

Weren't We Just Here?

Has anyone else had this feeling recently? Reading the financial press and following the daily ebbs and flows of the markets, it is hard not to have the sense that this feels all too familiar. Though almost a full year has passed since the summer of 2010, we are in almost every way reliving the exact set of dynamics that characterized last summer's market environment.

For starters, we once again have an equity market under steady pressure, though not quite as dramatic as last summer's decline. This pullback, like last year's, follows a very strong up-move in a short period of time. In both instances, the market had reached short-term overbought conditions and some giveback was a logical expectation.

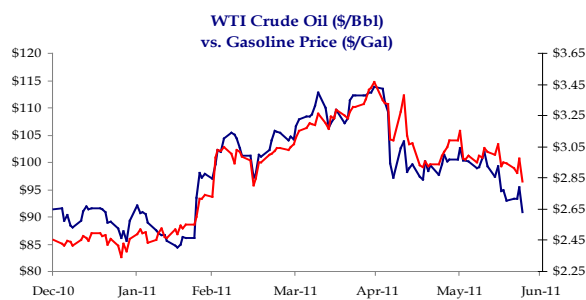
More importantly, it is largely the same set of macro factors dominating the discussion: European sovereign debt issues – notably fears of Greece defaulting; Chinese economic issues – notably the government's efforts to control inflation; weakening domestic economic readings – notably employment, housing, and manufacturing; and finally the end of a period of accommodative monetary action on the part of the Fed – QE1 last spring and QE2 this June.

That is not to say that there have not been a couple of new wrinkles added to this collection of concerns. The first was the sharp run up this spring in oil and gasoline prices resulting from the spread of unrest across the Middle East. The abrupt spike in oil prices from \$90 to \$115 per barrel and gasoline from \$3 to \$4 per gallon has undoubtedly weighed on economic activity and consumer sentiment. The second was the disastrous tsunami that struck Japan and its resulting disruption on demand from the 3rd largest economy in the world and on global manufacturing supply chains.

Under the weight of these collective factors, the talk is quickly shifting from whether this current economic slowdown is once again just a soft patch along a gradual road of recovery to the possibility of a more meaningful downward trajectory into a double-dip recession. While it is quite possible that many of the seemingly perpetual issues will persist for some time into the future, now just as last summer, this does not necessitate that the outlook for stocks is one of doom and gloom.

First of all, the two new factors that have pressured recent economic readings and market sentiment, higher fuel prices (all commodity prices for that matter) and Japanese disruption have both started to show signs of abatement. Starting with the latter, indications based on recent comments from Japanese auto-makers are that operations are ramping back up and this should have a positive read across for global manufacturing. Other comments from US-based companies selling into the Japanese marketplace indicate business and consumer spending activity there is also getting back on its feet.

Fuel prices have also witnessed favorable developments, largely a silver lining effect of the slowdown in recent economic activity as the muting of economic prospects has resulted in both crude oil and wholesale gasoline prices retreating from April highs back towards levels in place prior to the explosion of unrest across the Middle East region.

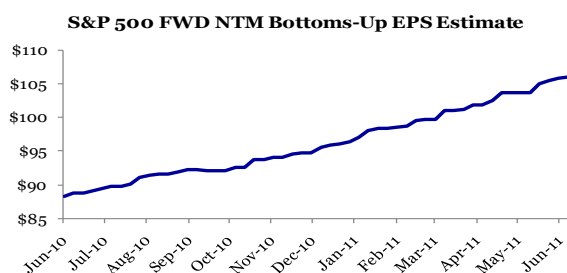


Source: Strategas

Relative to the past few months, this retreat in fuel prices (which has also been witnessed to varying extents across the full commodity complex including agricultural and metals) should effectively act as a tax cut for consumers and also benefit corporate margins via lower input costs.

While the Fed's announcement of a second round of quantitative easing last August was undoubtedly a major catalyst for the subsequent fall rally in stock prices the program is now at its end. Though it is unlikely that we will see a full-blown QE3 program announced in the foreseeable future, the Fed has indicated that it will remain accommodative via maintaining the low Fed Funds rate and by reinvesting the proceeds of maturing securities bought in the previous rounds of easing.

Continued Fed accommodation and a probable manufacturing rebound as parts shortages from the Japanese disaster wane, fuel costs moderate, and growing economies overseas push exports up, allow for an environment where corporations should maintain a path of forward earnings growth. Current fears in the market that earnings expectations are too high and need to come down parallel a similar fear last summer. Last summer's pessimism proved unwarranted as earnings delivery over the past four quarters and corporate outlooks have remained solid.



Source: Thomson Financial

Even if current expectations were to prove a bit too high, at a current valuation of 12.8X forward earnings compared to the long-term average of 14.4X, the stock market as measured by the S&P 500 appears to already be pricing in a more moderate earnings picture. In such an environment, simply delivering on current expectations should receive a warm welcome by investors.

So while the summer has definitely brought with it a sense of stock market déjà vu, it's still too early to call that a bad thing and we just might be pleasantly surprised as the rest of 2011 plays out.

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