

Orlando's Outlook: Goodbye and good riddance to May

May 28, 2010

For most investors, as we approach the long Memorial Day weekend that marks summer's unofficial start, the month of May can't end soon enough. From the "flash crash" the first week of the month, to rampant investor concerns about European sovereign debt, the potential for slowing Chinese growth, the escalation of military tensions in the Korean peninsula, the massive crude oil spill in the Gulf of Mexico, and a mixed bag of key economic metrics here in the U.S., the S&P 500 suffered its worst May point drop in history, and its worst May percentage decline since 1962.

Clearly, a lot of this aforementioned bad news has already been priced into and discounted by equity share prices. After a powerful 83% cyclical rally from the ultimate trough of 666.79 on March 6, 2009 to its recent peak of 1,219.80 on April 26, 2010, the S&P 500 then plunged by nearly 15% to 1,040.78 on May 25.



Philip J. Orlando

Market appears extremely oversold

So while we're officially in "correction" mode—which has already outstripped our own more muted expectations for a 5-10% seasonal pullback due to profit-taking—the larger and more important question is this: Will this 15% decline morph into a full-blown bear-market drop of 20% or more in coming months? Or have equities already overshot to the downside, and this correction represents an enormous buying opportunity for nimble investors who might have missed one of the most powerful bull market rallies in the past century? Technically speaking, the S&P 500 failed to hold the trough of the May 6 "flash crash" at 1,065. So that shifted our focus next to the trough of the recent 9% correction we suffered in late January and early February.

To date, it appears as if we successfully re-tested the 1,044.50 February 5 bottom this past Tuesday, as stocks have rallied off of that base. In fact, all of this equity de-risking over the past month has left stocks significantly oversold, in our view, with the S&P 500 at Tuesday's 1,040.78 trough selling at only 13.0 times and 11.0 times, respectively, consensus earnings estimates of \$80 and \$93 for 2010 and 2011. As a result of this massive flight-to-quality, -safety and -liquidity rally in bonds, however, benchmark 10-year Treasury yields plunged from 4.00% in early April to 3.15% this past week, resulting in a sharp relative valuation imbalance that leaves equity Price/Earnings (P/E) ratios vastly undervalued by some 60%, compared with Treasury yields.

Inflation benign, housing surprises

Inflation, moreover, remains benign. This morning, the Personal Consumption Expenditure (PCE) Index—the Federal Reserve's preferred measure of inflation—was reported through April at a year-over-year core inflation rate of 1.2%. That's consistent with the April updates we received recently on year-over-year core inflation for both wholesale and retail prices, as the Producer Price Index (PPI) and the Consumer Price Index (CPI) are running at very well-behaved levels of 1.0% and 0.9%, respectively. This core inflation sweet spot will likely to keep the Federal Reserve on the sidelines until the latter part of this year—if not into calendar 2011—which should facilitate continued sustainable economic growth in the U.S., as well as support higher P/E's on stocks.

Which brings us to a discussion of this past week's economic calendar, which was chock full of mostly positive data points that the market—due to its overwhelmingly negative investor psychology—largely chose to ignore. Existing home sales in April rose by 7.6% to a five-month high of 5.77 million units sold, while March results were revised higher to a sequential gain of 7.0%. New-home sales - which account for about 8% of total homes sales—surged by nearly 15% in April to their highest level since May 2008 to 504,000 units sold, while March results were revised higher to a gain of almost 30%.

Housing's kick may still have legs

Clearly, the recent expiration of the federal government's \$8,000 first-time, low-income tax credit for contracts signed by April 30 and for closings that take place by June 30 had a positive impact on this recent strength, as an estimated 49% of sales went to first-time home buyers last month, versus 44% in March. But this positive trend may continue through May and June, as the sale of existing homes—which account to 92% of the residential

market—is calculated at contract closings rather than at signings, which means the tax credit can still influence demand through the end of next month.

Additionally, 30-year, fixed-rate conforming mortgage rates have fallen to 4.78%, a level just above record lows of 4.71%. So with the employment picture brightening and household formations increasing sharply, we expect that housing trends in late summer and early fall may be stronger than last winter's dreadful results, even accounting for the expected hangover from the expiration of the tax credit. To that end, mortgage applications surged by 11.3% last week, although all of that strength came from refinancing activity, as purchase applications actually declined.

Consumers perking up

Finally with housing, March's 20-city Case Shiller composite showed a 2.35% year-over-year increase in prices, compared with a 0.66% increase in February, with 18 of the 20 composite cities posting a seasonally-adjusted year-over-year gain. Collectively, this improvement in housing is consistent with the recent National Association of Home Builders (NAHB) Housing Market Index, which soared to 22 in May from 19 in April and a trough of 9 in March 2009.

The Conference Board's consumer confidence index surged to a surprisingly strong 63.3 in May—its highest level since March 2008—compared with 57.7 in April and a record low of 25.3 in February 2009. The final May reading for the University of Michigan's consumer sentiment index also rose to 73.6 from 72.2 in April and a 30-year low of 55.3 in November 2008. The sharply improved levels of consumer confidence are likely due to the strengthening employment cycle. To that point, initial weekly jobless claims retreated for the week ended May 22 to 460,000, from a revised spike of 474,000 in the prior week.

Manufacturing good but mixed

Durable goods rose for the fourth time in the past five months by a stronger-than-expected 2.9% in April, compared with an upwardly revised break-even level in March. While core results—which strip out volatile transportation goods—did decline by 1.0% last month, that compares with an upwardly revised surge of 4.8% in March, the largest monthly gain since August 2005.

On the negative side of the ledger, personal income rose by 0.4% in April for the second consecutive month. But consumers pulled in their horns last month in a bid to rebuild their savings, as spending was flat in April compared with a robust increase of 0.6% in March. As a result, the personal savings rate leapt to 3.6% last month, from an upwardly revised 3.1% level in March. The Chicago Purchasing Managers' Index consolidated this month. Although it rose for the eighth consecutive month to 59.7, that was sequentially lower than April's powerful 63.8 reading, the highest such level in five years.

GDP revision a head-scratcher

Finally, the first-quarter flash report for Gross Domestic Product (GDP) was revised slightly lower to a gain of 3.0% from a previously reported increase of 3.2%. That represents something of a head-scratcher for us, as we had expected an upside revision due to improved trends during March in housing, consumer spending and inventory restocking, with a negative offset related to increased imports. As we dug through the data, it turns out that imports were much stronger, government and consumer spending were both a shade lighter, and business fixed investment in both structures and equipment were revised lower. Improvements in both inventory rebuilding and housing were unable to offset those declines.

Bottom line, investors are clearly nervous about a host of worries, and this negative investor psychology right now is overwhelming what we believe to be solid domestic economic fundamentals and extremely attractive valuation metrics. Stocks will eventually trade on fundamentals again, of course, and consequently, we are sticking to our longer-term price objective of 1,350 for the S&P 500 on calendar 2010 earnings estimates, which translates into a near-term target of 1,200-1,250.

Views are as of May 28, 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.

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.

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

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Producer Price Index (PPI): A measure of inflation at the wholesale level.

The Consumer Confidence Index is based on a survey by the Conference Board that measures how optimistic or pessimistic consumers are with respect to the economy in the near future.

The S&P/Case-Shiller Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States.

Federated Global Investment Management Corp.
42630

Copyright © 2010, Federated Investors, Inc.



Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
Telephone: 412-288-1900

[Click to Print](#)