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Market Memo: The end to the summer of our discontent?

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A month ago, we described the soft patch our economy was encountering as the pause that refreshes. Though clearly the numbers on everything from manufacturing and housing to consumer spending and employment have continued to be choppy, we still think that view is valid and that the preponderance of evidence argues against a double dip. The typical recession indicators just aren't there. The yield curve is sloped, not flat. Inventories are lean, not fat. Corporate balance sheets are strong, with cash at 50-year highs. And home and auto sales, net of maintenance-and-replacement demand, are at levels that have nowhere to go but up.

These fundamentals—combined with a continued benign inflation and low-rate environment—recently led our macroeconomic team to forecast growth to pick up as we head into fall (albeit at a slower pace than we were predicting a few months ago) and our stock-bond asset allocation team to reaffirm a healthy equity overweight. Abetting this view are second-quarter earnings that continue to surprise: 79% of S&P 500 corporations that have reported beat earnings forecasts and 63% beat revenue forecasts. Coupled with below-norm valuations—the forward S&P P/E currently is at about 13, vs. a long-term average of 19—stocks would appear due for a run, helping justify our 12-month price target for the S&P at 1,350.

Mood enhancers

But we believe another potentially more significant factor is bolstering the current case for equities: The end to our summer of discontent. The Gulf oil spill has been capped. Uncertainty about financial reform and energy policy is behind us. Europe is on the mend. Polls suggest that a more business-friendly Congress will be in place once midterm elections end. And soon, the uncertainty around the new Federal tax regime for 2011 and beyond will, by definition, be resolved.

There are still significant milestones that must be cleared, led by employment and jobs. Private businesses simply have been hesitant to hire given all the policy and economic uncertainties. But that veil arguably is lifting. The financial reform package that passed was less onerous than many had feared, and potentially costly cap-and-trade legislation was pulled out of the energy bill by Senate Majority Leader Harry Reid. These were big obstacles, financially and psychologically, for businesses. This is particularly true for small businesses, which according to monthly surveys, continue to be mired in distrust toward Washington.

Relief is near

Hiring won't take off until small businesses join the recovery party, and so far, they have avoided coming for fear of being stuck with costly new mandates and higher taxes. Midterm elections that could shake, if not outright end, the anti-business focus on Capitol Hill would be viewed favorably by this group, and polling data increasingly suggests they may get their wish, and with it a more private-sector friendly policy environment. Washington really has no choice. With its coffers empty and debt at a record high, it needs businesses to get the economy going; bashing them and burdening them with regulations are hardly the prescriptions to achieve this feat.

Other milestones include the overseas economic environment, particularly in Europe and China, where concerns about growth-inhibiting initiatives by the government spurred a steep spring sell-off in the Asian markets. There are positive signs on both fronts: Asian and major European indexes have rebounded of late, and reports indicate a reacceleration of growth in China and upward momentum is building in Europe. The euro is up, European economic confidence is at a 2½-year high and the sovereign debt crisis has eased, with both bank and sovereign debt spreads narrowing significantly over the past month and European banks scoring better-than-expected on their stress tests. It's been a hot and not particularly happy summer. But with a more favorable economic and policy environment on the horizon, relief—and fuel for the next stage of the equity rally—appear on the way.

Views are as of July 30, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Diversification and asset allocation do not assure a profit nor protect against loss.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Price-Earnings Ratio is a valuation ratio of a company's current share price compared to its per-share earnings.

The yield curve is a graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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