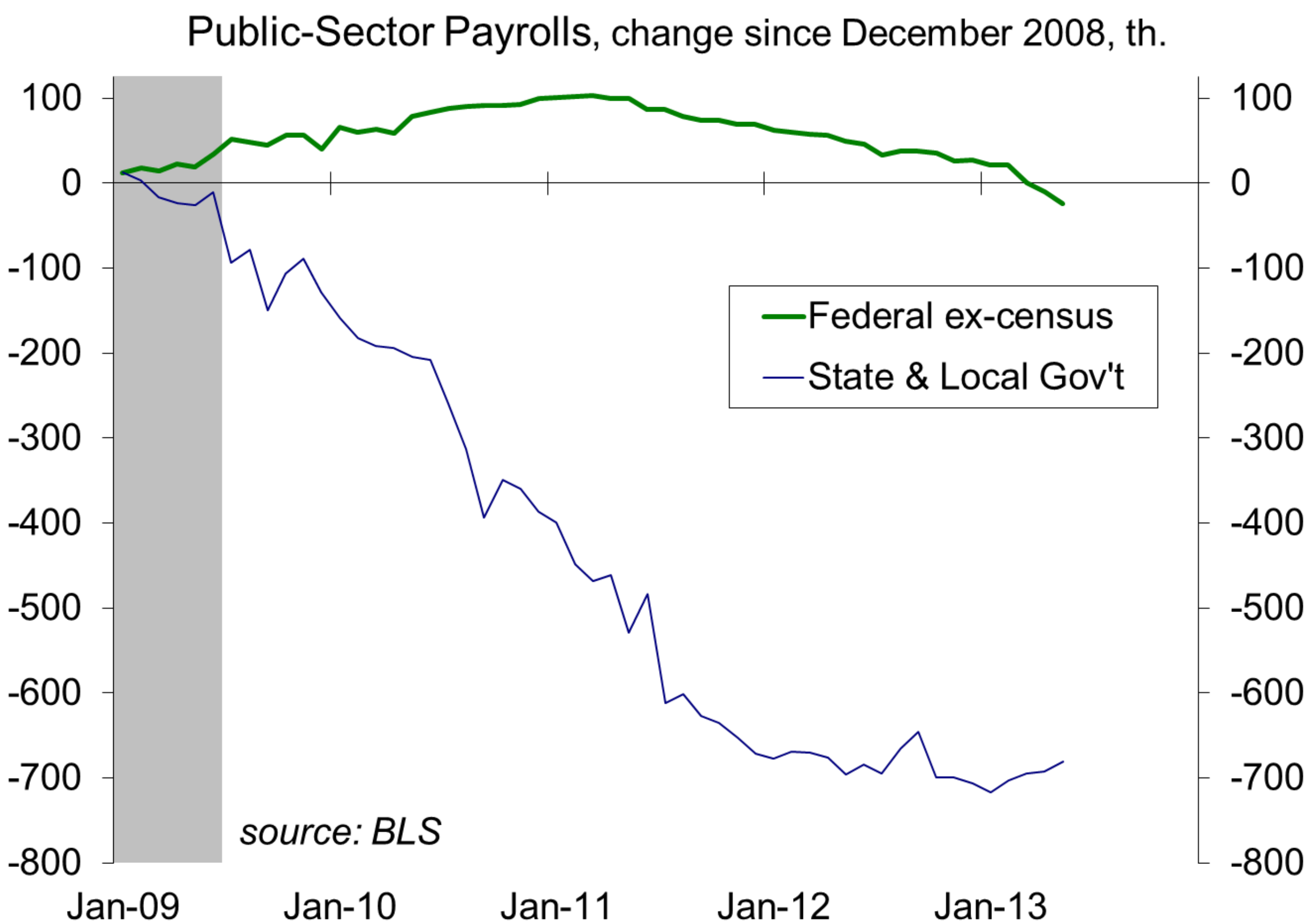
Real GDP growth has been moderately strong, but there is still a considerable amount of slack in the economy.



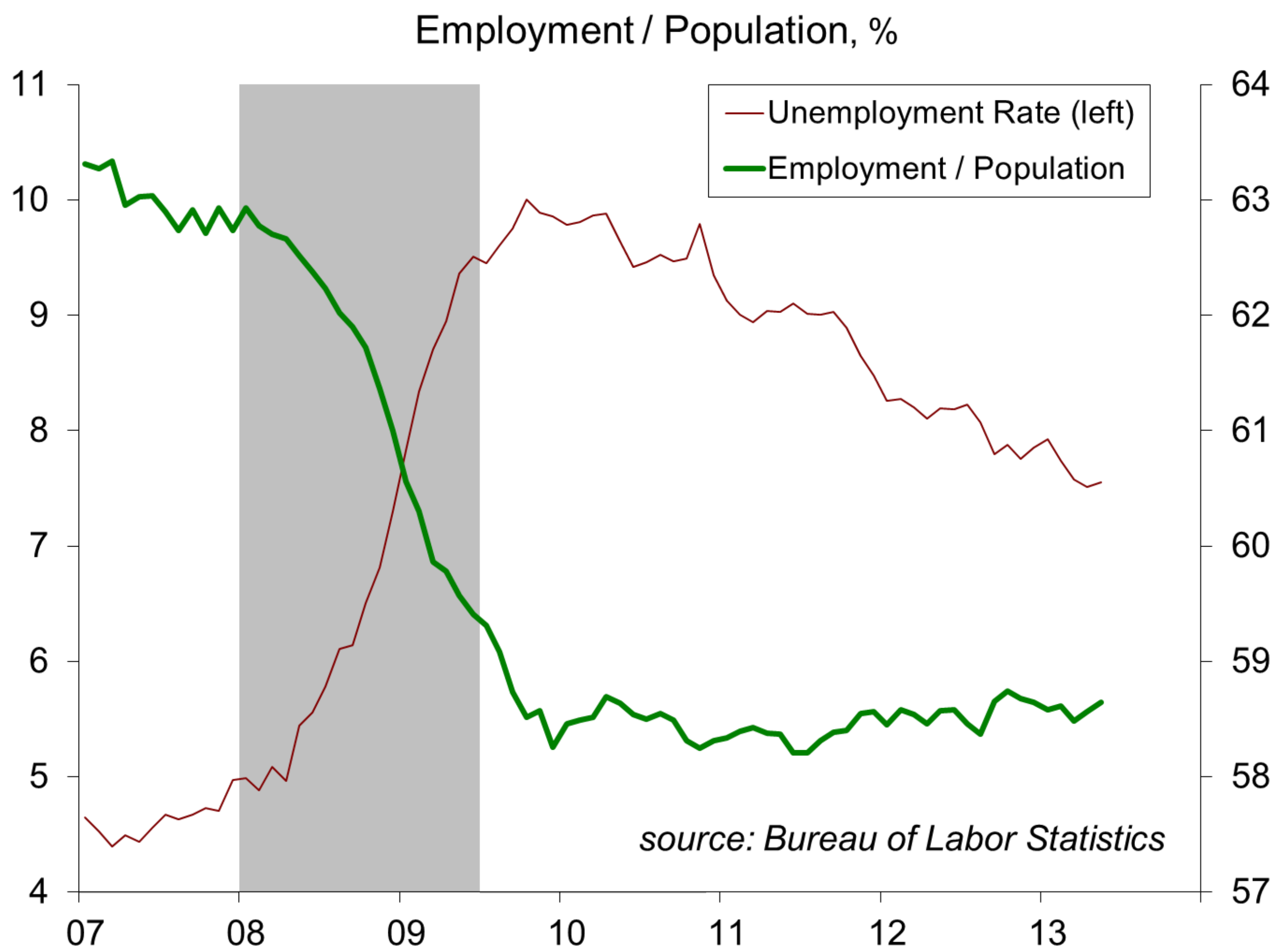
Private sector payrolls rose by 178,000 in May, a moderate 163,000 average over the last three months.



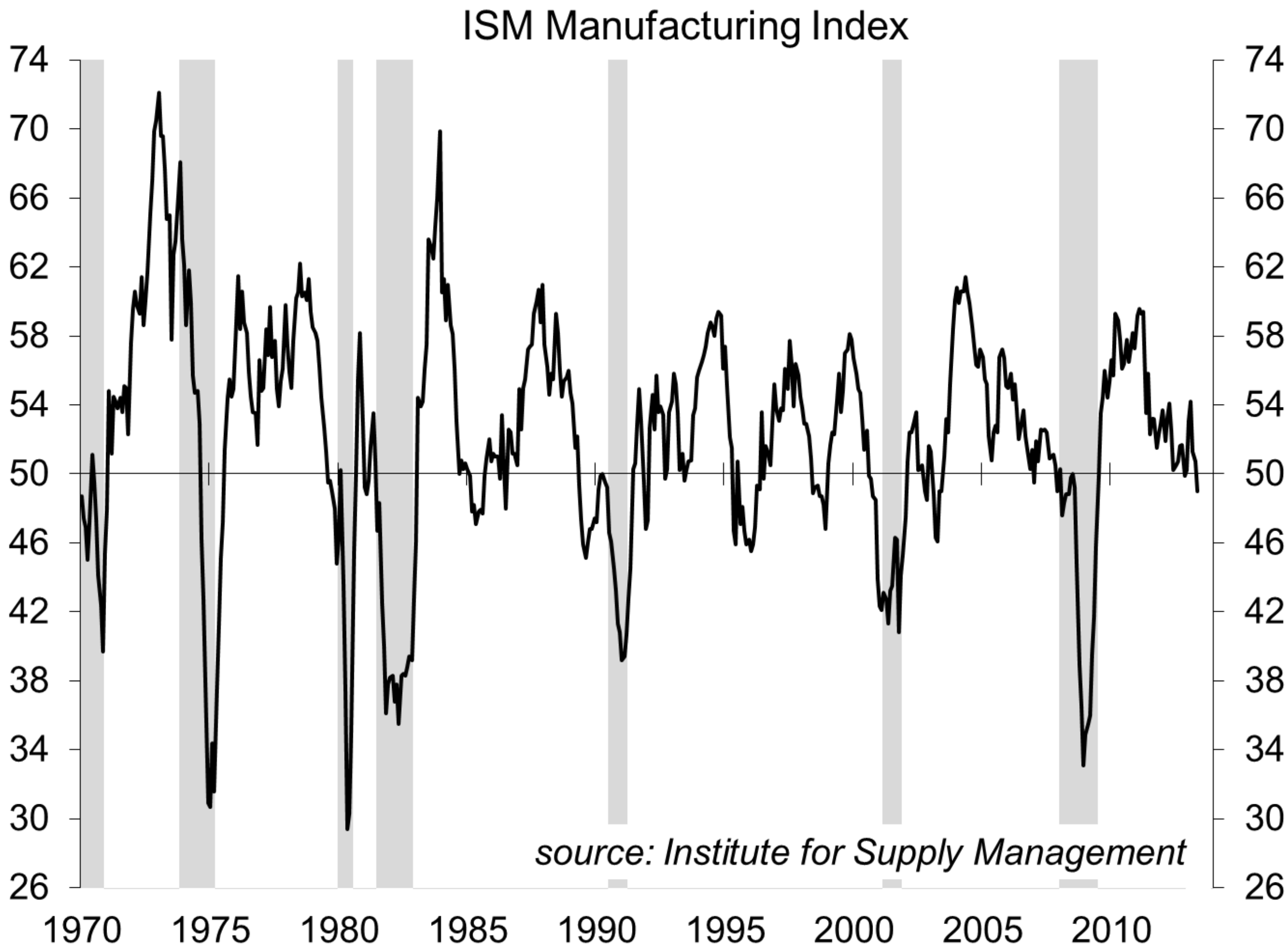
State and local government payrolls have bottomed, but federal payrolls are trending lower.



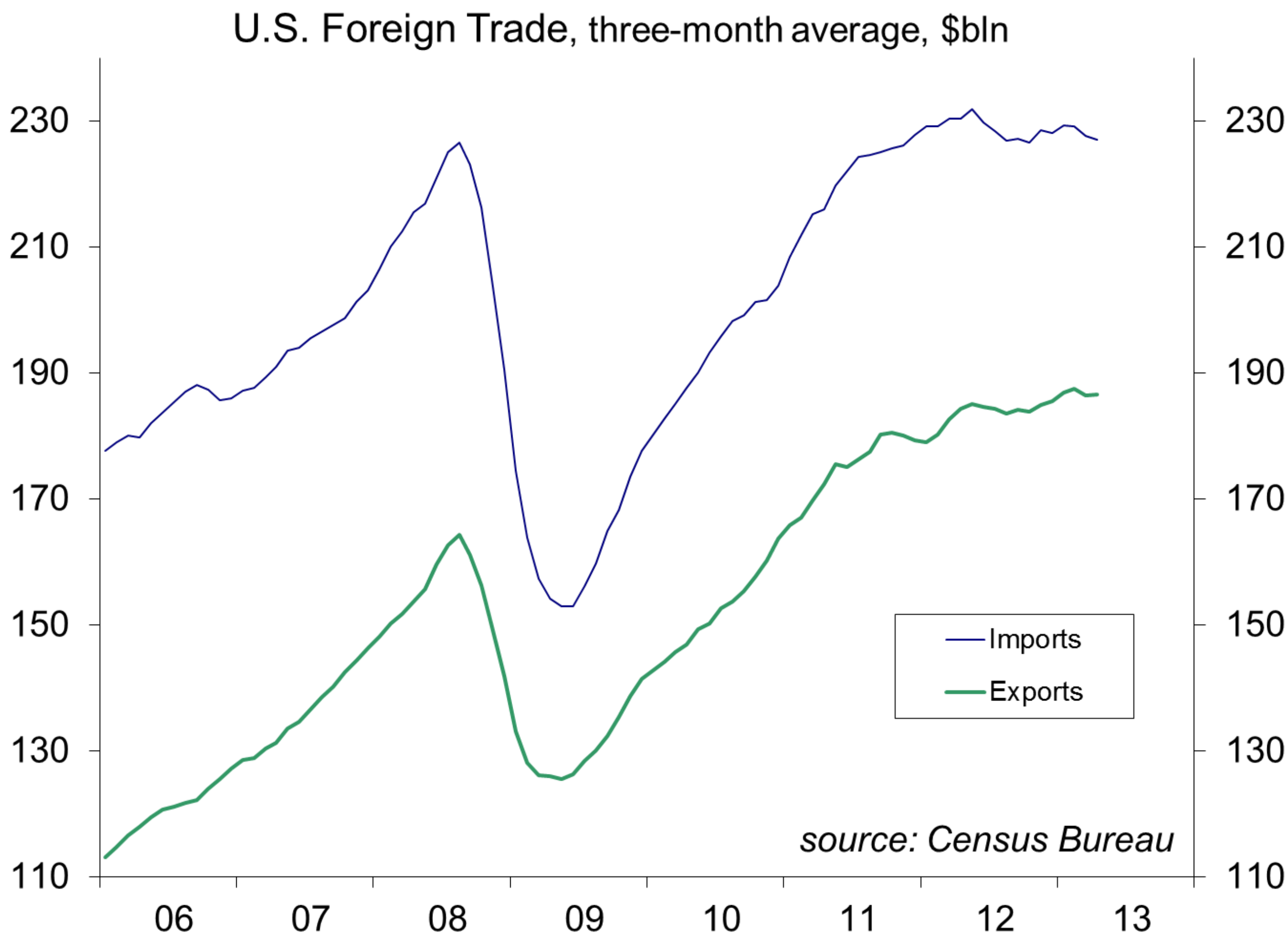
The unemployment rate has trended lower in recent years, but there is a huge amount of labor market slack.



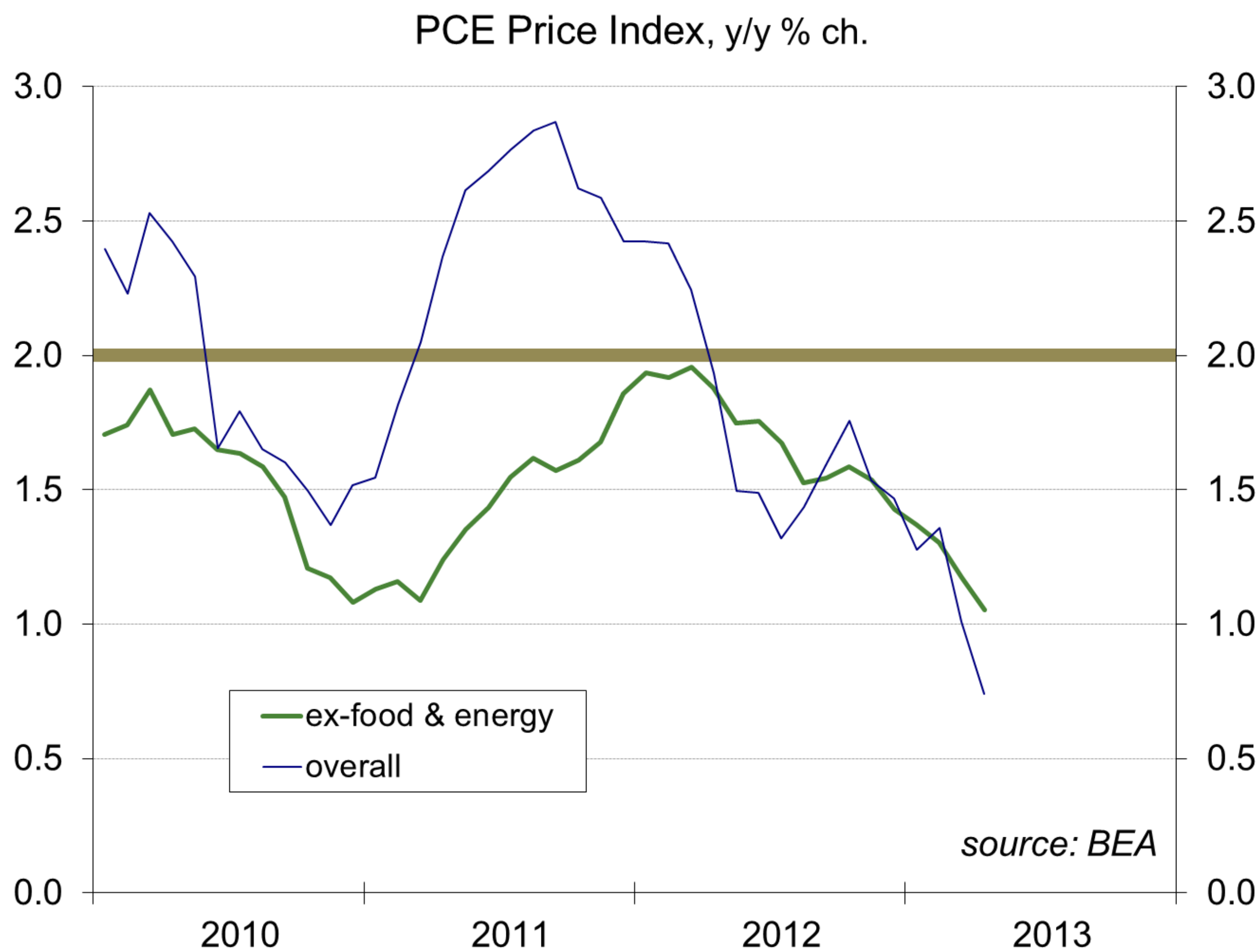
The ISM Manufacturing Index dipped below the breakeven level in May, reflecting a weak factory sector.



U.S. exports are trending only slightly higher, while imports have been trending a bit lower (reduced oil imports).



Inflation is below the Fed's 2% goal, but well-anchored inflation expectations may limit the threat of deflation.



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Fiscal Policy

- The Fed notes that *"fiscal policy is restraining economic growth"*
  - Payroll tax hike / sequester cuts: -1.5 ppts from GDP growth in 2013
    - Sequester impact is spread out over time (no cliff effect on economy)
- The debt ceiling went back into effect on May 19
  - Treasury: not binding until after Labor Day
    - perhaps not an issue until October or November
- State and local government
  - Tax revenues are continuing to recover, may see modest job gains
- The budget deficit is falling
  - Near-term outlook has improved considerably
    - The deficit will be about 4.0% of GDP in FY13, 3.4% in FY14
  - However, longer-term budget pressures remain

Federal Reserve Policy – Extraordinary Measures

1. **Forward Guidance** on short-term interest rates
   The Committee anticipates that this exceptionally low range for the federal funds rate will be appropriate *at least as long as*:
   - a) the unemployment rate remains above 6.5%,
   - b) inflation one to two years ahead is projected to be no more than 2.5%,
   - c) longer-term inflation expectations remain well anchored
2. **Large-Scale Asset Purchases** (LSAP or "QE3") – the Fed will purchase:
   $45 billion in long-term Treasuries and
   $40 billion in Mortgage-Backed Securities
   until the labor market *"improves substantially"*

In the forward guidance, these are thresholds or guideposts, not targets.

In the LSAP ("QE3"), this is a qualitative threshold (to taper asset purchases). The Fed will monitor a wide range of labor market indicators (including the unemployment rate, measures of job loss and new hiring, and the quit rate).

May 1: The Federal Open Market Committee *"is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes."*

Economic Outlook: Real GDP growth of 1.5% to 2.0% in 2Q13, likely to pick up (2.0% to 2.5%) in the second half.

- Economic Headwinds
  - Payroll tax increase (has restrained disposable income in first half of 2013)
  - Federal government (sequester) spending cuts (spread out over time)
  - Global economic weakness
  - Tight credit for some borrowers (consumers, small business)
- Economic Tailwinds
  - Accommodative monetary policy
  - Homebuilding (support for GDP growth, but years away from a full recovery)
  - Autos (driven by replacement needs, easier credit)
- Economic Wildcards
  - Gasoline prices
- Economic Risks
  - Europe (but signs of stabilization and much less fear than a year ago)
  - Fiscal Policy (debt ceiling, 2014 budget)

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