

The Oarsman Outlook

Third Quarter 2009

The global stock-market rally extended its run to seven consecutive months in the July-September period. Gains were broad based, with most equity benchmarks rising between 15% and 20%. Small-company and non-U.S. stocks, as well as real-estate securities recorded the strongest results. The third-quarter advance brought the cumulative rebound from late-2008 or early-2009 lows to greater than 50% for U.S. large-cap stocks, and better than 70% for domestic small-company stocks and a number of overseas markets.

Despite rising stock prices and improving economic conditions, fixed-income investments turned in a third-consecutive strong quarter. After an early-quarter spike, Treasury yields drifted lower through August and September; the 10-year yield ended the period at 3.30%, down from 3.52% on June 30th. Credit spreads (i.e., the difference between Treasury and corporate/municipal yields) also continued to narrow dramatically.

Among U.S. stocks, the best-performing sectors were Basic Materials, Consumer Cyclical and Financials; stocks in the Communications Services, Consumer Staples and Health Care sectors lagged the overall market averages.

Benchmark Performance – Equities

	<u>Third Quarter 2009</u>	<u>Year-to-Date</u>
S&P 500 Index	+15.6%	+19.2%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+15.1%	+20.7%
Small-Cap Stocks (Russell 2000)	+19.3%	+22.4%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+19.9%	+35.9%

Benchmark Performance – Fixed Income

	<u>Third Quarter 2009</u>	<u>Year-to-Date</u>
Barclays Intermediate Gov't/Credit Index (taxable)	+3.3%	+4.9%
Barclays Municipal Bond Index (tax-exempt)	+7.1%	+13.9%

What's Changed?

We recently added a new piece to our quarterly letters, called “*What's Changed?*” To give you a better insight regarding recent stock market performance, we can deconstruct the three-month return from stocks into three components:

- 1) Dividend Income (for three months this is the annual yield divided by 4)
- 2) +/- Change in Earnings Per Share* (average for S&P 500 Companies)
- 3) +/- Change in Valuation (Price/Earnings Ratio)

= Total Return

** based on forecast earnings for next 12 months (Source: S&P Outlook)*

So, *what changed* during the recent quarter to give us the +15.6% S&P 500 total return?

Third Quarter (July-September) 2009		
Dividend Income	+0.7%	+15.6%
+ Change in Earnings	+3.3%	
+ <u>Change in Valuation</u>	+11.6%	
=Total Return	+15.6%	

Our read: *Like the second quarter, much of the market's gain came from **change in valuation**. As noted in our “Outlook” comments below, we look for continued earnings improvement to become more important in the months ahead.*

Review

After an early-July dip of around 5%, stocks moved steadily higher through the rest of the quarter, with the Standard & Poor's 500 Index posting gains in nine of the quarter's last twelve weeks. The Index finished the quarter an astonishing 56% above its lowest closing level of the year (676 on March 9th), but still more than 30% below the October 2007 high. The speed and magnitude of the advance left many investors wondering how such a move could be squared against the myriad problems still facing the global economy and financial system.

However, although some highly visible statistics (e.g., the unemployment rate) are still getting worse, there has in fact been a steady and substantial improvement in a wide range of financial-market and economic indicators over the past six-to-eight months. Improvements have been most dramatic in the financial markets: liquidity conditions have eased dramatically, with credit spreads embedded in corporate bond yields and interbank lending rates narrowing nearly every week; corporate and municipal issuers (including some with below-investment-grade credit ratings) have successfully raised a near-record amount of debt financing and the equity-offering market (initial and secondary) has begun to show signs of life; measures of stock-market volatility (i.e., perceived risk) have declined markedly. With notable exceptions (e.g., the mortgage-backed and asset-backed securitization markets), large swaths of the financial markets have returned to conditions that prevailed in early- and mid-2008 (i.e., after mortgage-related problems had been recognized, but well before the near-

panic stage inaugurated by the collapse of Lehman Brothers). Many of the biggest banks have repaid the Treasury's "TARP" loans, and the recent suggestion that the nation's healthier banks should, in effect, bail out the FDIC seems noteworthy. The influential publication, *The Bank Credit Analyst*, recently noted that its proprietary Financial Stress Index had returned to a neutral reading after registering an all-time high amidst the late-2008 panic.

In the "real" economy away from Wall Street, signs of improvement have been widespread, albeit less profound. The index of leading economic indicators has advanced each month since May; purchasing-managers' indices have returned to "growth" levels not seen in over a year; job losses have slowed; and even house prices have turned up over the past three months. These and other data series indicate the recession likely ended during the early summer, and most economists now project substantially positive growth during the year's second half.

The bond market's behavior in the July-September quarter raises some questions. As noted, the most prominent feature was a continued narrowing of credit spreads – an expected response to improving economic data and receding risk-aversion. However, on top of narrowing spreads, "risk-free" Treasury yields *declined* during the quarter – perplexing given the other data outlined above. (Despite the three-month drop, however, Treasury yields have *risen* substantially from their late-2008 lows, more in keeping with other developments of the past six to eight months.) Two explanations can be offered for the third-quarter decline in yields. The more benign is that, despite an apparently improving economy, investors have grown less fearful of rising inflation that would force monetary authorities to hike short-term interest rates as early as the end of this year. The other, darker interpretation is that bond investors, unlike their stock-market counterparts, are not buying the recession-is-over story and believe the economy is headed for a "double-dip" downturn in 2010.

Outlook

Despite meaningful improvements, few would question the assertion that the global economy faces substantial near-term uncertainties as well as daunting longer-term challenges. With stocks up 50% in the past seven months, it seems prudent to wonder if markets have come too far, too fast. Skeptics argue that the astonishing rebound, *per se*, indicates investors are complacent and discount a "v-shaped" economic recovery and an implausible return to normal. While acknowledging the possibility that stocks may have gotten ahead of themselves, we would point out that prices remain 30% or more below late-2007 values, indicating that, globally, the present value of projected future profits is at least *15 trillion* (that's a "t") dollars lower than just two years ago. (As a reference point, the annual economic output of the United States – by far the world's largest national economy – is on the order of \$13 trillion.) Clearly, despite the recent rally, today's marked-down stock prices still reflect a substantially impaired economic and corporate-operating environment.

Aggregate valuation analysis also fails to reveal compelling evidence that stocks are overpriced. Prior to the current downturn, the S&P 500 (at around 1500) was trading at approximately 17 times expected earnings for the year ahead – a figure somewhat above the long-term average, but nowhere near levels seen in the late 1990s. Today, the market (at around 1000) is one-third lower, and expected earnings, too, have declined by around a third, leaving the "forward P/E ratio" in that same 17 range. An alternative valuation measure that

has gained currency in recent years, which divides the current index value by the *average actual* earnings of the *previous 10 years*, also shows the S&P 500 to be modestly above its long-term average valuation, but still cheaper than anytime since 1991 and *less than half* the level in 1999-2000.

With stocks seeming to be approximately fairly valued, we are monitoring three key indicators for clues to the near-term course of the markets: real-time economic data, corporate profits, and Federal Reserve rhetoric. Our latest “read” is that all three are currently supportive of the market’s rise.

The 4% sell-off triggered by disappointing purchasing-managers and employment reports released in early October suggests investors will be easily spooked by negative surprises in the economic data. However, the forecast for the next several months should, on balance, be relatively bright: previous inventory reductions and capital-investment deferrals should translate into reasonably healthy corporate-sector spending, while the renewed slide in the foreign-exchange value of the dollar will be a boon to the export sector. Moreover, substantial amounts of fiscal stimulus remain “in the pipeline,” poised to hit the economy in coming months. As noted above, most economists predict these boosts will be more than enough to offset the well anticipated drag from the consumer sector, leading to solid growth over the next two or three quarters.

As for profits, we noted in our “*What’s Changed?*” piece that recent stock-market gains have so far been accompanied by only modest improvement in earnings. We believe that a key to sustaining the rally will be a meaningful acceleration of profit growth. In stark contrast to consumers, the (non-financial) corporate sector appears to have emerged from the recession in a strong position, thanks to aggressive cost cutting and relatively judicious use of financial leverage (debt) since the last recession (2001). Profit margins have held up much better than the historical norm, with the result that average earnings, although down 30% or more from 2008, were above expectations in the first two quarters of 2009. Healthy margins and improving economic conditions will combine with easy year-over-year comparisons beginning in the fourth quarter; the result could well be a string of several quarters with profit gains in the 25%-30% range.

Finally, we are keeping our eye on the Federal Reserve. Investors are extremely anxious to see how (and how soon) central banks will “unwind” the massive stimulus injected into markets and economies in the wake of the recent financial panic. While the fragile recovery and continuing need to reduce financial leverage (debt) probably preclude any change in policy for at least the next couple of quarters, at some point the economy will need to be weaned off this monetary life support. In recent official statements, the Fed has explicitly pledged to keep interest rates at “exceptionally low levels” for “an extended period” (although the definitions of both “exceptionally low” and “extended” are subject to interpretation). In public comments over the past several weeks, however, Fed officials appear to have begun the process of “telegraphing” to the markets their intentions, long before any actual policy change is made. This is a delicate task: if economic actors become convinced policy will tighten too soon or too abruptly, the economic recovery could be dealt a major setback; conversely, if policy seems likely to remain too accommodative for too long, the economy could overheat, igniting a damaging bout of inflation, or a new financial-market bubble could be created. Recent declines in Treasury yields, and stock-market volatility

following disappointing economic reports, seem to indicate that market participants *currently* believe there is little chance of “too strong” growth leading to inflation and abruptly higher interest rates. Because this belief has the effect of keeping bond yields lower than they might otherwise be, *as long as the economic and earnings news remain broadly positive*, it could produce a near-ideal environment to sustain the stock market advance. But clearly the Fed has its work cut out over coming months if it is to keep investor attitudes in this relative “sweet spot.”

Given our analysis of the above factors, we would not be shocked to see stocks move sideways or higher in coming weeks, confounding calls for an imminent “correction.” The widely held view that a correction is overdue, low yields on competing investments, and the still-huge amount of cash sitting on the sidelines all reinforce our view that the current rally, although seemingly bound to moderate, may have yet to run its course.

As we have discussed in recent letters, beyond the next couple of quarters, stocks are likely to encounter headwinds presented not only by the prospect of rising interest rates, but also by longer-term uncertainties regarding fiscal imbalances, the evolving status and role of the U.S. currency, and perhaps a slowing pace of sustainable economic growth. Because these challenges are widely acknowledged, they need not represent insurmountable obstacles. But it seems plausible that they will act as a brake on stock market returns over the next several years. In such an environment, portfolio *balance* – including exposure to high-quality corporate and/or municipal bonds, U.S. Treasury-issued inflation-indexed notes (TIPS), and other investment categories whose returns are less correlated with those of the stock market – would be increasingly beneficial.