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Market Review: Range-Bound for the Near Term

By Barry Mendelson, CIMA
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Strong corporate profits and an accommodative Fed are powering the bulls. Lack of confidence and uncertainty is driving the bears. These competing forces indicate continued volatility ahead as the markets navigate the crosswinds.

For the past several months, stocks have been caught amid the crosswinds of a range of positive and negative forces. Investors in U.S. stocks can expect continued volatility ahead. Here is a look at some of the forces affecting the markets.

Corporate profits

One of the more interesting features of the current economic and market landscape has been the continued resilience of the corporate sector in the midst of weak economic data. The [growth in corporate profits](#) and the ongoing decline in corporate credit spreads are forecasting economic strength. In fact, corporate profit margins as a percentage of GDP are near 40-year highs.

During a normal economic cycle, such levels would encourage companies to spend more on capital expenditures and/or ramp up hiring plans, but most companies have remained reluctant to reduce their cash levels. We have seen some increases in capital spending, but a lower amount than would normally be expected given current profits, and, of course, private-sector hiring has remained anemic.

Some of this reluctance to spend can be attributed to uncertainty surrounding potential legislative and regulatory changes coming out of Washington, but we believe that we are at a point where companies will need to either accept slower growth levels or begin to put more of their capital to work. We are nearing "put up or shut up" time.

Inflation

After three consecutive declines, headline consumer prices rose 0.3% in July. A modest contribution from housing helped core CPI increase 0.1%. Barring any major shock, annual inflation will likely be around 1.2% throughout the remainder of 2010.

Given the significant excess capacity in the economy and the recent performance of the job market, the risk of a deflation cannot be ruled out yet. However, July data adds to the stabilizing trend in both headline and core CPI observed over the two previous months, which reinforces our view that a deflationary episode will not materialize.

The Federal Reserve

The Fed has indicated that it expected weaker growth in the months ahead and reiterated its view

that it was [too soon](#) to consider a shift in interest rate policy. It has made it clear that more monetary policy easing will be in store unless the economy improves.

This should help ease fears among investors who remain concerned about the possibility of a double-dip recession. The reasons for the Fed's optimism include ongoing [monetary policy](#) accommodation, the improvement in consumer balance sheets, the stabilization of bank lending standards, and a general improvement in financial conditions that are becoming more supportive for growth.

Trade balance

The U.S. trade deficit narrowed by 14% in July to \$42.8 billion from a downwardly revised \$49.8 billion the month before. The deficit figure posted its biggest drop in 17 months, as U.S. demand for imports fell across the board reflecting the slowdown in the U.S. economy.

Businesses cut back on rebuilding their inventories, and consumers retrenched due to high unemployment.

Given this underlying sluggishness in domestic demand, we expect the trade deficit will continue to fall in coming months as exports bounce higher (from continuing overseas strength, especially in emerging markets) and imports continue to decline. Oil is always a wild card and will probably dampen the narrowing in the deficit, with oil imports rising in both volume and price.

The surge in the trade deficit in the second quarter trimmed 3.4% from the GDP, leaving the Q2 GDP rising at an anemic rate of 1.4%. The narrowing of the deficit in July, if it continues, could help increase GDP growth in the third quarter.

Equities

The S&P 500 Index has remained in a rough trading range of between 1,020 and 1,120. We do not expect to see a dramatic breakout of this range at the current time, but we do believe that as economic conditions slowly improve, the positive forces should win out.

On the bullish side, strong corporate profits, increases in merger-and-acquisition activity, high levels of corporate debt issuance, and some renewed spending on capital expenditures show that the corporate sector remains a source of strength. Additionally, the Fed has made it clear that it will continue to do what it can to remain accommodative. Outside of the United States, economic data also continues to be somewhat stronger than expected through most of Europe and Asia.

There are, however, a number of bearish forces that warrant mentioning as well. A lack of overall confidence has been depressing markets, which is not surprising, considering that the most visible aspects of economic growth—job growth and the unemployment rate—have continued to disappoint. It must be reiterated, however, that these are lagging economic indicators and the corporate profit picture is a very telling signal.

Capital Markets Performance thru 8/31/10

Index performance as of August 31, 2010	1 month	QTD	YTD	1 year	5 year
Russell					
3000 Growth	-4.88	1.86	-5.52	6.21	0.08
3000	-4.71	1.91	-4.26	5.64	-0.72
3000 Value	-4.53	1.96	-2.96	5.08	-1.66
1000 Growth	-4.67	2.13	-5.68	6.14	0.10
1000	-4.47	2.17	-4.37	5.55	-0.71
1000 Value	-4.28	2.20	-3.03	4.96	-1.69
MidCap Growth	-4.30	2.28	-1.10	11.58	0.80
MidCap	-4.40	2.47	0.35	12.32	0.82
MidCap Value	-4.48	2.63	1.73	13.01	0.45
2000 Growth	-7.29	-1.16	-3.44	7.16	-0.17
2000	-7.40	-1.04	-2.97	6.60	-0.69
2000 Value	-7.52	-0.92	-2.54	6.06	-1.33
S&P 500					
Consumer Discretionary	-3.85	3.67	2.02	17.19	-0.60
Consumer Staples	-1.45	4.51	1.59	10.64	5.60
Energy	-4.30	3.43	-9.19	0.35	2.00
Financials	-7.80	-1.65	-5.27	-6.54	-12.07
Health Care	-1.49	-0.16	-8.94	0.38	-0.46
Industrials	-7.01	2.61	1.75	14.48	-0.02
Information Technology	-7.02	-0.33	-10.87	3.11	0.93
Materials	-2.65	9.37	-4.72	7.37	4.62
Telecommunication Services	2.25	11.84	2.48	13.35	3.18
Utilities	1.48	9.15	1.35	10.22	2.72
Other U.S. equity					
Dow Jones Industrial Avg.	-3.91	3.03	-2.11	8.39	1.77
Wilshire 5000 (Full Cap)	-4.67	2.06	-3.53	6.51	-0.25
International equity					
MSCI EAFE	-3.09	6.11	-7.61	-1.93	1.43
MSCI Emerging Markets	-1.91	6.33	-0.09	18.34	12.71
MSCI AC World	-3.46	4.43	-5.08	3.99	1.66
MSCI AC World ex: US	-2.73	6.08	-5.38	3.27	3.78
Fixed income					
Barclays Aggregate Bond	1.29	2.37	7.83	9.18	5.96
Barclays 1-3 Month T-Bill	0.01	0.03	0.08	0.12	2.54
Barclays Government	1.78	2.47	8.00	7.72	5.83
Barclays Credit	2.01	3.97	9.82	12.87	6.02
Barclays High Yield Corporate	0.04	3.59	8.27	21.52	7.51
Barclays Muni Bond	2.29	3.57	7.00	9.78	5.02
Barclays TIPS	1.72	1.87	6.36	10.52	5.33
Barclays Global Agg. Ex: US	1.46	6.63	2.32	3.58	5.71
Barclays Emerging Markets	2.01	6.26	12.26	20.18	9.25
Alternatives					

Source: CMC Research

Outlook

In many ways, the root of the current problem is one of confidence. There is a high degree of uncertainty around such issues as the future direction of tax policy and high deficits, and the mid-term elections remain a wild card. It is hard to imagine confidence levels getting much worse than they are at present.

For equity and fixed-income markets, both leading indicators, this is bullish. For employment and hiring, housing, and discretionary household spending, this will remain a negative for the time being.

The capital markets will remain volatile in this environment of uncertainty. Valuations on equities are becoming more attractive with each downward move in the market that is combined with an improving corporate earnings outlook, even if the rate of earnings growth moderates somewhat.

Barry K. Mendelson, CIMA, is the managing partner of [Capital Market Consultants, LLC \(CMC\)](#), a specialized RIA that provides customized investment manager, mutual fund, and economic research as well as portfolio modeling advice to financial organizations and RIAs. [CMC Unified Management Account portfolios](#), based on CMC manager research, are available to RIAs on all major independent custodial platforms.

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