

# The Oarsman Outlook

## Second Quarter 2009

What a difference four months make! The stock-market rally that began in March gathered momentum in April and May, and, after a flat June, major U.S. equity benchmarks finished the quarter up more than 15% – an astounding 35% or more above early-March lows. Gains were nearly universal, with small-company stocks, most non-U.S. markets, real-estate securities and commodity-linked investments all producing three-month returns in the +15% to +30% range.

Despite a headwind from rising Treasury yields (the 10-year note ended the period at 3.52%, up from 2.68%), most corporate and municipal bonds provided solidly positive returns for a second-straight quarter, as risk-aversion continued to moderate. Treasury Inflation-Protected Securities (TIPS) also gained as deflation fears receded.

Among U.S. stocks, the best-performing sectors were Capital Goods/Business Services, Transportation, Technology and Financial Services; stocks in the Consumer Staples, Health Care, Consumer Cyclical and Communication Serves sectors lagged the overall market averages.

### Benchmark Performance – Equities

	<u>Second Quarter 2009</u>	<u>Last Twelve Months</u>
S&P 500 Index	+15.9%	-26.2%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+16.3%	-25.9%
Small-Cap Stocks (Russell 2000)	+20.7%	-25.0%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+27.4%	-30.3%

### Benchmark Performance – Fixed Income

	<u>Second Quarter 2009</u>	<u>Last Twelve Months</u>
Barclays Intermediate Gov't/Credit Index (taxable)	+1.7%	+5.3%
Barclays Municipal Bond Index (tax-exempt)	+2.1%	+3.8%

## What's Changed?

We are adding a new piece – *What's Changed?* – to our quarterly letter; we hope it will help shed some light on the sometimes inscrutable internal dynamics of the stock market.

The **total return** from stocks decomposes into three components:

- 1) Dividend Income (quarterly; annual % divided by 4)
  - 2) +/- Change in Earnings Per Share<sup>1</sup>
  - 3) +/- Change in Valuation (Price/Earnings Ratio)
- = **Total Return**

So, *what changed* to produce the +15.9% three-month total return for the S&P 500?

Second Quarter 2009		
Dividend Income	+0.6%	+15.9%
+ Change in Earnings	+0.3%	
+ Change in Valuation	+15.0%	
=Total Return	+15.9%	

**Our read:** *Most of the quarter's gain came from a **Change in Valuation**. Over longer periods, earnings are the primary driver of stock market gains; we would like to see some "catch-up" in the earnings component in future periods.*

### Review

In a remarkable turnaround from the past 18 months, the April-June period saw a continuation of a powerful stock-market advance that began in mid-March, producing the best calendar-quarter performance for U.S. stocks since the final three months of 1998. To put the surge into perspective, the S&P 500 Index gained more in percentage terms in the 14 weeks beginning March 9<sup>th</sup> (+42%) than it declined in all of 2008 (-37%).

What propelled this tremendous rally? Was it some sort of "technical" anomaly, or can it be justified on a "fundamental" basis? To a degree, the rally can be understood as an all-but-inevitable "bounce" from an unsustainably negative environment. From mid-September, nearly every economic and financial-market indicator essentially went into free-fall; financial markets and important aspects of "real" economic activity were afflicted by crippling dislocations; near-panic prevailed on several occasions between September and November; while unrelenting pessimism accompanied the renewed February/early-March swoon. The suddenness and severity of the drop-off almost guaranteed a sizable gain would ensue *from some level* when underlying economic conditions seemed to be stabilizing.

Once ignited, however, a rally needs substantive fuel to take it beyond the "bounce" stage. And in fact, improvements across a range of indicators began to appear around yearend

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<sup>1</sup> *Forecast earnings for S&P 500 companies over next 12 months. Source: S&P Outlook*

and solidified during the spring. The most unequivocal improvement related to the perceived health of, and confidence in, the financial sector, as credit spreads and interbank lending rates plunged from the panic-induced highs of October/November. Bolstering a sense that things were on the mend were the mostly reassuring results of the Treasury Department's "stress tests" of major financial institutions, which paved the way for a series of successful capital-raising actions by prominent Wall Street and European finance firms. Outside the financial sector, a host of economic indicators that plummeted between September and January began to exhibit slowing rates of decline, leveling off, or even modest improvement; these included: consumer confidence measures, the index of leading economic indicators, purchasing-managers surveys, first-time and continuing jobless claims, and even residential real-estate sales volumes and prices. By June, Wall Street analysts' estimates of future corporate profits began to inch up for the first time since late 2007, suggesting a spreading perception that economic conditions had bottomed.

### ***Outlook***

The March-June stock-market rally seems to have been predicated not only on an end to the *financial* panic of late 2008, but also on the *economic* "green shoots" of early 2009. Accordingly, the ebb and flow of economic news may be more meaningful than usual over coming months, as it sheds additional light on the trajectory of the economic recovery and whether the resulting rebound in corporate profits will be sufficient to justify the substantial rise in stock prices.

With recent improvements, a number of important indicators of economic and financial-market health have returned to levels that prevailed prior to the mid-September collapse of Lehman Brothers, suggesting the "crisis" phase of the current economic downturn has run its course. However, recall that *prior to* the Lehman-triggered financial-sector meltdown, U.S. house prices had been declining for nearly two years, global stock markets had been falling for 10 months, and the U.S. economy – in recession for three quarters – had lost more than two million jobs (a tally that now stands above six million). So, even if many trends have stopped getting worse, depressed conditions are still prevalent.

Looking ahead, the bulk of the fiscal stimulus enacted in February is still "in the pipeline" and has yet to exert much influence on the economy. Moreover, firms have been aggressively paring inventories in recent months, while many would-be buyers have been "frozen" by scarcity of credit and/or lack of confidence. These trends should gradually reverse in coming months, which could result in a period (perhaps two quarters) of quite-strong growth and sharply improved earnings.

Beyond this temporary boost, however, the outlook is subdued at best. Most economists expect only gradual improvement in residential real estate and employment. With these key determinants of consumer confidence hobbled, the U.S. economy will remain fundamentally weak and any recovery fragile. Moreover, despite clear improvements in credit markets, the economy is confronted with what seems likely to be a protracted – possibly multi-year – period in which both lenders and borrowers are reluctant to increase debt. While the gradual de-leveraging this implies will eventually result in a fundamentally stronger, less debt-dependent economy, in the near term it will act as a further headwind to growth. In sum, while the economy is likely emerging from intensive care, it seems a safe wager that it is some ways from a return to full health.

As we noted in our April letter, we are mindful of serious longer-term challenges posed by government responses to the 2008-2009 economic collapse. Federal finances are on an unsustainable trajectory that is obviously exacerbated by current circumstances (even if it is fundamentally the result of ongoing political failure to reconcile long-standing spending/taxation imbalances). Nor is it at all clear that policymakers will be able to unwind their myriad market interventions without incident. At some point, global investors may begin to question the prudence of continuing to put faith in the government and corporate securities of such a feckless nation, leading to a currency crisis, soaring interest rates and plunging stock prices. However, any such assessment of the U.S. would have to be made *relative to other national economies/markets*, most of which (with some notable, primarily emerging-market exceptions) face even more vexing problems. Similarly, the unprecedented infusion of liquidity into the global economy over the past nine months might, at some point, ignite a pernicious rise in inflation. However, price pressures are as yet nonexistent; given the massive amount of slack resources in the global economy, inflation worries seem misplaced for the next few quarters, if not years.

While daunting challenges loom on the horizon, we worry about potentially detrimental hand-wringing regarding longer-term issues given the fragile present condition of the global economy. Economic history provides two distinctly unpleasant episodes – the U.S. in the late 1930s and Japan in the late 1990s – in which incipient concern about fiscal imbalances forced the premature reversal of stimulative government policies, resulting in renewed and prolonged economic weakness. Happily, Treasury yields have fallen noticeably in recent weeks, suggesting investor anxiety with these issues may be waning – *at least for now*.

Even if currency crisis, rising inflation and/or disastrous policy errors are avoided, the combined effects of wealth destruction and tight credit seem bound to constrain consumer spending for some time, making a lengthy period of below-average growth more than plausible. Though common stocks would still be likely to outperform other mainstream asset categories (e.g. bonds, cash-equivalents) in a slow-growth environment, the margin of outperformance might be narrower than in past decades, and so the reward/risk trade-off of investing in stocks versus lower-risk alternatives might be less compelling than we have come to expect. Accordingly, we believe it may be prudent, at the margin, to de-emphasize equities (especially low- and no-dividend “growth” stocks) in favor of high-quality corporate and municipal bonds and other income-generating vehicles (including common stocks with above-average dividend prospects).

As hinted at above, another characteristic of the current environment seems to be a new form of “decoupling” among national economies. As the U.S. and other developed nations struggle to overcome their well documented challenges, China, Brazil, India and certain other emerging economies that have been *relatively* insulated from the dislocations of the past year seem poised to take global economic “market share” at an accelerating pace. These bright prospects may be largely discounted in the strong recent performance of many emerging equity markets. Nevertheless, we believe this pattern could be more persistent than many investors anticipate, suggesting that, within the equity portion of an investment portfolio, it may be advantageous to make a relatively larger commitment to potentially decoupling emerging-market champions.