Economic and Financial Commentary

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At the onset of the fourth quarter, the financial and commodity markets are dominated by speculation that the Federal Reserve will announce, at its November 3 meeting, that it will engage in large-scale asset purchases, known as Quantitative Easing, or QE. This speculation has led to a surge in buying of long-term Treasury securities and, consequently, a sharp reduction in their yields. The yield on the standard 10-year bond has dropped below 2.50%, a level eclipsed only in December 2008 following the Lehman bankruptcy, when investors rushed into Treasuries because of fears of a widespread financial collapse (Source: Bloomberg).

THE BOND BUBBLE

The surge of buying of government bonds has also spread to the Treasury Inflation-Protected Securities, or TIPS. TIPS bonds add a rate of inflation to the "real" yield, which is determined in the market. The real yield for the 10-year TIPS bond has dropped below 0.50%, and the real yields have fallen below zero for maturities of eight years or fewer. It is hard to believe that when these securities were first introduced in 1997, their inflation-protected yield was almost 4% (Source: Bloomberg).

Virtually no market has remained untouched by the prospect of the Fed entering the bond market on the buy side. Anticipations of QE have sent the price of commodities, particularly gold and other precious metals, to new highs, while the dollar has fallen significantly in the foreign exchange market.

It is likely that the Federal Reserve will indeed announce QE at its next Federal Open Market Committee meeting. But in my opinion, that does not justify the magnitude of the rise in the prices of fixed income securities. I believe that the bond market is in a bubble that will burst soon and that by the end of this year bond yields will have risen significantly. If the Fed does not announce QE at its November meeting, the collapse in bond and commodity markets will be even more severe.

Although I am a supporter of QE and believe the economic recovery would proceed faster if more reserves were created, the U.S. economy will recover without additional reserve injections. Low interest rates and increasing economic activity abroad, especially in Asia, will stimulate exports and spark a revival in spending.

Surprisingly, the equity market has been the least influenced by the anticipated Fed purchases. Certainly stock prices have risen lately, and September, usually a down month for stocks, was the best in more than 70 years. But most of the rise in the stock market is due to the increasingly compelling earnings and dividend data on stocks. Therefore, even if the bond bubble bursts, this will have only a temporary impact on the equity market.

RISING EARNINGS AND DIVIDENDS

One aspect of the sluggish economic recovery that has often been ignored is the dramatic recovery in earnings. Current projections for earnings on the S&P 500 Index for 2011 are near $94.00 a share, which is above the all-time high reached in 2007, when the S&P 500, was nearly 35% higher. It is extraordinary that just two years after the worst recession in post-World War II history, S&P 500 earnings have surpassed their previous high while so many other economic indicators have lagged.

Even if the investors assign a very reasonable 15 P/E ratio for the stock market, the fair market value for the S&P 500 Index is over 1400, nearly 20% above its current levels. And P/E ratios average 19.2 when interest rates are below the postwar average of 6.8%, which they are today. This leads to an 1800 valuation of the S&P 500 Index, more than 50% higher than today (Source: Bloomberg).

With interest rates at or near record lows, investors are increasingly looking toward dividend-paying stocks as a viable alternative. The most attractive choices are blue-chip stocks whose dividends are well-covered by current earnings. Portfolios yielding 4% or more can be constructed of such stocks. Theoretically, this yield should be compared to the TIPS yield, because, historically, dividend growth has more than compensated investors for inflation. The gap between dividend-yielding stocks and TIPS yields have never been higher—another indicator that makes stock compelling.

While historical valuations are not always reflected in the equity market, with current stock valuations so reasonable and the economy on the verge of recovering from its slowdown, this is an extremely attractive time to participate in the equity markets.

Definitions:

Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

The S&P 500 Index is a capitalization-weighted index of 500 stocks selected by the Standard & Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

P/E ratio is a metric used to gauge the valuation of the market; it is equal to the price of the index divided by its earnings.

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