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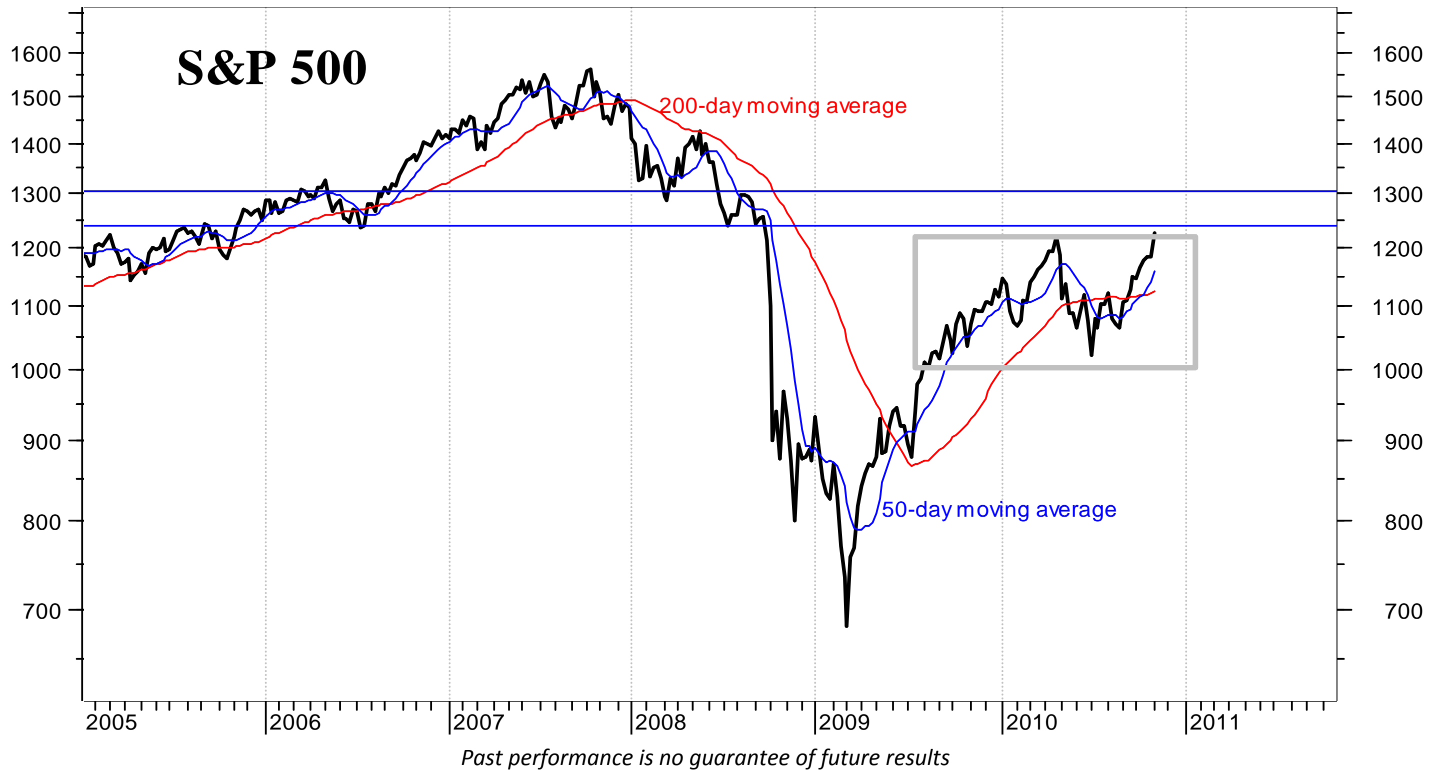
Stocks Test Top of 'Decision Box' as Double-Dip Fears Recede

- Riding a wave of positive economic reports that suggest the economy will avoid a return to recession, the S&P 500 broke out to a two-year high. Last week, we acknowledged the potential for a stock market pullback as investors 'sold the news' of a Republican house and renewed Federal Reserve quantitative easing as both their prospects seemed heavily anticipated. However, better than expected economic data trumped any inclinations for profit taking. Key manufacturing and services surveys showed a pick-up in economic activity in October, while the employment report greatly exceeded consensus expectations for hiring. We think continued progress along these fronts, along with ongoing earnings improvement, justifies higher stock prices over the next year. We see good fundamental and technical support at the S&P 500's 200-day moving average, currently 1125, and upside potential to 1350 during 2011. That said, our Weekly Chart shows that the 65%-plus annualized pace of the advance since early September looks unsustainable, and with already optimistic crowd sentiment creeping higher, we think the current rally will soon lose momentum. We expect to add equity exposure as the S&P 500 reverts to its longer-term (50- and 200-day) moving averages.
- Republicans picked up more than 60 seats in the House of Representatives last week, gaining a majority. We believe the most immediate policy impact is an increased likelihood of extensions to some and perhaps all Bush-era tax cuts for at least another two years. Although tax cut extensions are positive for markets and the economy over the intermediate term in our view, the absence of a bipartisan plan for long-term deficit reduction remains a negative. On this point, President Obama's bipartisan committee to reduce deficits is expected to release its plan December 1st. We believe investors would react positively to a comprehensive solution, similar to the UK's recently released budget plan, which included cuts to defense and entitlement spending and is designed to set the country on a sustainable fiscal course without causing another recession. Another area of bipartisanship that could find traction is a jobs bill that would give employers a payroll tax holiday to help further boost hiring.
- On Wednesday, the Fed committed to $600 billion in asset purchases over the next 8 months in addition to reinvesting its existing portfolio as it matures or is prepaid. We think this much-anticipated Fed decision to ramp up quantitative easing has been the dominant influence on markets for the last few months. The Fed is becoming increasingly comfortable using its balance sheet as a permanent tool of monetary policy, rather than as a one-off emergency measure as originally intended and conceived. The statement following last week's Fed meeting said: "The Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability." In addition, in a *Washington Post* op-ed explaining the decision, Fed Chairman Ben Bernanke said, "Although asset purchases are relatively unfamiliar as a tool of monetary policy, some concerns about this approach are overstated... We have made all necessary preparations, and we are confident that we have the tools to unwind these policies at the appropriate time." To us, this level of confidence understates the risks.
- We believe the Fed's open-ended commitment to expand its balance sheet 'as needed' to promote maximum employment and price stability is a net positive for markets, especially risk assets. While negative for the dollar — particularly with other major central banks' expressed reservations and reluctance to utilize their balance sheets — quantitative easing aids growth by raising the value of assets, keeping interest rates low, supporting exports, and stimulating consumption via the wealth effect. The major downside is the risk of future inflation, particularly commodity inflation and emerging market asset bubbles. Rationalizing their action, the Fed notes that inflation is currently too low in the US with unused capacity, unemployment high and labor costs (about 70% of end unit costs) stagnant. Thus for the Fed, quantitative easing's risk-reward trade off is acceptable... until 'price stability' is jeopardized. Inflation expectations have begun to rise, which is what the Fed wants, but they have not yet become unmoored, at which point quantitative easing would cease its effectiveness. Some critics also contend that, by itself, the Fed does not have the power to lower unemployment and spur growth, and we agree. Bernanke does as well, saying in his op-ed: "The Federal Reserve cannot solve all the economy's problems on its own. That will take time and the combined efforts of many parties, including the central bank, congress, the administration, regulators and the private sector."
- The Institute for Supply Management (ISM) manufacturing and non-manufacturing reports on business rose in October, up 2.5 and 1.1 points to 56.9 and 54.3, respectively. A level above 50 indicates expanding economic activity. Furthermore, both surveys' component indexes for new orders and employment also rose, which we view as encouraging. New orders are a good leading proxy for future economic activity, while employment expansion suggests that business managers are confident enough

in their earnings and the economy to increase their payrolls. Indeed, October's private nonfarm payrolls increased by 159,000 (versus expectations of 60,000), while the previous two months were revised 110,000 higher. Moreover, aggregate payrolls — a comprehensive measure of employment health because it combines the number of workers with how much they worked and were paid — gained 0.6%, implying sustainable recovery since households have a greater ability to repair their balance sheets and/or raise consumption. That said, job growth is still too anemic to reduce the unemployment rate, which stayed at 9.6%. Given that we expect GDP growth of around 1.5%, unemployment is likely to remain elevated.

- In addition to the ISM's strong purchasing manager indexes (PMIs) in the US, global manufacturing surveys also point to continued global growth, particularly in China and India. China's PMI rose 1.9 points to 54.8, while India's increased 2.1 points to 57.2 in October. We think accelerating growth in the two largest developing economies helps explain crude oil's breakout to $86 per barrel last week, its highest level in over two years. Emerging markets' per capita energy use is still only a fraction of the developed world. For example, if China's per capita oil consumption were to match Mexico's (about seven barrels of oil per year, compared to 28 in the US) global oil production would have to rise by one-third to meet the increased demand. Needless to say, global proven reserves of oil are far from supplying another 25 million barrels per day for production. We think three other factors will likely drive oil prices higher: (1) a weaker dollar, since oil is priced in dollars; (2) Saudi Arabia's oil minister indicated last week that Saudi Arabia is willing to tolerate higher oil prices; and (3) emboldened by Republican victories, Israeli Prime Minister Benjamin Netanyahu and Senator Lindsey Graham — a member of the Armed Services Committee — are increasing their rhetoric against Iran, escalating geopolitical tensions that could threaten oil supplies.

The Weekly Chart: Top of the box with rising support



Past performance is no guarantee of future results

The S&P 500 has risen to the top of the 1000-1220 'decision box' (grey rectangle in the chart), which we introduced last May as a range that we thought reflected investors' deeply divided views of the economic outlook. If the breakout occurs, we expect strong resistance between 1240 and 1300 (blue horizontal lines). This is because (1) the S&P 500 has been rising at an annualized trend rate of around 80% since early September, which we view as unsustainable for much longer, and (2) crowd sentiment is approaching levels of extreme optimism, which generally precede corrections. If it turns down from the top of the box, we see good support at the 50-day moving average (1148) and then at the 200-day moving average (1125) both of which are rising.

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