April 2013
Market Commentary

Stocks have steadily risen throughout 2013. After March's solid increase, the market is up about 10% on the year. The recent rise has taken the S&P 500 to within striking distance of its all-time high. There's no single issue that appears to be driving markets higher, but it seems pretty clear that investors have largely decided that there's enough good news in the private sector to compensate for ongoing struggles in Washington and Europe.

Consistently strong home price data over the past several months are providing convincing proof that housing has finally turned the corner. The S&P/Case Shiller composite index of 20 metropolitan areas rose 8.1% in January from a year ago, its biggest rise since June 2006. Moreover, all 20 metropolitan areas tracked by the index showed year-over-year price increases for the first time since March of 2006. The Commerce Department reported home prices rose by 12.3% from February of last year. Distressed sales are also dropping and are expected to account for about one in five home sales in 2013, down from one in three a year ago.

The housing recovery should help stabilize slow economic progress as increased construction and sales add jobs and fuel growth across a wide range of industries beyond housing. Manufacturers and sellers of appliances, furniture, flooring, nurseries (plants) and so on all benefit. Services such as landscapers and remodelers also profit as new homeowners mold their new residences to their preferences. Housing should contribute around 0.6% to GDP growth this year, and in 2014, its contribution could reach 1.0%.

Orders for long-lasting U.S.-made (durable) goods surged 5.7% in February partially resulting from a rebound in demand for transportation equipment (largely cars) according to the Commerce Department. February's rise reversed January's 3.8% drop associated with the fiscal cliff uncertainty and resoundingly beat economists' expectations.

February also saw ISM manufacturing and Non-Manufacturing data exceed expectations. Readings of the Purchasers Managers Index indicated expansion for the third consecutive month and were the highest since June 2011. The Non-Manufacturing Sector Index grew at a slightly faster rate and registered its highest reading since February of last year.

The growth of supply and cheap prices for natural gas continue to provide the U.S. with a tailwind by lowering costs and creating new jobs. Cheap and clean natural gas is almost single handedly wiping out coal and even nuclear energy, but overall it's providing a tremendous net economic gain to the U.S.

Jobs data also continues to improve, albeit slowly. More importantly, growth is being driven by sustainable private payroll expansion. Given the pickup in housing, it's not surprising that construction is the largest contributor to new jobs adding 48,000 of the 246,000 new jobs in February. Total employment increased a respectable 236,000 in February (including the 10,000 government jobs lost) dropping the official unemployment rate to 7.7%. The strength of the private sector should be able to easily push employment higher throughout the year in spite of the 300,000 to 500,000 job losses resulting from the sequester.

Challenges coming out of Washington may be slowing down the economy, but the private sector continues to generate enough good news to keep investors confident that the economy will move forward. January's payroll tax increase affected consumer spending initially and drove consumer sentiment down.

But spending bounced back and retail hasn't struggled as much as many forecasted.

Similarly, the sequester which mandates $85 billion in government budget cuts, is only slowly biting into the economy. The impact of the sequester will grow over time, partly because politicians are working hard to make sure that cuts are felt by Americans as part of their political maneuvering. Yet, there is still some evidence of progress.

In mid-March, Congress passed a "continuing resolution" to keep the federal government operating for six months taking the country well past the previous funding deadline of March 27. The continuing resolution also eliminates some of the particularly destructive effects of the sequestration spending cuts that began on March 1. The original process mandated cuts across all departments equally. The changes allow agency heads to more sensibly reallocate funds within their agencies and retain full funding for crucial programs.

The next major deadline looming this year is the borrowing limit. On May 18, the United States runs out of borrowing authority. Technically, the government can pay its expenses for another few months without additional borrowing, but sometime in July or August, the limit will have to be raised or the U.S. will be unable to meet its existing obligations, including interest on its debt.

While each house of Congress has passed a proposed budget – the first time in four years any budget has been produced – they are virtual opposites in every regard. Reaching agreement will be difficult at best. We're very likely to hear much rhetoric and reports of major problems that could rattle U.S. and foreign markets. A market correction based on the perception of Washington dysfunction could be a buying opportunity as it's probably not going to get much worse than it already is.

Outside of the U.S., Cyprus highlights Europe's ongoing challenges. Still, Cyprus' lurching progress seems to demonstrate again that solutions eventually arrive, even if they're painful and ugly. New challenges will certainly arise, but should only temporarily disrupt most U.S. and global markets since private sector fundamentals are likely to override problems in smaller European economies. The concern is always that problems will spread, but Europe seems to be improving in its ability to clean up messes as they erupt.

The challenges are likely to continue to slow U.S. growth but not shove it over any cliffs. The sequester and debt limit battles will likely last well into third quarter if not beyond and could cause GDP growth to slip below 2%. Essentially, this constitutes more of the same for the economy and markets – not great, but not too bad either. Overall, equity markets will probably continue to cruise along until there's a big enough event to force a change in direction.

Given the recent upward progress of the markets, a pullback seems likely at some point although it should not present a major concern to long-term investors given reasonable valuations and many signals pointing to ongoing gains. Conversely, anyone looking to take some funds out of the market might consider now a good exit point since valuations are well above the fire prices of the last few years.

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