PNC Advisors Expects Fed Easing to Come to a Close as Conditions Improve; - Market Insight: June 2001 -

PRNewswire

Passing the Baton From Rate Cuts to Tax Cuts

In an effort to cement a recovery, Federal Reserve policy makers reduced the target rate to a seven-year low of four percent at the May 15 meeting and left the door open for yet additional cuts. However, improving economic conditions suggest we may be close to the end of the rate cutting cycle and the Fed may be passing the economic stimulus baton from rate cuts to tax cuts.

Tax cuts equivalent to one percent of GDP are set to begin in the second half of 2001 and can help to offset some of the negatives facing taxpayers, such as high energy costs. The bulk of the tax cut is due to the cut in the bottom tax rate from 15 to 10 percent. About $40 billion is likely to be refunded by check in the third quarter, providing a sizable shot of stimulus, just as the Fed begins to slacken the pace of interest rate cuts.

Classic Recovery -- History Just Keeps Repeating Itself

The markets have exhibited signs of a classic recovery from a bear market. The combination of the Federal Reserve's aggressive rate cuts, coupled with the outlook for tax cuts, has bolstered investors' confidence. Historically, the average lag time between the beginning of the Fed easing cycle and the bottom in stock prices has been three months. The trend proved itself again this year, as the market bottomed on April 4 -- exactly three months following the first rate cut on January 3.

History also shows that, over the four Fed easing cycles during the past 25 years that included a fifth rate cut, the market always moved higher without looking back. On average, the market was up 30% one year later.

The rest of this quarter is likely to see continued inflows of cash from the sidelines. Investors will look at any small pullbacks as opportunities to deploy cash into the market. Until we get an earnings-driven bull market, the Fed has proven willing to provide us with a liquidity-driven one.

Earning Respect

PNC Advisors dropped its S&P 500 operating earnings target to $55 from $56, based on final numbers from the fourth quarter and first quarter reports. This change is also consistent with our continued outlook for flat earnings growth in 2001. Our S&P 500 year-end target remains 1450.

Earnings estimate reductions have abated in recent weeks after peaking in the first quarter pre-announcement period. The second quarter pre-announcement period should not result in the flurry of downward earnings estimate revisions and pressure on valuations that accompanied the first quarter, given that companies have lowered the bar sufficiently in the first quarter.

Fully Stocked

The steepening of the yield curve witnessed over the past two months is a classic sign of the end of a Fed easing cycle. Bond market participants have become more concerned with inflation than recession. Stocks should continue to outperform bonds over the next 12 months; however, the recent advance leaves stocks less attractively valued. Rather than increasing broad equity exposure, an increase in exposure to more aggressive sectors and industries may be warranted for certain types of investors. Economically sensitive growth and value stocks should outperform defensive groups.

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