With no end in sight, the stock market’s recent slide continued last week as investors expressed concern over the week-old government shutdown and looming debt ceiling crisis. Market volatility is growing in conjunction with concerns over the budget stalemate in Congress. While the Republicans are holding out against the Affordable Health Care Act, and the Democrats are unwilling to negotiate on the issue, markets are likely to see increased volatility this week. As with the 17 prior shutdowns, we do not anticipate a lasting impact on the economy or markets. As lawmakers dig in their heels, many of our clients are asking, what steps should be taken to weather what seems an unpredictable market?

The ongoing failure of any political party to budge is a major disappointment for the markets, and one that is likely to send stocks lower. House Speaker John Boehner has forewarned that the U.S. is on a collision course with credit default in an interview in ABC’s ‘This Week’ on Sunday. He stated "My goal here is to have a serious conversation about those things that are driving the deficit and the debt up. The President’s refusal to sit down and have a conversation about this is putting our nation at risk of default... it’s the path we’re on". On the other hand, President Barack Obama is refusing to negotiate over raising the debt ceiling and remains fervent in his opposition. Basically, the two sides are at war with each other over a relatively simple matter; our country spends more than it makes. Running a business in this manner eventually leads to bankruptcy or a defunct organization. Perhaps someone in Washington feels confident that this nation is “too big to fail.”

Let’s get back to the question of what steps should be taken to weather this market. Behind the scenes, the market fundamentals appear reasonable. The U.S. economy is growing at a 2.5% pace. Inflation is below the Fed’s target of 2.0%. However, this optimistic outlook on growth is being undermined with every passing day of the budget stalemate. Experts agree that GDP will be reduced by as much as 0.50 percentage points at the end of a two week shutdown. Based on the inflexibility out of Washington, stock prices may require more selling to gain the attention of pigheaded leaders.

So far, selling pressure has been rather benign; markets have remained resilient. Until there is obvious economic pain, don’t get excited about resolution. We anticipate a deal sometime between the end of this week and the October 17th U.S. Treasury deadline. The House Republicans are still hopeful that a grand bargain of some sort can be accomplished; it would potential proposals for entitlement reform, spending cuts and tax reform. It is probable to expect a discussion of grand bargains, but the outcome will be something of a compromise.

As for the markets and where they are headed, the rancorous debate in Washington has shaken investor confidence. In the short term, this means a bumpy ride for investors. Looking back to summer 2011, the S&P 500 reached a recovery high around 1,360 in May. The index then fell to the 1,260s in June as both parties refused any compromise. An optimistic bounce back to 1,350 as July got underway seemed to say everything is okay. Leading up to the debt-ceiling expiration, July 11, 2011, stocks held their gains through mid-month. Then, with eight days remaining until expiration, the bullishness turned bearish. Interestingly, the worst damage occurred after an agreement to raise the ceiling. The S&P 500 fell to 1,287 as the ink was drying on the bipartisan agreement, which contained tax hikes and the universally hated sequester for year-end 2012. From that 8/12/11 level, the index fell 150 points, to 1,119, by 8/8/13. The S&P 500 didn’t trade above its 200-day trend-line again until late-December 2011. What’s different about this time? During 2011, party leaders had some control of their members.

We continue to favor stocks, but note increased threats to the bull market as the Fed’s QE3 program draws to a close. Additional risks include economic concerns in Europe; federal budget levels in the U.S. and the ongoing government shutdown (now one week old), which could reduce GDP; the recent rise in gasoline prices, which could upset the domestic economy; and geopolitical threats in the Mideast. Despite the political acrimony in Washington, a fiscal agreement will likely come “in the nick of time” as it usually does. We reckon this to be a large assumption, but barring no resolution the U.S. economy should gradually improve as consumer and business spending advances at a moderate pace. Small business lending demand is growing and provides a solid indicator of things to come.
The economic outlook outside the U.S. is becoming stronger as Chinese growth is solidifying, Japan is in recovery mode and Europe is emerging from their multi-year recession. Even a moderately improving outlook should encourage investor confidence and propel the shift from bonds into stocks, post political wrangling. However, we view profits and economic growth as a bigger challenge to the outlook than the fiscal impasse or Fed tapering. Equities are currently 3% from all-time highs with little room for advancement without stronger growth, better earnings or a major policy surprise out of Washington. So far, the outlook for upcoming earnings is far from encouraging.

For now, the Fed’s decision not to taper its massive bond buying program ($85 billion per month) affirms their commitment to economic recovery. This unconventional method of keeping real interest rates artificially low favors the rise in equities; consumers consider this a means of increasing their wealth. This ostensible recovery is not sustainable and the Fed will have to taper at some point. Continuing to add $1 Trillion per year to their balance sheet will eventually lead to inflation, a tanking dollar and fewer companies willing to invest in the economy. Nonetheless, investor positioning and relative valuations reinforce our argument for overweight to equities, at least in the interim. Realizing our outlook could be too optimistic, we admit the global economy has not achieved escape velocity and is vulnerable to adverse shocks such as geopolitical turbulence and untoward political skirmishes. The U.S. economy continues to demonstrate impressive resilience in spite of continuing headwinds but all could be lost should the upheavals in Washington become more protracted. Either way you slice it, our country is highly levered and no one seems to be concerned with a very important question, how much can a levered economy stand?

We anticipate a continuing negative reaction to the government shutdown. However, we also see this as temporary assuming a compromise is reached within the next week. It is not unlikely for markets to continue moving lower following a resolution. Therefore, we have prepared to increase our exposure to equities as they reach more affordable price levels. Following the last government shutdown, occurring in 1996, markets rebounded over 10% in the following month. Should the government shutdown become more extended, we are prepared to lower our market exposure. The technical picture has deteriorated with a lot of negative divergences; our relative strength and MACD (Moving Average Convergence/Divergence) indicators began moving lower during July while stocks continued higher. Emphasizing this corrective action is the percent of NYSE stocks trading above their 50-day moving average; currently less than 50% of stocks are trading above their 50 day moving average.

POSSIBLE DOWNSIDE TARGETS – Looking at the S&P 500, daily chart, the index has slipped below its 50 day moving average as well as a rising trend-line which begins at the July intraday low. That would signal a potential drop 1627 (a drop of 6%). A further drop to its 200-day average (near 1600), or even the intraday low in June of 1560, wouldn’t be out of the question. This would represent a 10% correction from the S&P 500 intraday high recorded on September 19th. Market risk has increased since late September (VIX has risen more than 70%) but the longer range market trend remains positive. October has brought some of the market’s worst selloffs while providing some of the best buying opportunities.

Best Regards,

Phillip L. Clark, RFC
President/CCO

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