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Weekly Update: The market is vulnerable to an upside surprise

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What's Ahead

North Korea, oil spills, flash crash, Spanish banks, Thai riots, Germany's expanded naked selling ban, financial reforms, a 15% correction in a short period—am I forgetting anything? Before the mid-week rally, the market was at its deepest oversold condition since its March '09 lows on all the above-mentioned worries. This really isn't all that unusual. Morgan Stanley says a study of 19 cyclical bulls within secular bear markets saw a 25% correction after an initially rally of 71% off their cycle lows. Might this be a refreshing correction before a year-end rally? Interestingly, RBC cites a 100-year study with a 4-year cycle reset, which would indicate potential cycle lows toward the end of Q3 and early Q4. That would be good.

Clearly a lot of the worry still is centered on sovereign contagion. But the IMF estimates that fiscal austerity packages will only reduce developed countries' collective GDP growth 1/2% and total global GDP growth by 1/4%. That would be a great result. Empirical Research also notes that direct exposure of U.S. companies to the PIIGS is small, and that Europe overall only sources about 10% of S&P 500 company revenues. Moreover, in the last 15 years, there have been 15 fiscal crises and, with the exception of Greece, the imbalances of today are not large by comparison to the earlier episodes. The only difference this time is affected countries cannot depreciate their currencies. News like today's downgrade of Spanish debt from the European region could very likely continue to result in market volatility through the summer months, and we could potentially test the next major support level around S&P 1,000.

There are plenty of other worries—the financial reform bill keeps getting toughened in conference; the flash crash still hasn't been fully explained; the oil spill, as of this writing, has not been fully stopped. Forward price-earnings multiples seem stuck around 12, vs. a normal 15. This could change if and when fears subside, the S&P successfully pierce its 200-day moving average of 1,103 (which is now in resistance) and the VIX starts moving down again. This is not 2008, when were on the edge of the cliff and necessarily slashing capacity. We're on the other side of a sharp business cycle now, and once the market turns its focus back to that, the rally will resume. Why not first enjoy this summer, but pass the sun screen, would you?

Positives

- ***Housing shifts to higher gear (for now)*** April new home sales blasted through forecasts to a 2-year high, while inventory plunged to a 42-year low. Existing home sales, up 8%, also surprised, though inventory rose sharply, too. Moreover, March-April new home sales rose the most since '80, with prices trending up. The now-expired tax credit did help—1st-time buyers were at least ½ of April buyers, 10% above normal, and mortgage purchase applications fell 34% the 1st 2 weeks of May to '97 lows. But with job growth starting to perk up and mortgage rates near 50-year lows, housing's spring rise could have legs.

- ***Consumer outlook shifts to higher gear*** Though still at relatively historical levels, consumer confidence rose a 3rd straight month and above expectations, with current conditions their best since November '08; expectations of conditions 6 months hence their highest since August '07, before the recession; and jobs expectations 6 months hence their highest since December '03. Separately, the National Association for Business Economics raised growth forecasts for this year and next, and projected the jobless rate to fall to 8.5% by end of 2011.

- ***Robust manufacturing may be moderating*** April durable goods topped consensus, rising 21.6% year over year. But ex-aircraft, the reading was weaker than expected, with inventories starting to pile up, and Chicago's regional gauge, while still robust, also was lower than expected. Still, the inventory-to-sales ratio is the lowest since the series started in '80, and the last 2 inventory restocking cycles, starting Q4 '91 and Q1 '01, lasted 10 and 6 years, respectively. All this suggests strong but slower manufacturing growth in the 2nd half. That would be fine.

Negatives

- ***Revised Q1 GDP disappoints slightly*** It dipped from an initial 3.2% to 3%. The revisions were broad-based, with the biggest declines in household spending and nonresidential fixed investment (buildings and business equipment). Personal consumption expenditures were lowered to a gain of 3.5%, still the most since Q1 '07. Does this report, along with recent manufacturing reads (*above*), recent higher-than-expected jobless claims and today's flat April personal consumption gauge reflect a temporary soft patch or something worse? This is still solid growth, even if the rate is tapering off.

- ***We just keep piling up debt ...*** U.S. debt issuance is running at a $1.5 trillion annualized rate, with $2.2 trillion of new federal spending added the past 15 months. And this week, Congress is weighing adding more through a jobs bill that the Congressional Budget Office estimates will add $134 billion to the deficit. All this comes as nearly two-thirds of existing U.S. sovereign debt matures within 3 years. Mounting record debt and how we pay for it is our biggest long-term concern.

- ***And that doesn't include Fannie, Freddie or Ginnie debt*** These government sponsored enterprises provided 70% of new mortgage originations last year. Yet they continue to lose money and their debt, supported by the government, is not included in U.S. public debt calculations. If it were, it would add more than $5 trillion to the nation's gross debt—roughly 35% of GDP.

What else

- ***Tuned in but turning off the TV*** Of the 9 in 10 households that currently subscribe to some form of pay TV, 1 in 8 are expected to eliminate the service this year and shift to PCs, gaming consoles or smart phones to access video programming, Yankee Group says. The biggest shift is expected among 18- to 34-year-olds, including so-called Millennials (14 to 25), who only watch 10½ hours of TV a week, half that of older viewers, yet consumer more media than any other group through the Net, video games and online music.

- ***Euro-zone mavericks*** Sweden, Bulgaria and Estonia are the only European Union members that are expected to meet euro-zone guidelines that require a budget deficit of no more than 3% of GDP, even though *none of the three countries use the euro*.

- ***A view into our future?*** As part of its newfound austerity, Greece raised its VAT to 23% from 19%, and added another 10% on fuel cigarettes and alcohol; raised the qualifying retirement age for benefits to 64 for men and 60 for women, with a ban on any benefits for retirements under age 60, and the minimum work years for public workers to qualify for a full pension is being raised from 37 years to 40 years by 2015.

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.

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

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

PIIGS is the acronym for European Union members Portugal, Ireland, Italy, Greece and Spain.

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 Chicago Purchasing Managers Index, produced by the The National Association of Purchasing Management-Chicago, gauges factory health in the upper Midwest based on surveys of companies in that region.

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