Where to next for US markets?

Philip Petursson, Managing Director, Portfolio Advisory Group from Manulife Asset Management, shares his view on recent Fed comments on potential tapering of Quantitative Easing and looks at historical trends for clues as to where US markets are headed from current highs.

After reaching an intra-day high of 1687 on May 22, the S&P 500 Index retreated by as much as 5.3% on an intra-day basis through Thursday before reversing course to end the week with a modest gain of 0.8%. The bond markets were uncharacteristically more volatile with the US 10-year Treasury yield gaining 5 basis points during the week, 10 basis points on Friday to 2.17%.

"We could do it in the next few meetings."
- Ben Bernanke testimony to the Joint Economic Committee, May 22, 2013

Will he or won't he? That seems to be the question the markets are asking. 'He' being referenced is Federal Reserve Chairman Ben Bernanke. The action in question is towards Quantitative Easing (QE) and any potential change in policy. According to his testimony on May 22, Bernanke stated "With unemployment well above normal levels and inflation subdued, fostering our congressionally mandated objectives of maximum employment and price stability requires a highly accommodative monetary policy.

"At its most recent meeting, the Committee made clear that it is prepared to increase or reduce the pace of its asset purchases to ensure that the stance of monetary policy remains appropriate as the outlook for the labor market or inflation changes."

When asked when he expected to slow the monetary stimulus however, Bernanke threw markets for a loop by suggesting it could happen in as soon as the "next few meetings". Perhaps he was merely testing the waters. Either way, markets reacted. Equities retreated from their highs, and bond yields jumped to their current levels.

According to Dan Janis, Senior Managing Director, Fixed Income, with Manulife Asset Management, "We think it unlikely that Bernanke makes any changes to the current pace of stimulus this year. The Nonfarm Payrolls report on Friday showed 175,000 jobs were created in the month of May while the unemployment rate rose 0.1% to 7.6%.

"Given the Fed's mandate of low unemployment and moderate inflation, neither of which is the case today, it's not an obvious decision. If an announcement was forthcoming, it would likely happen in September and would have to follow improving economic data. With the full impact of the sequesters yet to flow through the economy, the more likely scenario is status quo. However, the market may do the Fed's job for it in terms of tightening with the longer end of the yield curve moving even higher from current levels."

In the meantime, the markets will continue to move on the news and react in an imperfect fashion.

Over the past couple of months conversations have, more often than not, turned to the longevity of the market rally and its sustainability. The common belief is that the strong rally in the S&P 500 Index over the past six months may give way to downside weakness. Contrary to popular belief, history has shown otherwise.

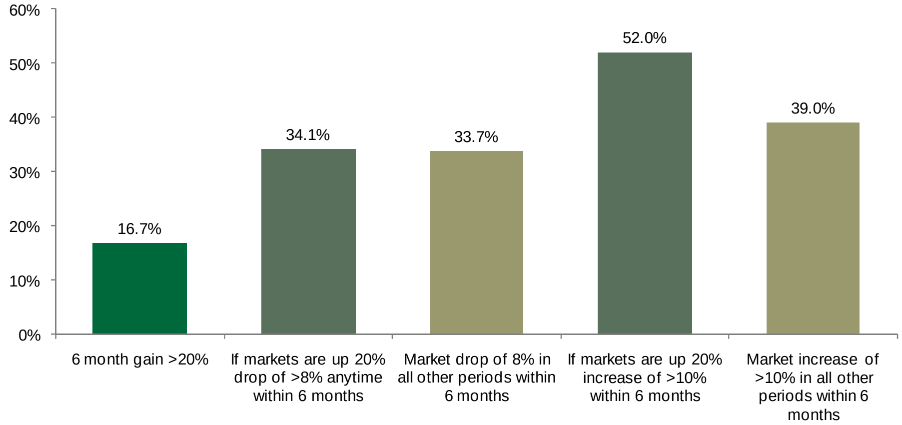
Looking back at the daily index level to 1927 I identified periods of gains of greater than 20% within a six month time frame, similar to what we have had over the last six months. The data shows that gains of 20% or more off of the low within a six month period are fairly rare, having occurred only 17% of the time. More interesting, however, are the results when looking at the six months following gains of 20% or more.

When the S&P 500 Index has gained at least 20% from the low within a six month period a pullback of 8% or more has occurred 34% of the time. In all other times the S&P 500 Index experiences downside of 8% or more 34% of the time within six months. The average downside within either period definition is 8%. The results would imply the downside risks are similar regardless of whether the market has rallied or not.

Further, the data would indicate that the upside risks are greater following a market rally. Using the same 20% threshold, the S&P 500 gains a further 10% or more within the following six months 52% of the time vs 39% of the time in all other periods. This suggests that we may yet see further upside to the current rally.

History is never a perfect guide and is no indication of future equity market performance. However, as an imperfect guide the right question to be asked might not be "how much of a drop can we expect" but rather "what further gains might we see."

Historical occurance of market events



Source: Bloomberg, Manulife Asset Management Calculations as of May 2013