Markets in Limbo

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Needed for a rebound: economic growth or some help from the Fed

For months now the stock market has lingered in a trading range without a clear trend, but it has headfaked investors on occasion. To some investors, the June 21 high looked like it might be the start of rally, but turned out to be a headfake as the markets quickly reversed course, and the July 2 low seemed to be the beginning of a slide to some, but the markets quickly whipsawed back. Now I worry that another headfake could be in the making. I fear that the market may have peaked here as part of a large summer trading range and that another down leg has begun, which could last into September before perhaps beginning a more sustainable rally into 2011.

The idea that the market is closer to a short-term high than a break-out is corroborated by both the 1975 and 2004 analogs, in my opinion. During both cycles, an August peak was followed by a September low. The 2004 analog is particularly compelling to me, because it occurred during a slowdown in the wake of a reflationary boom in 2003.

Technically, the charts show a "rising wedge"—that's a bearish chart pattern which forms when a rising market trades a narrowing range between highs and lows. Given that the S&P 500® Index fell through the trendline, it could be an indicator that another correction has started.

Looking for a driver

As I have been writing for several months, it seems to me that investors are looking for one of two things, or preferably both, to drive the market higher: positive economic momentum or renewed stimulus. Since April, we have been getting neither. The Fed stopped quantitative easing in March and leading indicators for the economy peaked in April (see chart below). Is it any wonder the S&P 500 has corrected 17% and has been languishing in a range of 1000 to 1200 since April?

What are the prospects of getting one of these drivers back in gear? I think they are slim, at least over the near term.

Slow but positive growth

On the economic momentum side, I think last week's employment report illustrates that the direction of economy remains a concern. The U.S. economy is still growing, just less than before. However, it has not slipped back into recession either. I continue to think that this growth scare will turn out to merely be a soft patch, but, needless to say, the data have been disappointing lately.

If the index of leading economic indicators is any guide, I think GDP growth in the U.S. may moderate in the coming quarters. The problem is that the inventory cycle seems to have run its course, while the fiscal stimulus is running dry. On top of that, cash-strapped states and municipalities are cutting jobs to balance their budgets, which means more job losses are possible.

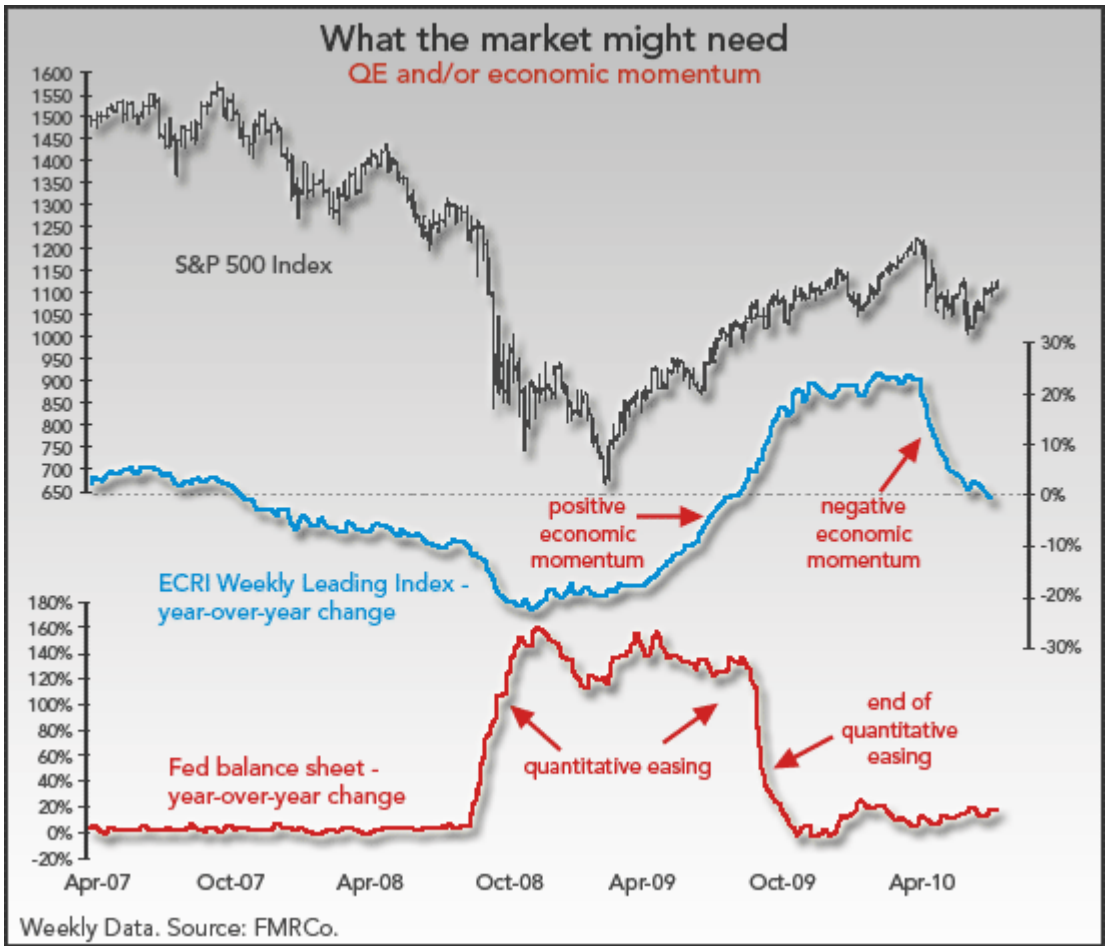
With these employment drivers fading away, it may be up to the private sector to pick up the slack, but as Friday's employment report demonstrates, this hasn't happened yet. So, I think the economy remains in a state of limbo.

The Fed

This brings me to the Fed and the prospect of more monetary stimulus as the way out. Risk assets such as stocks, commodities, and high-yield bonds took off in early 2009 when the Fed started its asset purchase program (otherwise known as quantitative easing). When that program ended in March 2010, the markets quickly lost their footing—not surprising, considering that the above-mentioned economic momentum had also faded away by then.

It seems to me that the markets are looking for a second round of quantitative easing—call it QE2. Did we get that at Tuesday's meeting? The Fed announced that rather than letting its existing assets roll off the balance sheet upon maturity (which would be a form of tightening), it will instead use the proceeds to buy Treasuries. In other words, it is not prepared to exit out of QE1 yet.

Because the Fed isn't expanding its balance sheet—the move can be seen as a continuation of its existing programs—not QE2. I suspect it would take a considerable economic turn for the worse before the Fed chooses to expand its balance sheet in a significant way.



Next Steps

Particularly during times when uncertainty around the economy and economic policy may keep the markets turbulent, it's important to keep your eye on your long-term goals and time horizon. Don't try to time the market by hopping in and out. In our view, that's typically a recipe for trouble.

Try to remember why you are invested as you are. Ask yourself if anything has changed. If it hasn't, it's probably best to stay on the course you have chosen. Keep a long-term perspective and stick to a plan that includes an asset mix that's appropriate for the amount of time you have to invest, your tolerance for risk, and your financial goals.

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