

Market Commentary First Quarter 2010

The Dow Jones Industrial Average posted its best first-quarter performance since 1999, while the 5.9% return posted by the S&P 500 index in March was its best monthly showing since last August. Although pullbacks will undoubtedly occur, especially now that investor sentiment (a contrarian indicator) has become more optimistic, we believe they will be relatively brief. Investors remain somewhat skeptical about both the stock-market rally and the sustainability of the economic recovery, leading to investor sentiment correcting relatively quickly with any pullback and setting the stage for a renewed move higher. Earnings reporting season is kicking into high gear and will likely drive the market in large part over the next few weeks. Now that businesses have moved from improved bottom-line numbers to improved top-line (sales) numbers—for example, they've kept costs low while demand for goods and services continues to increase—analysts are looking for a fairly positive reporting period. Additionally, the ratio of negative preannouncements has been lower than usual—suggesting that earnings should largely meet expectations.

Stocks are forward-looking, and with a relatively healthy outlook for this earnings season already baked into the market, it may take even better results to move the indexes substantially higher. While the reports will largely support the continuing recovery, we may see some "sell the news" sort of action in the near term. The major media continues to focus on the labor report, which showed much-welcomed job gains of 162,000 while the unemployment rate stayed at 9.7%. However, as has been the case lately, the data was a bit murky, and traders continue to debate the impact of weather issues and Census hiring on the numbers. Additionally, there is a widespread belief that a large number of discouraged workers will return to the ranks of those seeking jobs once we start to see a string of positive jobs reports.

The improving economic data, including manufacturing and labor, has allowed the Federal Reserve to slowly remove the quantitative easing measures it put into place during the height of the financial crisis. Earlier this year the Fed ended its purchases of Treasury securities, and at the end of March it stopped purchasing mortgage-backed securities. Now we are watching to see if the economy can continue to improve without these extreme pillars of support.

One area in particular that we'll be watching is mortgage rates, as the housing situation remains relatively tenuous. Recent data shows that the housing market continues to stabilize, but the numbers certainly haven't provided any great hope that a nice rebound is in the offing. The big question is when the Fed will raise rates off of its 0%-0.25% target. Fed members have been adjusting their messaging somewhat of late, which suggests they could be preparing the market for at least a modest increase in rates. As we've been noting for some time, we believe that emergency rates are no longer needed, and that some normalization of rates would be beneficial. The stock market could view such action as confidence on the part of the Fed that things are improving, while savers could again start to earn more meaningful returns on their short-term investments.