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Weekly Investment Commentary

The Bull Market Has Not Yet Reached Its Highs

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Stocks Sink Again, but Overreaction Would Be a Mistake

Last week was a difficult one for the markets with stocks sinking yet again. The primary culprit appeared to be an escalation of Europe's debt woes. For the week, the Dow Jones Industrial Average declined 1.7% to 12,820, the S&P 500 Index fell 1.2% to 1,353 and the Nasdaq Composite sank 0.8% to 2,933.

Although markets have been troubled in recent weeks, we do not believe investors should confuse the current situation with an ending to the bull market that has been in force since early 2009. Historically, sustained declines in equity prices tend to be associated with either economic downturns or earnings recessions, neither of which appears to be in the cards.

Europe's Problems Intensify

It has been the case for some time, but recent events serve as a reminder that the primary risk to the global economy and global markets is the ongoing debt crisis in Europe. Confidence over policymakers' ability to deal with the crisis took a hit recently given that the election results in Greece and France signal a shift away from governments' willingness to move forward with unpopular austerity measures.

The resulting political uncertainty and investor confusion has put downward pressure on stocks and other risk assets. Unfortunately, the reality is there is no quick fix for Europe's problems. To date, the European Central Bank and other policymakers have stepped in to provide liquidity and promote some potential long-term solutions, but they have often done so only after financial market turmoil has escalated. Clearly, the debt crisis remains a significant downside risk, but we maintain our view that developments in Europe are unlikely to derail global economic growth.

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An additional area of concern for many investors is China. Many are worried that China is headed for a hard economic landing and some are forecasting that China may enter into a slowing growth/rising inflation spiral. In our view, such fears are overblown. True, Chinese growth is slowing, but not at a pace that should trigger any sort of calamity.

US Economy and Earnings Should Remain on Course

Outside of these potential downside risks, we continue to believe that the US economy remains on a slow growth trajectory. The United States appears to be in the midst of a manufacturing renaissance as most data is pointing to an expansion in manufacturing activity. Overall consumer and business sentiment have been improving as well and we have even been seeing some signs of life in the housing market. Additionally, exports have remained resilient for some time now and continue to represent an important source of strength.

Corporate earnings remain a bright spot for the US economy. Thanks in large part to low interest rates, improvements in productivity and a lack of upward pressure on labor costs, corporations have been able to maintain and grow their earnings. The pace of earnings growth has slowed compared to recent quarters, but most companies are still reporting results that are ahead of expectations.

The labor market, of course, remains an important wildcard. In recent months, we have seen some softening in employment growth (at least compared to the relative strength we witnessed early in the year). One bright spot is that initial jobless claims have either been declining or holding steady in recent weeks, which may be an indication that the recent softness will be reversed somewhat.

Look Past the Bearish Short Term

Bearish sentiment has increased in recent weeks and confidence has taken a hit. At present, the risk premium for US stocks looks high to us, which implies that the markets have already discounted some significant downside risk in share prices. The risks are real, but in our view, as long as the economy is able to continue along the path of recovery, the risk premium should fall in the coming months. As such, we maintain our view that the current bull market has not yet reached a peak.

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