What is Holding this Market UP?

"With Europe in recession, China slowing and the U.S. economy limping along, it's hard to justify stocks being at multi-year highs, if not for the extraordinary support markets are getting from global central banks." a quote from Sharon Lee Stark, chief market strategist at Sterne Agee.

Over the medium and long term, financial markets are driven by the convergence of various fundamentals: economic growth, level of interest rates, earnings, monetary and fiscal policy. Over the short term however, <u>expectations of any one of these fundamentals can become the main driver of a market trend.</u>

Since June, the markets have been fixated on monetary policy to solve the weak global growth and have become convinced of (risen on) the hope of major stimulus action both from European Central Bank and US Federal Reserve. This past week, the ECB delivered, making a huge promise to print enough money to buy the government debt of any EU member struggling to fund itself (prevent default and lower borrowing cost). This promise is absolutely wonderful, but it is also totally conditional upon agreement to austerity measures dictated by the EU. Will Spain, Greece, and Italy adopt more stringent economic measures when their economies are already in a deep recession? Most agree they must. Stay tuned.

Back in the good old USA, the **employment data released today confirmed the job market is dead in the water**. Although the unemployment rated dropped from 8.3% to 8.1%, it was <u>due to a decline in the labor pool, not new jobs</u>, and **marks the 43rd consecutive month of unemployment above 8%.** But the markets continue to rise.

As an investor, the time horizon is much longer, and thus ALL of the fundamental drivers must be considered but the **most significant factor is growth of earnings. Without earnings growth, stocks are dead capital unless there is P/E expansion.** P/E expansion occurs when stock prices rise, not because earnings are higher, but because the <u>market is placing a higher multiple on future earnings.</u> The recent gains in the stock market have been just that, where multiples have expanded from 12x earnings to 14 x earnings (which is just about at historical average.) **In other words, the market is moving higher on hope of better things to come.** So the key question is: **Will all this stimulus provide the key ingredient to enable businesses to deliver better earnings next year?**

This past week, FedEx (FDX) announced an earnings warning for the quarter ending August 31, citing 'weakness in the global economy" as a reason for the revision. FedEx is considered a key leading "tell" for the global economy. According to Todd Schoenberger managing principal of The Blackbay Group, *' FedEx's warning was a portent of ill news to come.* ***Economic weakness is a given but the impact on corporate earnings has yet to be factored into the market.*** *FedEx could have figured out how to make the EPS look decent through "headcount reduction" (ie: firing* *people) or accounting fudges. The fact that they didn't is a sign that **weak revenues seen in recent earnings reports is finally hitting the bottom line.***

Stocks are not rational on a day-to-day basis but, eventually, earnings do matter. *It's nothing but hope propping up the market,* as Schoenberger sees it. Hope that all the Central Bank stimulus will keep earnings growing. *"When are we going to start talking about fundamental analysis again?" Schoenberger howls.... the markets don't seem concerned about FedEx, China, or anything else.*

Buying on 'hope' has been a profitable strategy for 2012 to date. Regardless of what any of us think stocks should do, over the short term, history suggests that betting against the trend is a losing play. Over the longer term however, the fundamentals will converge/collide and stock prices will reconcile.