

2006 Third Quarter Market Review

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After flirting with lows for the year in mid-July, stock market investors enjoyed a classic late summer surge. Federal Reserve policy makers decided in early August to pause in their two-year-plus campaign of raising interest rates, resulting in a stock rally that progressed in earnest through the end of the quarter. Nevertheless, the stock market's comeback in the third quarter crammed bigger gains and more dissonance than most investors had experienced in a long time.

All three major stock indices enjoyed strong quarters. The Dow Jones Industrial Average advanced 4.7% in the quarter, its fifth consecutive quarterly increase. The S&P 500 index rallied 5.2%, leaving it up 7% for the year. Meanwhile, the Nasdaq finished up 4% in the quarter and is up 2.4 % year to date.

What was the impetus? Beyond the Fed rate pause, interest-rate and inflation concerns diminished, allowing buyers to breathe easier and focus on continued strong corporate earnings results. Moreover, a pullback in the prices of crude oil and other commodities helped keep inflation fears in check. The most interesting paradigm for money managers, however, was how low Treasury yields not only helped buoy the rally but also remained low in the face of it.

By rising in tandem, the stock and the bond markets appear to be making opposing bets on the outlook for the U.S. economy. Stock-market investors seem convinced the U.S. economy is easing into a soft landing. Treasury-market investors are signaling something much more jarring. Who's right? Usually, stocks and bonds don't see eye to eye. Investors in stocks tend to think that the economic glass is half full while bond buyers generally see it as half empty. Yet prices of both stocks and bonds have risen sharply since late June. The S&P 500 is up nearly 10% over this period while yields on the bellwether 10-year Treasury (which move inversely to prices) have plunged by about 45 basis points to about 4.80% from their high of 5.25%.

Stock prices are driven by earnings, interest rates and investor mood swings. Stock investors seem to think that, despite a housing downturn, the economy will keep growing enough for earnings to continue their upward march. They're also encouraged by the likelihood that the Federal Reserve will hold off on more interest-rate increases, thanks in part to the recent drop in oil prices, which is taking pressure off inflation.

Bond investors look at the same backdrop but see something more severe. They worry most about inflation. They bid up bond prices when the economy slows which eases inflation pressures. With 10 year Treasuries having rallied, their yields are well below yields on short-term Treasury securities such as three-month bills. When long-term yields drop much below short-term yields, it often indicates that investors foresee the economy stalling and forcing the Fed to lower rates to revive it.

On the surface, you might expect that one of these markets will wind up with some unhappy returns. After all, we can't have both a healthy and an unhealthy economy at the same time, can we? While true, there are other reasons why stocks and bonds can continue to outperform in the near term.

The main catalyst is the sharp drop in energy prices. Lower energy prices have played a role not unlike the cavalry riding to the rescue. They are reducing inflation pressures while, at the same time, injecting buying power and confidence into the hands of consumers and business. This development alone makes the simultaneous rise in prices of both stocks and bonds easier to understand, but there is more. The reduction in inflation expectations justifies the drop in bond yields, which, in turn, is helping to cushion the decline in housing. Indeed, sales of existing single-family homes stabilized in August while purchases of new homes actually rose.

Lower interest rates help the economy by making it easier for people to borrow or to service their existing debts. This will give a lift to consumer spending - which comes just in time as merchants prepare for the important holiday selling season. By lowering the valuation bar, the decline in bond yields has also lowered the hurdle for Corporate America in terms of profitability, and, by extension, for its shares. This assumes continued growth in corporate profits which will be facilitated by the drop in energy prices and interest rates.

Now, the important question for stock investors is whether interest rates will stay as low as they are. With energy and commodities prices well off their highs, inflationary pressures appear to be easing. That means the Federal Reserve might not need to raise short-term rates again for some time. Moreover, with the housing market heading south, long-term rates are facing downward pressure.

But plenty could upset that view. A resurgence of energy prices, a tighter labor market causing wage pressures and inflation, a sharp drop in the dollar, an explosion of economic activity, ballooning budget deficits could all begin putting upward pressure on interest rates that upsets stock investors. Other major hurdles loom for stocks as the year draws to a close, including a hotly contested U.S. Congressional election in November that could result in changes to economic policies and affect the always-precarious energy markets.

Having fallen so much for so long, it would be dangerous to think interest rates can't start moving in the other direction. If that were to happen, the appeal of stocks would change rapidly. On the bright side for stocks, both Thomson Financial and Reuters Estimates forecast double-digit increases in aggregate profits for companies in the S&P 500 when they start reporting third-quarter financial results in the weeks ahead. Maybe then, we'll get back to stocks and bonds moving inversely again - which will mean investors have a clear consensus on the economy. We'll try and stay ahead of the curve - even if it is inverted.