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Orlando's Outlook: Mixed data keeps equity market mired in volatile trading range

June 25, 2010

Don't be surprised if you see investors storming their local pharmacies in search of relief this weekend, having manically bounced from suicidal tendencies to euphoria and back to fits of depression over the past two months, their mood swings incrementally triggered by the latest news headline or economic data point.

Philip J. Orlando

Last Friday's week-ending news headline boasted that stocks had capped their biggest two-week rally since last November. Yesterday, Reuters' headline lamented that stocks were suffering through their longest losing streak in seven weeks – a significant change in investor sentiment and stock-market performance that had transpired over the course of just four trading days.

Treasurys enjoy big rally amid mixed data and uncertain outlook

All of this back-and-forth has seen Treasury securities rally big time over this period, with the 10-year yield plunging from nearly 4.00% in early April to today's cycle low of 3.08%. The bear-case argues that yields are likely headed to 2.50% this summer, and may even retest 2.00% later this year on fears of a double-dip recession. This is great news for mortgage borrowers, as the plunged in benchmark Treasury yields has pulled the rate on 30-year, conventional, fixed-rate mortgages down to 4.69%, a half-century low.

Turning to fundamentals, the economic data flow this past week was decidedly mixed. To be sure, new and existing home sales for May were significantly weaker than expected, and the final revision for first-quarter Gross Domestic Product (GDP) was also lower than expected. But durable goods orders for May were better than expected, initial weekly jobless claims for the week ended June 19 were much lower than forecast, and the final June reading for the University of Michigan consumer sentiment index was surprisingly more robust than planned.

Financial overhaul's bite not as bad as bark

In terms of this week's geopolitical news flow, Congress today finally approved its sweeping overhaul of U.S. financial regulation, just ahead of the start of the G-20 summit this weekend in Canada. At first blush, it appears that the new financial regulation was not quite as onerous as many on Wall Street and in the banking industry had feared. So with the worst-case scenario perhaps off the table, investors might enjoy a brief sigh of relief. The recent news out of China has also been favorable, in that the government will allow their currency to appreciate vs. the U.S. dollar at a modest pace over time.

Regardless, the near-term trend for stocks remains unclear. After the S&P 500's powerful 83% rally from the market's trough on March 6, 2009, to its cycle high on April 26, 2010, stocks experienced a painful 15% correction to its recent low on May 25, likely due to the oft-discussed economic soft patch and the tsunami of global headline risk that has inundated the equity market over this time.

Bears see summer doldrums driving down equities

From that point, the S&P 500 drifted sideways and successfully tested the critical 1,040 support level on June 8, sparking a relief rally of nearly 9% to 1,131 over the next fortnight into June 21. The balance of this week has been ugly. Stocks have given back more than 5% of those gains over the past four days, as the S&P 500 could be headed for another retest of the 1,040 support level.

So, are we destined for summer doldrums, with the S&P 500 manically stuck within a relatively narrow trading range of 1,040 to 1,130 for the rest of the summer? The bad news is that if the 1,040 technical-support level fails to hold to the downside, the S&P 500 could trade down to about the 1,000 level and then down to the 940 level, which would approximate an important 50% Fibonacci retracement. That suggests the 15% correction we've already experienced over the past two months could tack on another 10% decline, and thus approach a total 25% pullback before we hit bottom.

Bulls see potential for a 20% equity rally

On the more favorable side of the coin, we continue to believe that stocks remain extraordinarily cheap, with the S&P 500 now selling at Price/Earnings (P/E) multiples of less than 14 and 12 times, respectively, current consensus earnings estimates of $80 for 2010 and $91 for 2011, creating roughly a 60% valuation imbalance between the earnings yield on stocks and the 10-year Treasury yield of 3.08%. That suggests that the S&P 500 enjoys near-term upside potential back up to 1,200 and then to 1,250, which translates into a potential 20% rally.

So while both sides of this bull-bear debate believe that the technicals support their point of view, ultimately we believe that the fundamentals will prevail. So let's take a look at this past week's highlights and lowlights.

- **New Home Sales** Plunged in May by 33.7% sequentially to 300,000 annualized units, their lowest level in the 47-year-history of this data series. We had expected that in the immediate aftermath of the April 30 expiration of the government's $8,000, first-time, low-income tax-credit deadline, new home sales might collapse by 20% or so, but this weakness clearly shows how sensitive business was to the incentive, likely pulling normal seasonal demand into the relatively strong months of March and April.

- **Existing Home Sales** Fell by 2.2% in May to 5.66 million annualized units, compared with an upwardly revised April reading of 5.79 million homes sold. We had thought that existing-home sales – which now account for 95% of the total housing market – might actually be up in May, because existing home sales are calculated at closing rather than at contract signing, as they are for new-home sales. As we've discussed before, the bigger question for housing and the economy is what happens absent the federal government's artificial stimulus.

  After the tax-credit hangover fades, the longer-term fundamental drivers for housing include an improving employment cycle, an increase in household formations, record low mortgage rates, improved pricing, record high affordability, sharply lower inventories, and a decline in vacant housing units from peak levels. But near-term visibility clearly remains uncertain.

- **GDP** The final revision of first-quarter 2010 GDP was revised down from a gain of 3.0% to a smaller gain of 2.7%, largely due to weaker consumer spending and business fixed investment and a larger trade gap. Consumer spending was revised down from a gain of 3.5% to an increase of 3.0%; business fixed investment was reduced from a 3.1% increase to a smaller gain of 2.2%, due to weaker equipment and software spending; and an increase in the trade deficit, as imports surged by a revised 14.8% – compared with a preliminary increase of 10.4% – which outstripped the 11.3% gain in exports, which itself was revised up from a preliminary increase of 7.2%. Inventory restocking rose by $41.2 billion, which was revised up from a preliminary $33.9 billion gain, but this improvement was not enough to offset the weakness in the other categories.

- **Durable goods** Core readings, which strip out volatile transportation goods, rose for the third month out of four, which reaffirms the positive trend in capital spending. There had been a large aircraft order in April, which distorted the sequential results. This remains consistent with strong manufacturing activity in the U.S. since last fall.

- **Weekly initial jobless claims** For the week ended June 19, claims surprisingly dropped by nearly 20,000, to 457,000. That focuses all eyes on the upcoming June employment report – to be released next Friday, July 2 – in the wake of the extraordinarily disappointing May report. The good news is that Census hiring may have peaked during the week ended May 8, so we may, in fact, see a negative headline number for June – due to the firing of the temporary Census workers – but with an underlying resumption of growth among the permanent private payroll and household surveys, as the "crowding-out" affect from the Census program begins to fade.

- **Michigan Sentiment** The Thomson Reuters/University of Michigan final index of consumer sentiment for June surged to a stronger-than-expected 76.0, its highest reading since January 2008. This compares with a 30-year low of 55.0 in November 2008, and is consistent with very strong readings from the Conference Board's consumer confidence index. We continue to believe that after terrific Back-to-School (BTS), Christmas and Easter seasons, retail sales will take a breather in May, June and July but start to re-accelerate in August and September. If we're right, then Christmas sales will be solid, too, given the historical 90% correlation between BTS and Christmas results. There's enormous pent-up demand that's starting to be unleashed among high-end consumers, who are clearly feeling better about themselves in the face of an

improving jobs picture, a recovering economy, and a rising stock market.

It's easy to be a bear, but we think fundamentals favor bulls

Bottom line, it's easy to be a bear right now, in the face of mixed economic news, the tsunami of negative headlines, and questions about the strength of the upcoming second-quarter earnings season and the tone of management guidance. In our view, it all comes down to whether the double-dippers are right. In stark contrast, we continue to believe in the sustainability of the economic recovery, and that we are, instead, now wallowing in the economic soft-patch that we've been forecasting.

If we're right, then investors will ultimately re-focus their attention on an eventual resumption in economic activity, due to the longer-term recoveries we envision in employment, inventories, consumer spending and housing. Given that the bears have already priced in a double-dip recession, we believe that provides a potentially outsized profit opportunity for patient and opportunistic equity investors.

Views are as of June 25, 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.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

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.

The Fibonacci retracement level is a term used in technical analysis of the market that refers to the likelihood that a financial asset's price will retrace a large portion of an original move and find support or resistance at key levels before it continues in the original direction.

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

The Thomson Reuters/University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

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