Investment Commentary

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It was the second week in a row of strong equity markets. The Dow Jones Industrial Average rose 4.0% to 9,093, the S&P 500 Index advanced 4.1% to close at 979 and the Nasdaq Composite added 4.1% to close the week at 1,966. This puts the Dow Jones Industrial Average into positive territory, the S&P Index up almost 10% and the Nasdaq up almost 25% for the year to date.

The last two weeks were the best back to back weeks the market has seen in nearly a decade due to the fact that earnings expectations increased as second-quarter earnings are coming in generally better than expected. We would note that the number of new highs last week was 175, while the number of lows was only 9. We have not seen this for quite some time. Maybe even more important than this, though, is the character of the rally. While the rally from early March to early May was about low quality names and weak companies surviving, the last two weeks have been more fundamentally oriented, focusing on blue chip, high-quality names.

The upside surprises in earnings are accompanied by better-than-expected economic activity. US leading indicators were up 0.7%, consumer confidence increased another point, mortgage applications for purchase increased more than 1% and China showed strong growth. Earnings are doing well versus expectations, and that has the bulls excited. However, the bears cite the fact that both revenues and earnings are still showing double digit declines and that the earnings blips are coming from cost cutting not revenue growth. We still think there is a lot of skepticism about economic recovery in the market and as a result investors seem to be defensively positioned and are being forced into these higher prices. Reasons to be constructive remain the aggressive policies, the decline in short rates globally, the inventory cycle, positive yield curves, emerging markets like China improving, credit markets improving and, again, skepticism resulting from the cash on the sidelines. Having said that, as we know, the market is up nearly 50% in less than five months. Paying for this stimulus could mean higher interest rates and/or higher taxes, hardly the stuff of rising valuation levels.

So where does this leave us? Well there was the correction in June as growth expectations were less than expected, inflation expectations rose and policymakers considered reducing stimulus. Despite this, however, a significant amount of cash made its way back into the market. The rally witnessed over the last two weeks could, in fact, imply that the market is getting ahead of itself and discounting a profit rebound, but we believe the underlying cyclical rally ultimately will be durable. Coupled with that, we like the fact that the FOMC confirmed its position that there is no need to normalize monetary policy at this time. In addition, we believe that both falling oil prices and Treasury market action provided an outlet for stock price declines.

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There are some good stabilization signs in parts of the economy following the decline in gross domestic product. The inventory cycle is beginning to improve and should add growth. In addition, leading indicators have been rising. We would argue that equities are roughly at fair value, that earnings estimates are being revised higher and investors are still cautious as evidenced by the significant amount of cash still on the sidelines. And while second-quarter earnings reports are positive, they are largely the result of aggressive cost cutting. In general, top line growth remains weak. We would agree with the bears that investors are also looking for sales to improve. But we do think we will eventually get that.

We believe that abundant liquidity conditions will continue to support the equity market while investors await confirmation that top line growth is expanding. The risks are that inflation expectations put Treasury yields and borrowing rates higher before the recovery gains traction, and that improving consumer spending contracts again next year after the impact of fiscal stimulus.

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