The Market Landscape from 10,000 Feet

With the Dow Jones Industrial Average marching to fresh all-time highs and risk assets shrugging off every potential roadblock out of Washington (i.e. election results, fiscal cliff, sequestration, etc.), we thought it would be helpful to step back from the party and offer a 10,000-foot view of the real progress we have made since the Great Recession. As we have previously argued, in most cases, the fundamentals of the economy have not experienced the same recovery that we have seen in asset prices; and in some cases, they have actually deteriorated further. If this is true of the broader economy, why has the equity market done so well and how long can this divergence continue? In this month's MAInsights, we will take a look at today's economic and market barometers versus their pre-crisis levels and make a few comments on the current backdrop for financial assets.

Economic & Market Snapshot: Oct-'07 Top vs. Mar-'09 Bottom vs. Today

	October '07 Top	March '09 Bottom	8-Mar-13
Nominal GDP ($BN)	14,126	13,923	15,851
Employed (NFP, Thous.)	137,838	132,106	135,046
Unemployed (in Labor Force, Thous.)	7,237	13,421	12,032
Labor Force Participation Rate	65.80%	65.60%	63.50%
Inflation (CPI Y/Y)	3.60%	-0.40%	1.60%
Consumer Confidence	95.2	26.9	69.6
Gold ($/OZ)	738	922	1,579
Crude Oil ($/bbl)	80	47	92
Regular Gasoline Price ($/gal)	2.77	1.94	3.71
Fed Balance Sheet Assets ($BN)	859	1,992	3,104
Federal Debt Outstanding ($BN)	9,079	11,127	16,687
U.S. Deficit (LTM, $BN)	-169	-923	-1,030
S&P 500 EPS (LTM)	89.31	43	96.99
S&P 500 Sales per Share (LTM)	1,005	999	1,093
S&P 500 Margin (LTM)	8.90%	4.30%	8.90%
S&P 500 Market Cap ($BN)	13,806	5,895	13,801
S&P 500 Trailing P/E	17.5x	15.7x	15.9x
S&P 500 Trailing P/Sales	1.6x	0.7x	1.4x
Largest Sector (% of S&P 500)	Financials (20.1%)	Tech (17.6%)	Tech (18.2%)
Largest Stock (Market Cap)	Exxon ($514bn)	Exxon ($328bn)	Apple ($405bn)
NYSE Avg Daily Volume (LTM, Mil)	1,581	1,454	746
10-Year U.S. Treasury Yield	4.65%	2.89%	1.99%

Source: Strategas Research Partners

As illustrated in the above snapshot, the magnitude of the stimulus provided by the Federal Reserve and federal government has been nothing short of unprecedented. Since the previous peak in October 2007, the Fed's balance sheet has more than tripled and the federal debt has nearly doubled. One would think that with all this support the U.S. economy would be firing on all cylinders, but in reality, the economy remains far from robust. Although GDP is now above 2007 levels, the job market remains very depressed, as evidenced by the fact that there are nearly five million more unemployed workers today than in 2007. On top of that, the labor force participation rate (the ratio between labor force and the total population) has fallen from 65.8% to 63.5% as millions of people have dropped out of the workforce altogether due to discouragement, disability, educational endeavors, or other reasons. This phenomenon has masked the true state of the job market; since without this drop in the number of workers, the unemployment rate would still be north of 10% today (well above the 7.7% official rate). This is not to say that the actions of policymakers have been completely futile, however. On the contrary, they have proved instrumental in putting a floor under the financial markets, restoring confidence to the system, and corporate margins and earning have returned to 2007 levels in spite of stagnant revenue growth, and accordingly, stock prices have reclaimed their all-time highs. **But where do we go from here?**

With merger economic growth and already lean cost structures, the outlook for corporate earnings growth has begun to look increasingly tame. In our opinion, however, stocks can still do well without a robust economy or strong earnings outlook as long as the Fed continues to print money and the list of other alternatives to stocks keeps getting shorter. At the rate they are going, the Fed will add another $1 trillion to its balance sheet in 2013, which is not only a continuation of their easy policy, but an acceleration of it! This downward pressure on interest rates should function to make safer asset classes, such as high-quality fixed income, increasingly unappealing and riskier assets, such as stocks with dividends and appreciation potential, that much more appealing. We think both of these market forces – Fed intervention and growing demand for risk assets – will continue to prevail until the economy reaches full potential; and, considering the employment picture that is depicted in the above chart, that looks to be a long way off. As a result, we have been forced to come to grips with a world where bad news isn't always bad news (if it signals the potential for less stimulus). For example, while the impact of the fiscal cliff and sequestration is negative for the economy, it is actually good for the market because it keeps the Fed in the game. We admit that the ultimate consequences of this unprecedented policy are a big unknown, but for the foreseeable future, we are squarely in the camp that investors should have a normal allocation to the equity markets in accordance with their long-term strategic allocations. As the old investment adage goes, "don't fight the Fed."

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