Bulls Vs. Bears: A Look at Both Sides of the Current Environment

Presented by Peter J. Caplan

Few experiences are more enjoyable than relaxing on the porch on a summer afternoon, when the sun is shining and the sky's a brilliant blue. Sure, it may be hot and muggy, but that's nothing a cold drink can't fix. Yet, sometimes, you can't help noticing those ominous-looking clouds that pop up on the horizon. Is a storm coming, or will it just blow over?

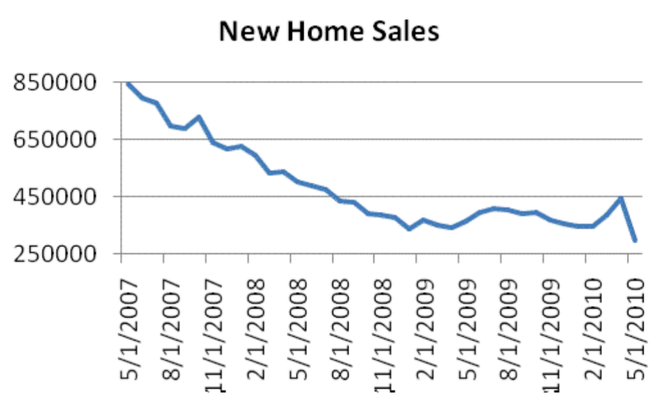
Historically, equity markets have often mirrored the calm and lazy pace of summer, but this year investors seem to have their eyes fixed on the dark clouds. The question is whether they're as harmless as heat lightning, or as dangerous as a summer hurricane.

We don't claim to be weather or market forecasters, but given the volatile investing environment we've been experiencing over the past couple of months, we thought now would be a good time for a brief overview of what the bulls and bears are saying.

BEARS: SHUTTER THE WINDOWS; A STORM IS COMING

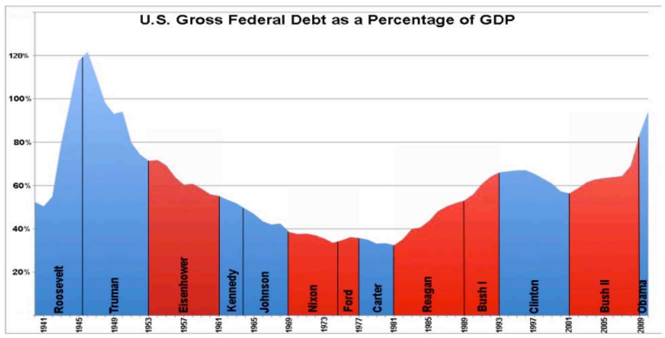
- **The economic recovery was only a mirage.** Recent economic data has shown signs that the recovery, which looked robust in the fourth quarter of 2009, is slowing down. After the expiration of the homebuyer tax credit, new home sales fell 32.70 percent—hitting their lowest level since recordkeeping began in 1963. Gross domestic product (GDP) growth was revised downward to just 2.70 percent for the first quarter of 2010, and unemployment is still elevated.

  The economy has continued to be propped up by a government spending plan that will ultimately only increase our ballooning deficit. Many consumers are strapped for cash, which means that there's not enough demand for goods to fuel a true recovery. Once the stimulus expires, the broader economy is likely to follow the housing market's lead.



Source: Bloomberg

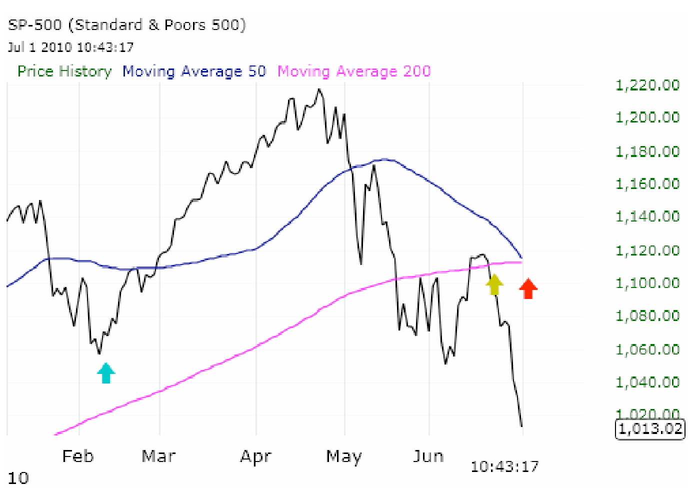
- **We shouldn't have bought that big lake house we couldn't afford.** The government, businesses, and private citizens have been borrowing on their future for decades, and now is the time to pay the piper. The debt burden our country carries is likely to stunt GDP growth going forward. We won't be able to grow our way out of this one, and, in the long run, no one can bail us out. Following systematic banking crises, downturns in equities average 3.4 years and unemployment rises for nearly 5 years.[1] Businesses and consumers aren't able to access as much credit as they used to, and once bond investors begin demanding higher yields on Treasuries, the government will have the same problem.



Source: Marktaw.com

- **All signs point to an impending hurricane.** Market technicals don't look very good right now. In the chart below, the second arrow from the right points out where the S&P 500 fell below the technical support/resistance point of the 200-day moving average in late June. The arrow at the far left designates the low point reached in February, through which the S&P also recently broke, and the arrow at the far right indicates that the 50-day moving average is poised to fall below the 200-day moving average, which is a bearish sign.

  The next significant support point is at 880, which was the low in July 2009 before the market bounced up off the 200-day moving average. Some bears are even calling for a retest of the lows of March 2009.



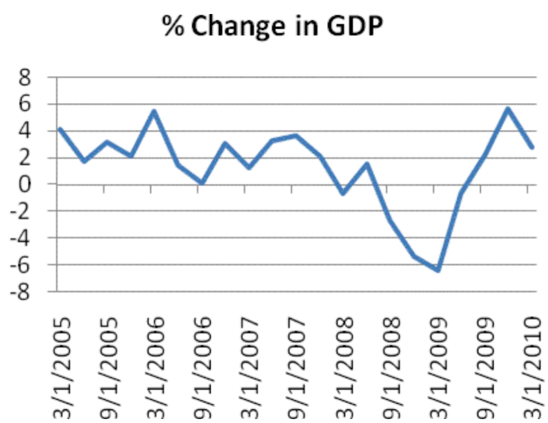
Source: QUODD

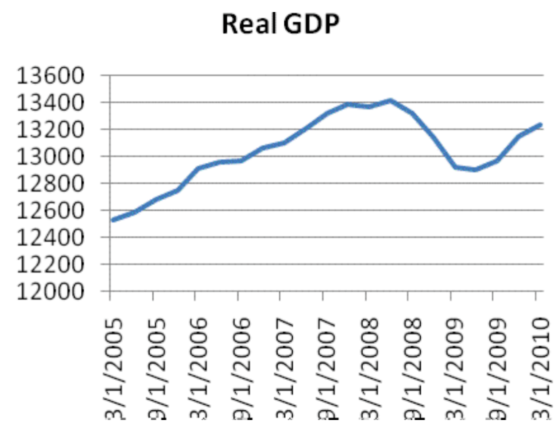
[1] John Hussman, "Recession Warning," June 28, 2010; Kenneth Rogoff and Carmen Reinhart, *This Time Is Different*, 2009

BULLS: SIT TIGHT AND ORDER UP ANOTHER LEMONADE

- **A tough winter means a beautiful summer.** Historically, some of the strongest growth in the economy and some of the best returns in the stock market have followed a recession. It isn't abnormal to see a choppy recovery, however. In the rally of 2009 and early 2010, investors lost sight of the fact that there will be bumps along the road and were shocked by the Greek debt crisis and other negative economic news.

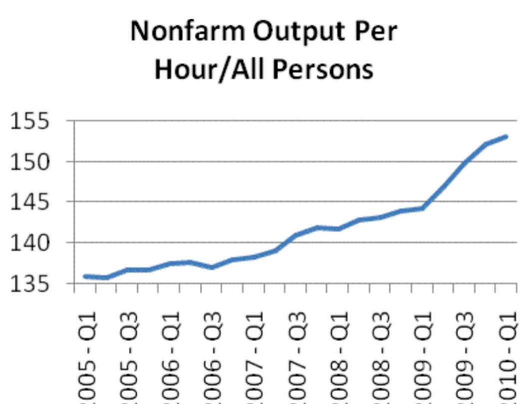
  Yes, we've seen a slowing of economic growth, but it hasn't stopped. GDP is positive, manufacturing is still expanding, and employment may be improving. The two graphs below illustrate why some bulls think the bears are overreacting.

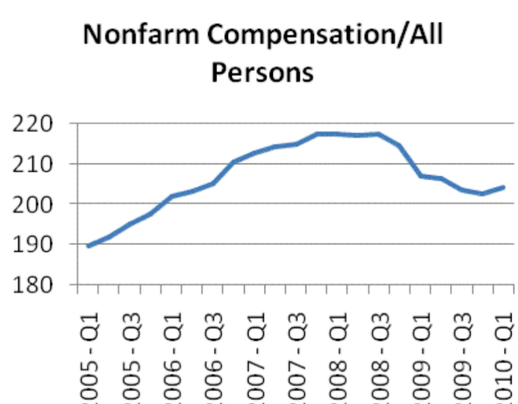




Source: Bloomberg

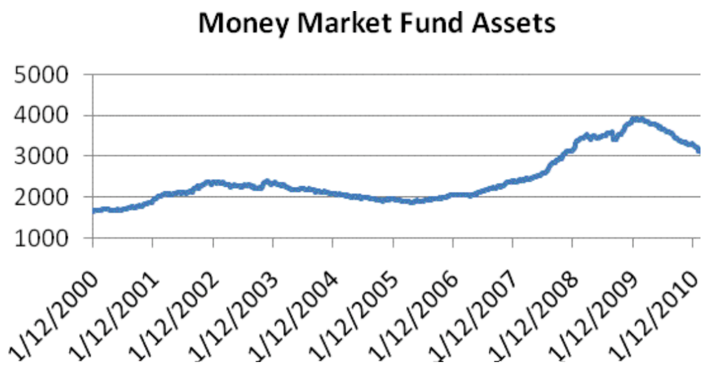
- **Stop looking at the clouds and you'll notice the sun.** You'd be hard pressed to find a time in recent history when U.S. corporations were in better shape than they are now. Balance sheets are flush with cash, which companies will ultimately have to reinvest, pay out in dividends, or use to make acquisitions. Earnings season is around the corner, and corporations seem set to report good news. If earnings don't disappoint, stocks will look cheap relative to historical averages. And with productivity increasing and labor inexpensive, it won't be long before corporations start to loosen their purse strings and hire new employees.





Source: Bureau of Labor Statistics/Haver Analytics

- **We've got the lake house—let's buy a jet ski, too, while it's cheap.** Because they fear temporary threats to the market, a lot of investors are still holding cash on the sidelines or are investing in bonds instead of equities. Once volatility is reined in and markets stabilize, bulls think that those scared investors will buy their way back in—and markets will take off.



Source: Bloomberg

ENJOY THAT LEMONADE, BUT KEEP AN UMBRELLA NEARBY!

So far, it has been a very confusing and stressful summer for investors. It is unclear whether the bears' structural risks or the bulls' cyclical recovery will triumph over the next few quarters. Despite the recent pullback we've experienced, the lightning is still in the distance and the sun is still peeking through the clouds. The best strategy is to focus on the long term, keep a diversified portfolio, and distance yourself emotionally from the market.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.*

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Authored by the Investment Research team at Commonwealth Financial Network.