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Registered Investment Advisor

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"This non-stop move higher for stocks will take a break at some point."

Perspectives

The Federal Reserve is doing everything it can to push investors and savers into stocks and out of perceived safe-haven investments. Due to the Fed's commitment to a long-term quantitative easing plan, yields on CDs are too low to create reasonable income and the downside risk in bonds is too great. Inflation will become a concern at some point due to the extended period of easy monetary policy. A high rate of inflation will cause those who are invested in low yielding bonds to lose money in real terms as stocks appreciate. Even with fewer positive economic indicators, stocks continue to gain ground. The less than stellar jobs data released on Friday gives the Fed room to continue running the printing presses at full speed.

What's good for stocks is not always good for individuals. Stocks benefit as savers are forced to rotate out of bonds as they seek growth and income from stocks and dividends. Retail investors (as opposed to institutional investors) only recently began this allocation shift into stocks. The "great rotation" could take well over a year before these smaller investors have finished adjusting their portfolios. The pressure to push stocks higher will continue, with a few pauses, until it reaches a zenith at higher P/E multiples. Investors who delay the allocation shift will miss out on gains earned by the heard. The investors who stay in bonds risk being caught with high priced bonds that no one wants to buy. The eventual steep sell-off in bonds will hurt the people who need safety the most.

This non-stop move higher for stocks will take a break at some point. Over the past three years, that point has been in the spring as the cliché advises, "sell in May and go away". A typical calendar year has four or five small corrections of at least 5%. The current rally in stocks has not seen such a break in buying since bulls took over in mid-November. Markets that have extended periods without a correction tend to have larger declines after they peak. In addition, major corrections do not start without valuations being overextended. Based on forward 12-month earnings estimates, the S&P 500's P/E ratio is only 14.1, well below tipping points of previous market tops.

Traders are antsy going into the warmer months as they wonder if the market will repeat the past three years of spring selling. Bears have been looking for a catalyst to sell after such an extended run without a true consolidation period. Events in Cyprus were an easy excuse for the bears to attempt to push the stocks lower, but it proved to be an insufficient trigger as stocks bounced from their lows to hit all time highs for the Dow Jones and S&P 500 indexes. The latest employment report could be the weak piece of data needed to get bulls to back away for a much-needed correction.

The headline numbers of the jobs report were mixed. The unemployment rate dropped 0.1% to 7.6%, but only 88,000 new jobs were added in March. As a silver lining, the previous two months' data were revised higher by 61,000 and the total hours worked rose by 0.1 again. The drop in the unemployment rate is attributed to the decline in the labor-force participation rate. In other words, fewer people are looking for work, so they are not considered job seekers and are no longer part of the roster of unemployed (i.e. the numerator in the figure). These previous workers are still not working. They simply gave up. That is not viewed as a positive for the economy and helped cause a brief sell-off in stocks on Friday. More important than the stock index declines, bond prices spiked over the past few days. Bonds often lead the path for stocks. If bond investors are correct, stocks could be in for a rough few months again this spring.

If US and European concerns aren't enough to derail the stock market, keep an eye on the events in North Korea. The simple fear of the unknown can cause the bulls to step away from further buying. Since selling begets more selling, the markets could be on borrowed time. The beginning of corporate earnings season next week will be crucial in determining if the forward P/E ratio is still on target to be accurate.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average TR	4/5/2013	11.87	14.53	12.90	5.89
NASDAQ Composite PR	4/5/2013	6.11	4.00	9.66	6.21
Russell 2000 TR	4/5/2013	9.07	14.51	11.29	6.80
S&P 500	4/5/2013	9.52	13.60	11.73	4.85
S&P MidCap 400	4/5/2013	10.55	15.96	13.17	8.31
Global Stock Indexes					
MSCI Emerging Markets	4/5/2013	-4.46	-2.81	-0.92	-2.52
MSCI World, Excluding US	4/5/2013	3.57	12.24	3.97	-1.74
Bond Indexes					
Core Bond	4/4/2013	0.42	4.66	5.98	5.67
Intermediate Core Bond	4/4/2013	0.62	4.11	5.59	5.73
Long-Term Core Bond	4/4/2013	0.35	10.33	11.82	9.21
Short-Term Core Bond	4/4/2013	0.35	1.64	2.32	2.85

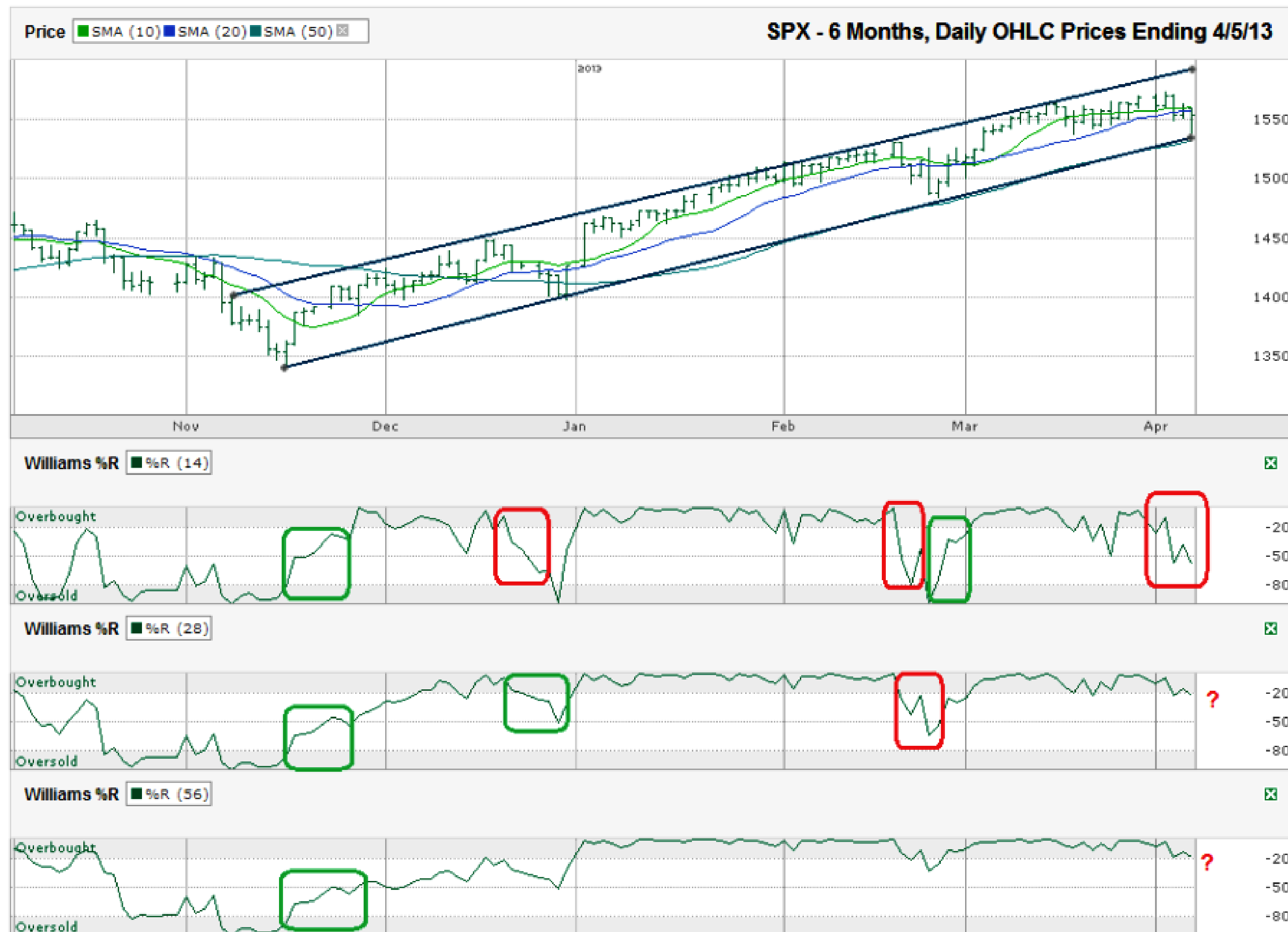
Market Movers

- Stocks started 2013 on a strong note after the fiscal cliff was avoided (actually only delayed) at the end of December. Little news could slow the market’s move higher after the overblown fiscal cliff concerns died down. Even the events in Cyprus didn’t cause more than a few days of lower prices for stocks. The extended effect of the March employment data is yet to be seen, but deserves to be watched.
- In early January, China's trade surplus helped the bulls’ case as it expanded to $31.6 billion due to strong export growth. This helped relieve concerns of a hard landing for China’s economy.
- In mid-March, Cyprus announced plans to take up to nearly 10% of bank deposits. Markets sold off for a few days as the fear of contagion to other EU countries spread. Many traders saw this as an excuse to sell and try to stay in front of an overdue correction. Other investors saw the slight decline in prices as a buying opportunity since the small country’s issues were unlikely to affect the global economy.
- By the final week of the month, Cyprus fears were allayed when officials announced an agreement to restructure Cypriot banks into good and bad banks.
- North Korea’s aggressive actions have traders on alert, which could lead to broader selling. For now, this is another global factor to track.

Fundamentals & Indicators

- After slumping by 0.2% in December, the Producer Prices Index (PPI) rose 0.2% in January and 0.7% in February.
- Retail sales have shown improvement recently with the past three months showing gains of 0.5%, 0.2% and 1.1% respectfully. Economists feared the payroll tax increase and sequester cuts would slow retail sales, but as employment has improved, consumers' appetite for new goods has stayed strong.
- The Empire Manufacturing Survey came in at -7.8 in January and then turned positive in February and March with readings of +10.0 and +9.2, both well ahead of expectations.
- Housing starts maintained a moderately steady annualized rate of the past three months with all reports showing better than an annualized rate of 900,000 (973k, 910k, 917k). This came after earlier months in the 800,000s.
- Building permits have bounced below and above expectations with reports of 909k in December, 904k in January and 946k in February.
- Existing home sales edged higher each of the past three reports from 4.90 million units in December to 4.94 million units in January and 4.98 million units in February. The median price has improved 11.6% year over year.
- The pace of pending home sales has slowed. The December report showed a decline by 4.3%, followed by a rise in January by 3.8% and a decline in February of 0.4%. This is one of the few weak spots from the housing indicators.
- New home sales fluctuated from 378,000 in December, up to 431,000 in January and then back down to 411,000 in February. This three-month average is more than 8% better than the previous three-month average and shows a strong trend of an improving housing sector.
- The Case-Schiller 20-city Home Price Index beat estimates for each of the past three months with readings of +5.5%, +6.8% and +8.1% year over year. The January numbers (reported in March) showed every city in the 20-city composite had a higher average price than a year earlier.
- Durable goods orders slumped in January by -3.8% after a stronger than expected December reading of 3.6%. February recovered with an increase of 5.7%, once again ahead of consensus.
- The Chicago PMI was flat in December, but surprised to the upside in both January and February with readings of 55.6 and 56.8 respectfully.
- The ISM Manufacturing Index continued its move higher through January and February with reports of 53.1 and 54.2 that beat forecasts. By March, the index dropped to 51.3. This report still shows expansion, but at a decreased rate for the first time since November.
- Construction spending rose again in February (+1.1%) after falling in January (-2.1%) and rising slightly in December (+0.1%).
- The ISM Services Index remained comfortably in expansion territory for the past three months with readings of 55.2, 56.0 and 54.4 from January through March. As an increasingly larger part of the economy, service sector growth is crucial in showing strength in the overall economy.
- Factory orders ebbed and flowed over the past three months with reports of +1.3%, -1.0% and +3.0% from December through February. The most recent report backed-up other economic data recently that confirm the US economy is improving, but is not without threats to its stability.
- The Philadelphia Fed Index fell in January and February by 5.8 and 12.5, which indicated a weakening factory-sector. The March report showed a turn-around with a reading of +2.0.
- Employment data started the year with mixed messages and multiple revisions each month. The unemployment rate fell from 7.9% in January to 7.7% in February and 7.6% in March. This appears to be a strong trend as a headline number, but much of the improvement has come from a drop in the labor participation rate to levels not seen since 1979. This dilutes the number of potentially unemployed workers and causes the overall unemployment rate to drop, but without much job growth.
- On the positive side, weekly unemployment claims trended lower over the past quarter signaling that although companies are not hiring as much as a typical economic recovery would expect, they are not firing workers at a pace that would indicate a recession is near.
- Hourly earnings rose by 0.2% in January and February, but flat lined in March.
- The average workweek gained each of the past three months from 34.4 to 34.5 and then 34.6. This indicates demand for workers is improving more than the overall jobs numbers show and that the March new-jobs figure might not be the start of a new trend lower.

Index Chart & Analysis



This S&P 500 (SPX) chart shows the past six months of daily prices on the index after it closed at 1,553.28 on Friday, April 5, 2013. Since November, the S&P 500 has traded in a narrow ascending trading channel with only two prior dips to the trend line of higher lows. This trend line was tested again on Friday and for the third time the large-cap index found support and moved higher from its morning lows. Starting in early January, this trend line has run close to even with the 50-day moving average (dma). The two combined technical indicators have worked together to keep the bears in check, but when these lines finally lose their battle, the sell-off could be steep and quick.

The warning signals are starting to add up on the chart. The SPX is trading below its 10 and 20-dma. Falling below these moving averages intraday on Wednesday and Thursday raised red flags. The gap move below them is a more significant sign for caution. The 10-dma has not fallen below the 20-dma yet. This bearish crossover will be the technical indicator that confirms sentiment has shifted beyond any one-day event. The reverse occurred in late November when the 10-dma moved above the 20-dma and a new leg of the bull market was confirmed.

The Williams %R indicator turned bullish in November, a week before the moving averages confirmed the move. The same pattern could emerge in April to the downside. The 14-day indicator issued a sell signal when it moved below the overbought three trading days ago. The following two days worked as the needed confirmation days. To avoid being whipsawed out of the market, traders pay attention to the 28 and 56-day indicators also. The 28-day indicator moved outside of the overbought area on Friday, but needs two confirmation days to show this isn't another short-lived dip. The 56-day indicator is still within the overbought area and has not presented a reason to

sell yet. By the time the 56-day indicator catches up, the SPX could be another 2-3% lower. This creates a balancing act for traders. Should they wait for the longer-term indicator to confirm it's the bears' turn to control the market or should they start taking profits now? The answer depends on each investor's risk tolerance and their time horizon.

The long-term bull market is still in motion. Opportunities present themselves to add to positions on dips during a bull market. By timing the entry and exit in these cycles, traders can reduce downside risks and increase returns. The upside is limited for stocks while the technical indicators are sending warning signals. The upside potential opens up 50 points (not much more than 3%) for the SPX if the index makes a run above its 10-dma within the next few days. The downside could be more than 130 points on the S&P 500 before it reaches longer-term support. A fall to the 1,420 range would be close to the definition of a correction, a 10% drop from recent highs. If the S&P 500 reaches those levels, it will be a great buying opportunity followed by a massive price surge again as value investors take advantage of the depressed prices. Investors who start to nibble in after a 5% drop in prices can build onto a smart long-term strategy.

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