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Stocks See 10% Correction and Bonds Rally on Global Debt Concern

Major U.S. stock market averages have corrected by greater than 10% from highs reached in May. Intensifying concern about potential default by some European countries, an unsettling debate over the funding of the U.S. deficit, and generally disappointing economic data has provided little reason for investors to bid up stock prices.

On the other side of the financial ledger, bond values have surged, forcing yields on Treasuries to levels reminiscent of the 1950s. The yield on 10-year Treasury bonds is now below 2.5% — down from 3.75% earlier this year, and near last October's lows. A further 0.25-0.50% drop in Treasury yields would put bond prices at levels that marked the end of bond rallies in each of the past three years.

Valuations Better for Stocks

Meanwhile, the +10% correction in stock prices has made valuations more compelling relative to earnings. With the S&P 500 Index generating about $92 in index earnings, and with the S&P 500 trading near 1,220, the earnings yield ($92/1,220) is near 7.5%. This is a historically attractive yield, to be sure, especially when compared to the very low Treasury yields mentioned above. Currently, the difference between the S&P earnings yield and the 10-year Treasury yield is about 5.25% — a level that is approaching attractive entry points for stocks in the recent past. Should fundamental conditions stabilize in the balance of the year, it would make for an even more attractive risk / reward tradeoff.

Without a Recession

Assuming for a moment that a slow and modest recovery continues from here and corporate profitability remains near current levels, then $90-110 of S&P 500 profits appears well within reach over the next couple of years. A reasonable market multiple of 13-15 times those earnings would put the S&P 500 in a range of 1,170 – 1,650 (a 0-18% annualized return potential, including dividends).

Compared to very low bond yields of 0-3%, potential returns in the scenario laid out above appear attractive. Of course, there are near-term risks to the scenario. Rising potential for default in Europe, a potential downgrade of the United States' sovereign credit rating, or continued uncertainty inflicting further damage on an already weak set of trends in economic data mean that investors should maintain proper balance and diversification, with an emphasis on quality and consistency for now.

We have seen volatility before, and each time it has been for different reasons. Emotional responses to volatility seldom produce good outcomes.

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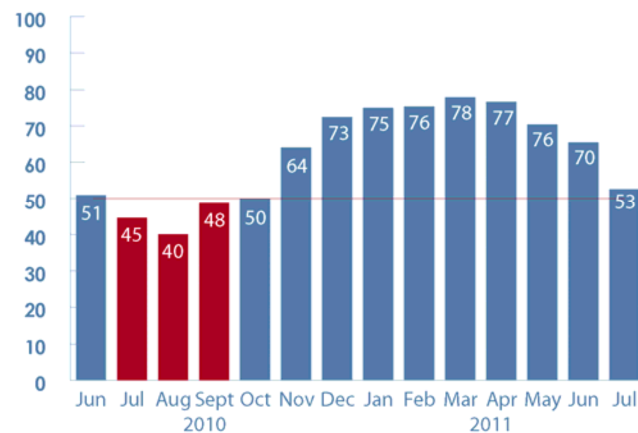
Not a Recession

By our judgment, we are not in a recession, but it is imperative that the current trends seen in the economic data begin to pick up. Otherwise, the first half "soft patch" could become a more protracted slide. Currently, our WCA Fundamental Conditions Index™, which attempts to capture broad changes in market and economic conditions, is nearing 50 (see below). A level above 50 is typically associated with an improving pace of growth, while levels below 50 are typically associated with deteriorating growth.



The current readings are not consistent with a recession, but growth has clearly slowed to an uncomfortable 0.8% rate in the first half of the year. Simply put, there is little room for further slippage. At present, payrolls are expanding modestly, automobile and retail sales are rising, and corporate profits are flush. However, the "soft patch" of recent months has happened even before various government stimulus initiatives run off.

For example:

- The $787 billion American Recovery and Reinvestment Act of 2009 is still working its way through the system. The final thrust of this should fade in 2012.
- The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 is set to expire at the end of this year. This means that payroll taxes are set to increase, potentially slowing already meager employment gains.
- The newly enacted Budget Control Act of 2011 just raised the debt ceiling and also insisted on meaningful cuts to budgeted and planned spending.

With first half 2010 growth below 1%, some have interpreted these reductions to be counter productive in the absence of additional private sector incentives for growth.

Some signs exist, however, that private initiative is starting to expand. Net corporate borrowing has swung to a positive $512 billion rate of annualized growth in the first quarter from a -$200 billion rate of annualized contraction in 2008. The turnaround is important, especially as households continue to retrench both in terms of borrowing (net household borrowing -$270 billion in Q1) and spending (0% average growth in personal spending over past 3 months).

In short, we acknowledge that the pace of improvement in fundamental conditions has moderated. We suspect some of this moderation is due to a receding profile for government stimulus against a not yet fully formed base of renewed confidence and vigor by business. Although fundamental conditions have slipped, we are not yet ready to declare a new recession.

What to Do?

Our focus continues to be equity investments in companies exhibiting a high degree of consistency in earnings and cash flow with low levels of debt and leverage, we look favorably on companies who can sustain and grow dividends (a marker of quality), and remain always vigilant with regard to price paid in owning an asset. For bond investors, we continue to favor a diversified portfolio of investment-grade and corporate issuers with an intermediate duration of 5-7 years.

Asset allocation portfolios are well balanced, with equity exposure generally in line with the mid-point of strategic ranges (given the near 50 reading on our WCA Fundamental Conditions Index™. Portfolios include stocks and bonds, dollar and non-dollar assets, foreign emerging market equities, hard assets, corporate investment grade, and high yield bonds.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.