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William Rutherford

Distrusted market rally gets summer love

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In July the equity markets as measured by the S&P index were up 4.9 percent. This brings S&P returns for the year through Aug. 2 to 19.9 percent.

Dow transports are up 22.67 percent through July 30, confirming the Dow industrial rise – a strong sign according to the Dow Theory of investing. Also through July 30, bond markets this year have had negative returns. Year to date through June 30, $80 billion flowed out of bond funds, in the great rotation.

After Fed Chairman Ben Bernanke's testimony in June regarding quantitative easing, the markets threw a taper tantrum. The yield on 10-year bonds jumped from 1.6 percent to 2.5, the largest increase in such a short time in history. The value of 20-year-plus bonds fell 11 percent after Bernanke's remarks.

PIMCO, the largest bond house in the world, saw outflows of $10 billion in June – the biggest outflow since tracking began in 1993. On a total return basis the fund's returns were down 3.6 percent in the second quarter – the largest quarterly loss since inception. Investors are engaged in the "great rotation" from fixed income to equities.

The markets are beginning to trade on fundamentals, not just quantitative easing. Corporate profits are coming in slightly above forecast, but revenues are slack. The macro picture looks even better.

In Asia, China recorded unexpectedly strong factory activity. In Europe, where European Central Bank President Mario Draghi has promised easy money for the indefinite future, the Eurozone Purchasing Managers' Indexes showed expansion. The U.K. expanded at the fastest pace in more than two years. The U.S. economy showed stronger than expected growth with overall GDP growth at a modest 1.7 percent, when the consensus estimate was for 0.9 percent.

With this trifecta, U.S. markets surged to all-time highs. With macro economies strong, the question now is how long QE will last in the U.S. The markets are predicting the end of QE in summer 2014; some economists think tapering may begin as early as September. The markets clearly dread any tapering.

The Federal Reserve Board of Governors met July 30 and 31 and said in a statement that "inflation was worryingly low." Its assessment of U.S. growth has been downgraded. Rather than

the “moderate” expansion that it reported in June, the Fed said growth in the first half of the year has been “modest.”

The Fed signaled that tapering its quantitative easing program won’t be considered unless unemployment keeps trending downward. The board would like to see unemployment decline to 6.5 percent.

The day following the Fed statement, the Labor Department published its jobs report. It revised downward the previously reported hiring for May and June. While the economy added 162,000 jobs in June, the number was the fewest since March. The unemployment rate overall ticked down to 7.4 percent, which is still high.

The numbers show that the trend for job creation is down. Hiring in health care, which has been an engine of growth slowed; so did federal government hiring as budget cuts took effect. State and local governments added jobs as their tax revenue strengthened. Hourly wages fell by a small amount, but were nevertheless down. That is worrisome because 70 percent of the economy is based on the consumer.

Also, companies are reducing hours perhaps because they are losing confidence in the future, or perhaps “Obamacare” is taking its toll. Workers appeared to be growing more pessimistic in July, when 2.3 million unemployed workers gave up looking for jobs – the most since last fall. Fewer people re-entered the job market to look for work. Close to a million say they gave up looking for jobs because none are available.

So, the economy may be growing, but it’s growing slowly – and the rate is diminishing along with job creation. Clearly, the movement to fundamental growth in the economy will still need the backing of the Federal Reserve, at least for a while.

Indeed, the Fed, in its statement after the board meeting, said, “To support continued progress toward maximum employment and price stability, the committee reaffirmed its view … that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens.”

Nevertheless, the market continues its upward trend in the face of headwinds, as it has done since this bull market began March 9, 2009. The rally has been unloved and distrusted, but that has been its strength.

After this run-up, we can expect the markets to take a breather. August is a slow month globally, and because trading volumes are low, we can expect volatility in the markets. But it is best to be fully invested and diversified. There is less premium on dividend stocks now than a few months ago as interest rates have risen. The emphasis is on growth stocks. As always, diversification is important.

William Rutherford is the founder and portfolio manager of Portland-based Rutherford Investment Management. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. *Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.*