MARKETS

Equities face steep fiscal cliff of worries in election year

BY PHILIP BURGERT

European uncertainties and the fiscal cliff countdown are pressuring equities, but election year cycles and defensive stocks are keeping equity indexes in the black and analysts bullish.

Surprising optimism has been showing up recently among traders and analysts in stock index futures despite continuing worries about our faltering recovery, the European sovereign debt crises and other potential drags on global equity performance. That is quite a turnaround for being just a few weeks after the S&P 500 peaked above 1,400 in early April, up 6.5% from a year earlier and then lost all of its gains for the year to a low of 1,278 in early June. The Dow Jones Industrial Average has swung even more sharply, peaking near 13,280 in early May, up 3.7% from a year earlier, before plunging 8.7% in the next month to a year-to-date low near 12,100.

Spain becomes Eurozone's next problem
Scaling the fiscal cliff

While an ultimate solution for Europe still may or may not materialize, market participants say that factors they see supporting performance among indexes in the next few months include continuing good performance of defensive stocks, historically strong performance among stocks during months leading up to U.S. elections and prospects for kicking the can down the road on the threatened U.S. "fiscal cliff" at year end.

The fiscal cliff refers to a point at the end of 2012 when the Bush era tax cuts expire and certain automated spending cuts kick in after the bipartisan Senate panel failed to agree on specific spending cuts last year. While the combination of tax increases and budget cuts would reduce the deficit, it likely also would have a negative impact on growth. The Congressional Budget Office (CBO) estimates that the policies set to go into effect would cut gross domestic product (GDP) by four percentage points in 2013.

"I'm bullish on the market," says Kevin J. Benoit, president and founder of fundamental equity index program Stratford Capital Management. "I know there are issues that are out there that are [difficult and] have potential to be a real problem. However, there are certain things that are more likely to happen than not."

Also bullish is Tony Dwyer, U.S. portfolio strategist with Canaccord Genuity,

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who has a bold target of 1,575 for the S&P 500. Dwyer says the European debt crisis and subsequent fall in global equity markets has priced in a U.S. recession that he believes is not likely to happen.

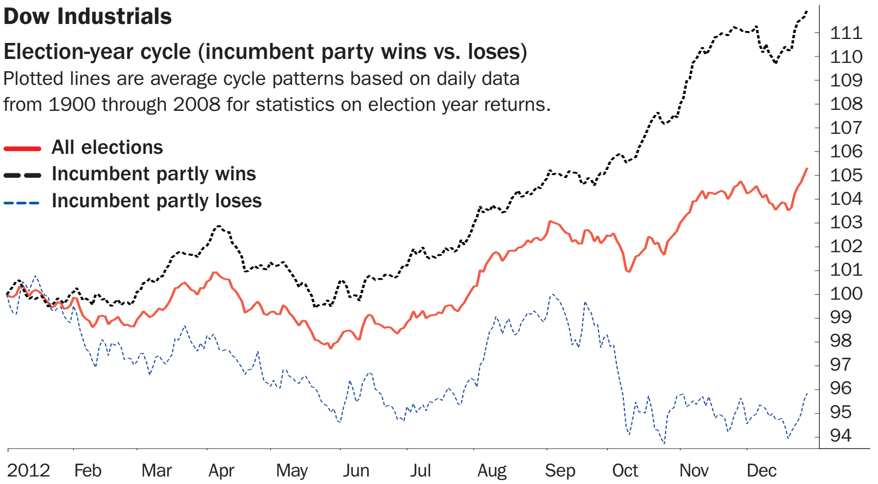
June typically brings the bottom for the Dow Industrials in election years, Dwyer says. The market generally bottoms in the last week of May or the first week of June and trades higher into September (see "Dow election cycles," right).

U.S. equity indexes have followed the typical presidential election year cycle in an exaggerated fashion to date with positive jobs data in the first quarter followed by a slide back toward anemic job growth in the second quarter (see "It might be, it could be, it isn't a robust recovery," right).

Perhaps exaggerating the typical election, Dwyer also acknowledges that it is hard to believe that the S&P 500 remains in a bull market that began in 2009. "Frankly, it is impossible to trade these day-to-day gyrations that are driven by unpredictable news," he says, adding that

DOW ELECTION CYCLES

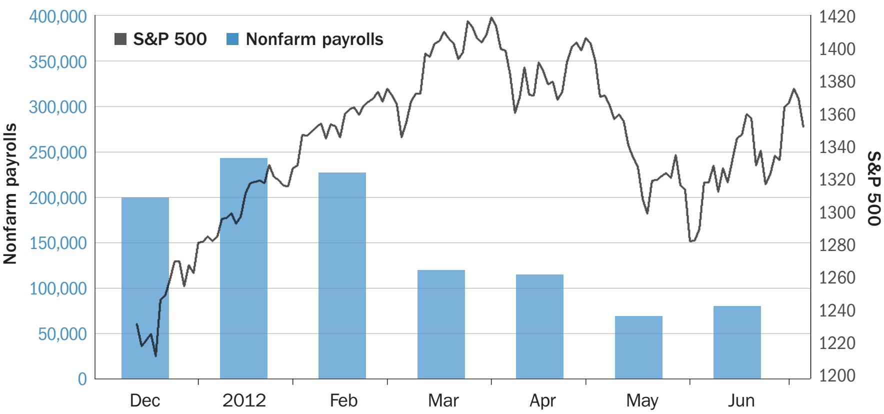
The market has followed a typical, though perhaps exaggerated, election year pattern for the first half of the year. The Dow tends to perform in the second half of a presidential election year.



Source: Ned Davis Research

IT MIGHT BE, IT COULD BE, IT ISN'T A ROBUST RECOVERY

Equities soared as jobs numbers seemed to indicate the recovery was kicking into second gear in the first quarter. However, job growth slowed in the second quarter.



Source: eSignal & BLS

Canaccord has little confidence in short-term calls but looks at intermediate-term indicators to see if any change in its bullish tactical view is warranted.

Also taking a longer-term view is Morningstar, where Paul Larson, chief equities strategist, says that the nearly 2,000 stocks covered by his company are mildly undervalued now.

"We're roughly 10% undervalued for the median stock at this point," Larson says (see "Undervalued equities?" page 14). "We don't make any projection regarding when the reversion to fair value actually is going to happen. But to just take the temperature of the market, the market does look undervalued."

Trouble in Europe

The main uncertainty in the outlook for stock indexes, traders and analysts continues to be the outlook for Europe and the resolution of bank and sovereign debt problems there. "You're dealing with a decision that Germany has to make here and it's hard to determine exactly what that outcome will be," says Steven Goldman, principal of Goldman Management Inc.

"I presume they prefer to kick the can down the road, but the market may not allow that," he adds. "It may mean that the market has to come under a bit more of a crisis before Germany reacts. Ideally everybody would like for them to take some significant stance now, but the talk seems to be more of issues on an intermediate-term basis. They're not focused on the short-term and that poses some concerns for investors."

Goldman notes that the rally seen in June had recouped about two-thirds of the losses to the trough at the end of May and had been a very defensive-oriented market rally. "It was not a robust rally, not one that global growth stocks were rallying with but really more defensive stocks. So it looks like more time will be needed to form this base-building process. Valuations are pretty interesting at these levels, especially when you adjust that for credit risk and for interest rates."

Such valuations are not used for timing but show the risk/rewards on an intermediate-term basis are favorable, Goldman says. "Right now it looks like it's still going to be a process before we have anything more sustainable on the upside — unless there is something significant coming out of Europe. But I don't know if that's likely to occur just now."

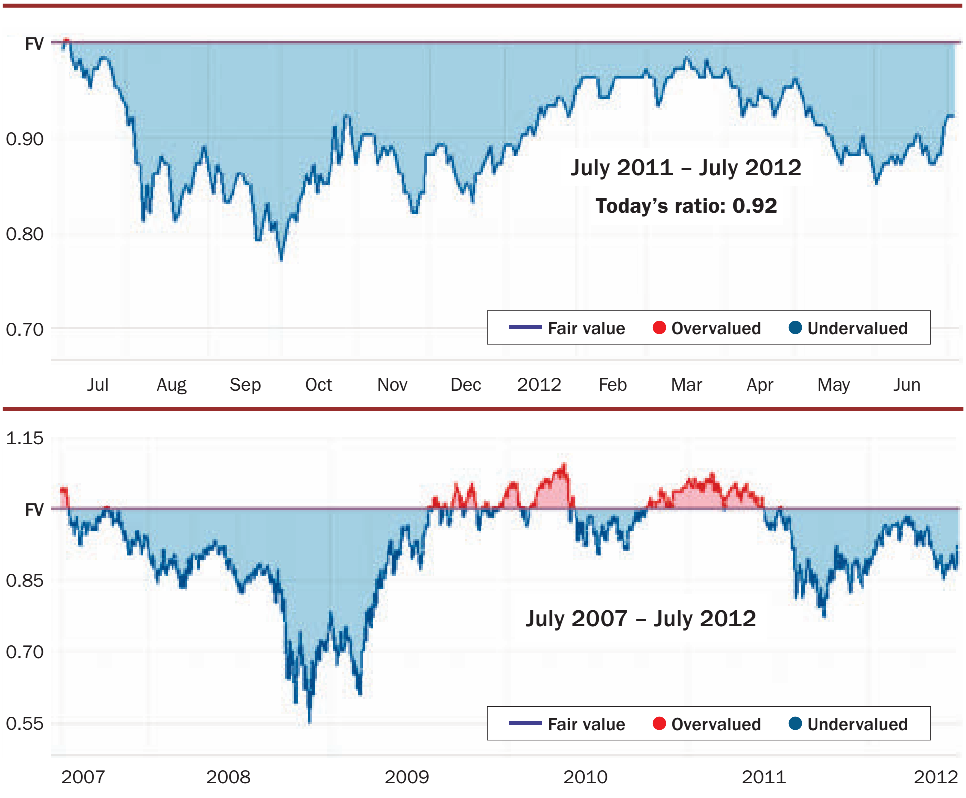
Spencer Patton, chief investment officer at Steel Vine Investments, is downbeat about equities because of continuing issues with Spanish banks. "That issue is not resolved and it's likely to get worse," he says.

Patton says that part of the problem with the European situation has been the reactionary and small incremental moves by European leaders, which the market has not responded to very positively. "Generally, the market is going to apply more pressure until a big enough solution gets presented. My core theory is that the Spanish debt situation is going to get worse before it gets better," he says.

The situation eventually will be resolved, Patton says, noting that Greece was bailed out three times and that Spain had not been even officially bailed out once yet. "My theory is that we're going to see the markets get quite a bit [lower] than where they are now over the Spain issue [this] summer," he says.

UNDERVALUED EQUITIES?

Stocks have been undervalued for the past year and now are down 10% according to Morningstar. However, looking back five years (lower chart) indicates that stocks can become much more "undervalued" before they recover.



Source: Morningstar

As China goes...

The European situation also is creating headwinds for other parts of the world, like China, and for commodities that are used in products manufactured elsewhere and sold in Europe. "China is slowing more than people believe," Patton says. "There have been a lot of rumblings over the last few weeks that the Chinese are flat-out lying about the data that they are putting out. They have a history of doing that – kind of masking the degree to which the economy is slowing down."

This also is being seen in crude oil prices, with West Texas Intermediate trading below $80 a barrel in late June. "That is telling you that something is very wrong in the global economy – when you get crude oil falling $30 in just two months," Patton says. "So that's very concerning to me. U.S. growth is stagnant, and we're building up to an election [that is] going to have big ramifications upon the U.S. economy. There's not a lot to be optimistic about."

Will equities fall off cliff?

Also contributing uncertainty to the market will be the debate leading up to the scheduled fiscal cliff at the end of the year when the expiration of Bush-era tax cuts and automatic spending cuts could produce a toxic cocktail to the economy. "It will be the debt ceiling debate all over again, and it would be happening in the fourth quarter. At this point, there may not be the same level of certainty that the fiscal cliff is going to be resolved like we knew that the debt ceiling eventually was going to be raised," Patton says, adding that this could result in a 10% haircut to equities markets.

Others take a more sanguine view of the fiscal cliff. "That won't happen until the end of the year and what I've heard from a lot of different sources is the most likely thing is they are going to agree not to put in the fiscal cliff," says Benoit, suggesting that politicians running for office in November will not want to have a pending threat to the economy hanging over them. "They'll push everything out by three months or six months, and when they get close they'll push out for another three or six months."

Also questioning the likelihood that the fiscal cliff actually will materialize is Larson. "I kind of doubt that Congress is going to let taxes rise at such a steep rate all at once," he says. "We can indeed expect higher taxes down the road, but I'm doubtful that it is going to happen all at once at the end of the year. In other words, if I had to bet on action or no action, I'm betting action on Congress' part."

Larson adds that the United States is not in the same situation as Europe, "but we are headed there if we don't get our own fiscal house in order. Given the fairly large budget deficits, it means that we can expect either lower government spending or higher taxes and maybe both in the future. Both those things are going to act as a drag on the overall economy."

But, he notes that for all the hand-wringing that has been seen so far this year, the S&P was up close to 9% for the year by the end of June. "We're on pace for a nearly 20% rise if this were to continue. That's a pretty strong performance. It sure doesn't feel like we're in a bull rally, but the numbers don't lie."

Past performance is not indicative of future results, though, and the market likely will get more volatile as the presidential election kicks into gear. We already have seen some pretty large swings in equity indexes in 2012 thanks to a strengthening recovery in the first quarter, and then a failure to follow through as well as the boom-bust cycles of the Eurozone crisis. Plus, we haven't gotten into the election season in earnest yet. Things may get rough. F