Has the Market Rally Gone Too Far Too Fast?

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Back in the middle of May in our report titled, "What's with the stock market sell-off?," we discussed a number of issues that were weighing on the stock market. Although the S&P 500 index was down almost 5% from its early May peak, we suggested that the bears had it wrong. We argued that, while economic numbers were softening, they were not collapsing. Inflation was not out of control, for the commodity price spike led by oil was more speculative than fundamental and vulnerable to a serious correction. Moreover, in an economic slowdown, the Fed was unlikely to keep raising interest rates. We concluded that, "the market sell-off is more due to the fact that the strong rally left the global stock market overdue for a correction than any fundamental weakness. Global stocks remain attractively valued, earnings momentum is positive, and the long-term uptrend is still intact. Buy weakness!"

The S&P 500 proceeded to fall another 3% before bottoming on June 13th at 1224. The index then traded in a volatile sideways pattern until the middle of July, about the same time we issued another report titled, "Staying the Course! Overweight Global Stocks." In late July, we also increased our recommended allocation to both U.S and international stocks .

Our July report cited the long laundry list of global hot spots and bearish concerns that were worrying investors. However, we also observed that, "although the world has always been a dangerous place, the economy and financial markets have nevertheless managed to lurch from crisis to crisis in a steady upward progression. We believe this is likely to happen this time, too. In times of crisis, emotion often takes over. Fear dominates our thinking and can overwhelm decision making." We went on to say, "Given that the stock markets are oversold and sentiment is extremely negative, the opportunity for a strong rally in stocks is being created."

Almost on cue, global stock prices started moving higher. Rather than melting down, as some feared, they appear to be melting up. As of this writing, the S&P 500 index is up 13% from its lows, the NASDAQ 100 index is up over 20% from its lows, and the MSCI All Country World-ex U.S. index (net dividends) is up almost 20% from its lows in U.S. dollar terms.

Risk created opportunity

As is often the case, risk created opportunity. Investor concerns drove stock prices lower, as overreaction set the stage for a strong rally on good news. And good news there has been. As we expected, economic growth has moderated and Fed policy has stabilized. Bond yields have fallen, which makes bonds less attractive relative to stocks. Geopolitical risks have subsided as the situation in Lebanon calmed down. The UN at least appears to be taking a more aggressive stance with Iran and North Korea. The hurricane season has been a nonevent, oil prices have tumbled, and inflation expectations have declined. Third quarter earnings have also been impressive. Of the S&P 500 companies that have reported so far, 75% have had positive earning surprises. If this trend continues, the third quarter will be the fifteenth quarter in a row that analysts' earnings estimates were too low and the nineteenth consecutive quarter of double-digit earnings growth.

Given the strong rally in stocks, what is the current outlook?

The bad news is that the market has risen so far in such a short period of time that we believe investor sentiment has gone from extremely negative to extremely positive. While the market appeared to be poised for higher prices on good news back in July, it now appears to be vulnerable to bad news. Future gains should be harder to come by since so much buying power has been absorbed by the market. As economic growth has moderated, forward earnings projections have declined. If earnings growth slows,

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it will also be harder to push prices higher. Potential bad news could come from another round of tightening by the Fed, renewed concerns about geopolitical risks or rising domestic political uncertainty.

The good news is that stock valuations remain attractive. The P/E (price-earnings) multiple on the S&P 500 index is still below 15 times twelve-month forward earnings, leaving plenty of room for multiple expansion. We believe the economic environment is positive, with the most likely outcome being moderate growth and contained inflation, which should be favorable for earnings. The long-term trend in stocks is still positive, albeit overextended. In our opinion, the biggest risk to stocks from a fundamental perspective is that, if the economy is stronger than expected, the Fed could raise rates. This might be unsettling for bond and stock investors at least in the short term, but it could create another buying opportunity longer term. If we are wrong on the economic outlook, the economy is likely to be stronger than we expect .

The question we are weighing now is how overweight do we want to be in equities. Given our current large overweight position in stocks, at some point we are likely to take some money out of the market with the idea of possibly reinvesting it on a pullback or after the market consolidates.

Sources: Bailard Research, Oak Associates, Bloomberg,

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