July 2010 Market Commentary

As the second half of 2010 starts, sentiments seem to be fairly pessimistic. After the rapid stock market advances of February, March and April, the months of May and June have seen a significant correction with the major markets down about 10% from their earlier highs of the year. Bears are dominating the news and investor anxiety once again seems fairly high.

In surveying various events driving the news, it's easy to understand why pessimism seems to be winning the battle. Europe is struggling with various issues including problematic debt, the US continues to accrue huge deficits at a rapid pace, unemployment remains stubbornly high, housing sales can't seem to build momentum, and the worst oil spill in America's history seems to drag on and on. Taken together, it's easy to understand why the stock market has been in the doldrums.

However, we believe there are many reasons to be somewhat optimistic although problems in developed markets mandate caution. Similar optimism is the main message from a June 24th Reuters poll of 300 strategists, brokerages and wealth managers, including some of the world's foremost experts on stock markets. They claim the world's stock markets are in good health and mere irritations like the euro zone debt crisis or a possible slowdown in the economic recovery probably won't get in the way. Of course, this guarantees absolutely nothing, but I believe it's meaningful given the apprehension that seems to be dominating the headlines.

In addition, much of the other news that is painted as negative simply isn't that bad. While unemployment numbers to be released this Friday will likely show the US losing about 115,000 jobs, this reflects the loss of approximately 250,000 temporary Census workers. As a result, private sector jobs increased by around 135,000 signaling a very desirable increase over May's increase of 41,000. While these numbers aren't fantastic, the trend is growing in the right direction.

Corporate earnings for second quarter will also be released over the ensuing few weeks. Although analysts have tempered their very high optimism over recent weeks with all the challenges facing Europe, earnings are still expected to post strong annual increases of approximately 27% according to Thomson Reuters. Earnings are likely to be very good instead of absolutely fantastic. In addition, profits appear to be improving despite increased hiring and inventory rebuilding. Solid corporate earnings, which are generally seen as the best predictor of stock market performance, are another signal that corporations have come through the crisis relatively strong.

In addition, current stock prices are quite low as a ratio of corporate earnings. This results partly from the rise in earnings and partly from the recent dive in stocks. The S&P500 is now trading just over 12 times expected earnings for the next 12 months. The long-term price to earnings ratio has historically averaged about 18. The current pricing suggests that the market is somewhat undervalued. In addition, analysts expect earnings to increase by more than 10% in the second half of the year. As earnings increase, stocks will either increase in value to reflect earnings growth or stocks will become even more undervalued if prices don't go up. This issue alone suggests that stocks could have a pretty good second half of the year as currently projected by most economists and analysts.

However, as always, other issues provide some room for doubt, and make projections less certain. For instance, housing offers less encouraging news. Once the housing tax credit expired, housing prices and sales weakened. For better or worse, prices will reach true market levels much more quickly now without government intervention. The market may remain soft for a while or may reach bottom quickly.

Government and debt issues create a completely different set of challenges that are going to be with us for a while. Both Europe and America have dug themselves holes that will require significant changes to fill back in. The overhanging debt issues are affecting developed markets' economies. Their current and future challenges are obviously making financial markets nervous. Like housing, this is another area that lacks immediate clarity. More than any other issue, investor's perception of this issue will likely determine whether corporate earnings continue to improve or stall in the near future. At this point, I, along with the strategists and economists mentioned above in the Reuters poll, believe investors have grown overly cautious and are overreacting to potential problems. However, current weakness and lack of global strength in developed markets are very legitimate concerns that warrant attention.

The last major negative issue that's dominating headlines is the gulf oil spill, now the largest in US history. The spill and its effects are obviously terrible producing an unrelenting stream of awful news. The spill has adversely impacted not only BP's stock price, but broader investor sentiment as well. I'll leave the moral issues alone on this and simply look at the economic side. In some ways, BP's predicament seems to be a replay of the recent market meltdown during which investors essentially priced into the market five years of negative 5% growth for the US economy. Similarly, many of the assumptions and projections regarding BP also seem very emotional and near term driven without a strong basis in a likely longer-term reality.

BP is a massive company with the fourth highest revenue and profits of any global company. Global operating profits for 2010 are projected to be around $34 billion before accounting for cleanup costs. High estimates for total costs associated with the spill are around $37 billion, or essentially, one-year's worth of profits. Most estimates are significantly lower. Costs will be spread across many years which should enable BP to earn its way out of their mess while compensating people affected. Erasing over $100 billion in stock market value appears to be a major overreaction. While damage awards can always conceivably go higher, history suggests that they will be lower. ***

Again, as bad as various issues can look, we feel more optimistic about the second half of the year. Much bad news is priced into the stock prices. As BP moves out of the news, emotions subside, and the other various issues mentioned above progress, we believe investor sentiment will be positively affected. In addition, there is substantial good news that's currently not getting traction.

Daniel Wildermuth and the Kalos Team
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****To help with perspective, there was a much larger spill in the Gulf of Mexico in 1979 when an oil well spewed 30,000 barrels a day for 10 months making it the third largest oil spill in history. Beaches recovered quickly, and Pemex, the offending company only spent $100 million on clean-up. Despite over 3.3 million barrels of oil ending up in the environment after the cleanup, the beach fauna or beach populations were back to where they were before the spill within two to three years. After 6 years, it was difficult to find any evidence of oil. Source: Wikipedia.*

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