Market Memo: Markets poised to move higher as correction ends

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Over the past three weeks, global equity markets have been battered by a seemingly endless list of bad news: unrest in Egypt, civil war in Libya, rising oil prices, and then the triple tragedy in Japan of a category 9.0 earthquake, a 30-foot tsunami destroying the coastline of northern Japan and taking more than 10,000 lives, and a near-meltdown in four nuclear reactors at Japan's Fukushima Daiichi nuclear power plant. All of these global events came against a backdrop of a market that was overbought near term, with too many "new normal" bears turned reluctantly into "recovery underway'' bulls. When Federated reduced its recommended equity exposure in its PRISM asset allocation model back in early February, we did so with this backdrop in mind, believing that because of these skittish converts, the market could be vulnerable to a near-term correction. With that correction now behind us, having dispatched many of the reluctant bulls and restoring to the market its necessary "wall of worry," we are reiterating our 1,450 year-end target on the S&P 500 and restoring much of the equity exposure we took down just six weeks ago by raising the equity overweight on our stock-bond model portfolio to 70% of maximum from the previous 50%.

Japan should recover; in the meantime, expect a new round of global stimulus

A key component of our re-risking call is based on our positive view on Japan, founded in part on our long study of its history, partly on our experience of having lived and worked there for several years back in the previous century, and partly on the cold hard facts in front of us. In the near term, until the Japanese get the Fukushima plant stabilized, a cloud of worry will shadow all else. However, while we are not nuclear physicists, it seems like the worse has now passed and the Japanese are close to getting the much-needed cooling systems there back up and running. In any case, with Japan's Special Defense Force and firefighters now fully engaged, and given the Japanese cultural trait to protect the group at all costs, we are confident that however dangerous the resolution may be, a positive resolution will occur. On other fronts, the economic losses from the quake have been estimated as anywhere from ½ of Kobe's $100 billion cost to double it; either way, the number is big but doable for rich and affluent Japan. Another issue is the near-term disruption to supply chains across Japan, power outages, etc.—we view all of these engineering problems as right in middle of the Japanese wheelhouse in terms of the kinds of problems they are expert at solving. Solve them they will. Meanwhile, the Bank of Japan is printing money to liquefy the system, and the government will most likely raise borrowings temporarily to fund the multibillion dollar rebuilding effort. So net net, while we expect Japanese GDP to take a short-term hit, over the next 12 to 18 months, we expect a relatively robust recovery there.

The Mideast remains a question mark, but seems to be moving in the right direction

As we write this, Allied forces are smashing Col. Gaddafi's military infrastructure, clearing a path for the Libyan rebel force to march on to Tripoli and potentially topple the regime. Soon after, expect the rebels to hook up the oil wells and start pumping to fund the government. The worst-case scenario for the global economy would be a protracted Libyan civil war, which could disrupt oil production at of the country indefinitely. The odds of this seem to have declined with last weekend's developments. This said, oil markets are likely to remain volatile on concerns of further spreading of Mideast unrest. However, as we wrote in a recent piece, we think the likelihood of unrest spreading in a meaningful way to the Kingdom of Saudi Arabia remain remote. So net, net, the marginal direction of change in the Mideast appears positive for markets.

The U.S. economic recovery appears to be gaining steam

As Phil Orlando has noted in his recent pieces, the flow of news on the economic side remains robust in the U.S., and we appear to be creeping towards our projected 300,000 net new monthly nonfarm payroll jobs by June. It is worthwhile noting that even as the news out of the Mideast and Japan has grabbed headlines, the U.S. economic numbers continue to print strongly, and most measures of business sentiment in particular remain strong. Credit markets in the U.S. have also been well-behaved, and corporate M&A, always a good signal of business confidence, has continued to roll along, most recently with this weekend's proposed ATT/T-Mobile combination. Then last Friday, the Fed finished its stress tests of the largest U.S. banks and cleared the way for the much anticipated resumption of dividend payments from this key component of the domestic equity market. We expect a reacceleration of U.S. and global growth later this year, driving earnings, and equity markets, higher. We continue to expect markets to end the year north of 1,450 on the S&P, and split our additional equity allocations in our stock-bond model between large-cap value stocks and international developed stocks because of the restoration of dividends by banks and the eventual rebuild in Japan. The allocations are coming out of our already large underweight position in U.S. Treasury securities, where we believe a rate-bottom may have been reached with the haven trade in the immediate aftermath of the Japanese temblor and tsunami, which pushed 10-year Treasury yields to 3-month lows.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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