

# The Oarsman Outlook

**October 2011**

After an early rally pushed U.S. stock benchmarks near their 2011 highs in mid-July, global markets turned dramatically lower during the third quarter in response to a worsening European debt crisis and the inability of policymakers on both sides of the Atlantic to take meaningful actions to improve a dour economic outlook. Major U.S. stock indices fell by more than 10%, while non-U.S. stocks fared even worse, on average. Real-estate and commodity-related securities also posted substantial losses, though safe-haven seekers pushed the price of gold modestly higher. Slowing economic growth and spiking volatility in the prices of growth-oriented financial assets drove investors to the perceived safety of high-quality bonds, sending benchmark yields to near-all-time lows (the 10-year U.S. Treasury ended the period at 1.92%, compared with 3.16% at the end of June). Despite a widening of many credit spreads (typical in periods of heightened volatility), the decline in yields produced healthy returns for nearly all investment-grade bond holdings.

Among U.S. stocks, there was unusually great variation in returns by economic sector, with some areas barely touched by the downturn while others were hit particularly hard. Unsurprisingly, the best results came from the traditional ‘consistent-growth’ sectors comprising Consumer Staples, Health Care and Utilities stocks; however, Consumer Cyclical (read: Retail) and Technology stocks were also relatively unscathed. Industrials (both manufacturers and materials producers), Energy and Financial Services stocks were, on average, much weaker. Small-company stocks fell somewhat more than those of large firms, while “growth”-oriented stocks, as a group, outperformed those in the “value” category.

## **Benchmark Performance – Equities**

	<u>Third Quarter 2011</u>	<u>Last Twelve Months</u>
S&P 500 Index	-13.9%	+1.1%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-15.1%	-1.5%
Small-Cap Stocks (Russell 2000)	-21.9%	-3.5%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-19.7%	-10.4%

## **Benchmark Performance – Fixed Income**

	<u>Third Quarter 2011</u>	<u>Last Twelve Months</u>
Barclays Intermediate Gov’t/Credit Index (taxable)	+2.7%	+3.3%
Barclays Municipal Bond Index (tax-exempt)	+3.8%	+3.9%

## Review

The sharp market downturn that began in late July came in reaction to heightened uncertainty surrounding the European debt crisis as well as a (not entirely unrelated) worsening outlook for global economic growth. Despite a late-July agreement to increase the fire-power and flexibility of the European Financial Stability Facility (EFSF), the situation in Europe deteriorated, as attention shifted from a likely Greek default to fears of insolvent banks and renewed recession. The exceptionally inept handling of the U.S. debt-ceiling end-

game, culminating in Standard & Poor's rating downgrade of American Treasury debt in early August, compounded a worsening economic picture that had been developing since spring.

Despite policymakers' frustrating inability to agree on actions to spur growth, economic statistics and anecdotal reports seemed to indicate that American consumers and business owners were taking the renewed financial-market turmoil somewhat in stride. Nevertheless, during the quarter, an increasing number of economic forecasters began calling for a return to recession at home, while a similar outcome in Europe was deemed a foregone conclusion. To make matters worse, data from key emerging markets (notably, China and Brazil) indicated that the lone engine of global growth was beginning to slow in response to anti-inflation policy tightening.

With U.S. stock prices falling some 15%, most overseas markets down considerably more, and volatility skyrocketing, the financial-market scene was, from time to time, unsettlingly reminiscent of the near-panic that prevailed during portions of the 2008-2009 financial crisis. As in that earlier episode, market declines were paced by the shares of financial institutions, particularly large European banks, some of which lost 40% or more of their value in a matter of weeks. At the same time, interbank lending rates spiked, suggesting fears of illiquidity (or worse) among the world's bankers. This pattern reflected concern that the debt crisis, particularly as it appeared to spread beyond Greece to Spain, Italy and even France, was beginning to undermine the global financial infrastructure in much the same way that the failure of Lehman Brothers threatened in September 2008.

With elected officials unable to act decisively, that role fell to the world's central bankers. The European Central Bank somewhat reluctantly waded into the debt crisis, providing the continent's banks with liquidity and buying non-peripheral (e.g., Italian and Spanish) government debt in an effort to hold down interest rates that had begun to spike on all but the safest (e.g., German) bonds. The U.S. Federal Reserve Board, which unlike its European counterpart has an explicit mandate to support economic growth and employment, was less timid. First, the central bankers made a highly unusual announcement interpreted by most observers as a pledge to keep short-term interest rates near zero for the next two years. Later came a new easing policy, dubbed 'Operation Twist,' designed to push down the longer-term bond yields used to set many consumer interest rates, notably those on mortgages and home-equity loans. Though internal disagreements prevented even stronger actions some market participants seemed to be hoping for, the Fed's actions were probably instrumental in lowering bond yields yet again to near record-low levels.

## What's Changed?

To provide 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 four)
- 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 -13.9% S&P 500 total return?

Third Quarter (July-September) 2011		
Dividend Income	+0.6%	-13.9%
+ Change in Earnings	+2.7%	
+ <u>Change in Valuation</u>	<u>-17.2%</u>	
<b>= Total Return</b>	<b>-13.9%</b>	

**Our read:** *Wall Street analysts appear overly optimistic about future earnings; the market's third-quarter nosedive suggests they will lower estimates, perhaps significantly, in coming months.*

### Outlook

As when we wrote following the April-June quarter, the immediate market outlook is dominated by the European debt situation. Though a recent vote in the German parliament seemingly paved the way for the EFSF-enhancement to be implemented during October, many observers believe that even a bolstered EFSF will be insufficient to put the crisis to rest. Accordingly, at least one more round of negotiations and subsequent tweaks to the rescue program seem likely in coming weeks. Meanwhile, market sentiment will likely ebb and flow, with investors alternately pessimistic and hopeful that policymakers have both grasped the seriousness of the problem and reached agreement on the required course(s) of action. Unfortunately, the political risks and complexities involved in reaching consensus among all 17 Euro-member nations may mean that a market meltdown worse than we've seen to date may be necessary before truly effective action is taken. Stay tuned.

If and when the European crisis can be successfully wound down, markets will be confronted with the unpleasant possibility that months of heightened uncertainty and volatility have tipped a fragile global economy back into recession. On this score, recent U.S. statistics (an upward revision to second-quarter GDP, falling claims for unemployment benefits, robust durable goods orders, and an up-tick in supply-managers surveys) have been mildly encouraging, suggesting a continuing slow-paced expansion is perhaps the more likely outcome. Europe, on the other hand, is almost certainly headed for at least a temporary contraction, while Japan's economy will gain only a temporary boost from post-earthquake reconstruction, and that improvement comes from a weak base. As noted above, authorities in key emerging markets have spent much of the year tightening monetary policy to stave off incipient inflation; unfortunately for the global economy, it appears these policies – combined

with weak demand in key export markets – may now be coming to fruition in the form of slower growth.

A worrisome component of the outlook is that fiscal (i.e., spending and tax) policy in both the U.S. and much of Europe is turning decidedly contractionary at a time of weakened private-sector demand. In Europe, the list of nations adopting austerity measures seems to grow each week. In the U.S., barring agreement on new spending and/or tax-cuts in coming weeks, already-programmed spending cuts and tax increases are slated to subtract as much as two percentage points from economic activity in 2012. And if the debt-reduction ‘super-committee’ fails to meet its mandate to reduce deficits by some \$1.5 trillion, additional ‘automatic’ spending cuts loom in 2013. Though there is an economic school that advocates such austerity as a means of boosting business and consumer confidence, it is difficult to see where near-term growth will come from when both public and private sectors of most developed economies are simultaneously tightening their belts, and many emerging market nations are purposely trying to curb demand with tight monetary conditions.

On the positive side, the downshift in global growth in general and emerging-market manufacturing output in particular continues to put downward pressure on the prices of many industrial commodities, including oil, which is more than 35% below its April peak. And as noted above, the combination of slowing growth, investor flight to safety and new Federal Reserve policies has pushed interest rates to yet lower levels. These developments improve prospects for spending and investment by both households and businesses, though until confidence picks up (primarily a function of trends in the real-estate and jobs markets) the impact is likely to be muted.

As noted in the *What’s Changed?* box above, the third-quarter decline in stock prices coincided with a small increase in analyst projections for company earnings, with the result that valuation improved substantially. While estimates seem likely to fall in coming weeks (Wall Street analysts are often slow to incorporate macro trends in their company-specific models), recent, reasonably up-beat company announcements suggest the near-term downside may be fairly limited. Moreover, the stock prices of economy-sensitive companies – those whose earnings prospects are most prone to be down-graded due to weak demand – have fallen much more than those of less cyclical names, suggesting investors have already discounted substantially lower profits for such firms (see table below).

Valuations fall among ‘Cyclical’ companies (*top half*), but remain stable for ‘Consistent Growth’ (*bottom half*)

Company	- June 30 <sup>th</sup> -			- September 30 <sup>th</sup> -			Three-Month Change in P/E
	Price	EPS est.	P/E	Price	EPS est.	P/E	
<b>Regal-Beloit</b>	\$67	\$4.63	<b>14.4</b>	\$45	\$4.38	<b>10.4</b>	-28%
<b>Emerson Electric</b>	\$56	\$3.87	<b>14.5</b>	\$41	\$3.66	<b>11.3</b>	-22%
<b>Caterpillar</b>	\$103	\$6.91	<b>15.0</b>	\$74	\$6.60	<b>11.2</b>	-25%
<b>Kimberly-Clark</b>	\$67	\$4.85	<b>13.7</b>	\$71	\$4.86	<b>14.6</b>	+6%
<b>Coca-Cola</b>	\$67	\$3.86	<b>17.4</b>	\$68	\$3.86	<b>17.5</b>	+1%
<b>Wal-Mart</b>	\$53	\$4.47	<b>11.9</b>	\$52	\$4.49	<b>11.6</b>	-3%

With valuations falling, we think the U.S. stock market is beginning to offer some attractive bargains, approaching those available near the lows of late 2008 and early 2009: stocks of world-class companies (like DuPont, General Electric, and Intel) selling at 10 or 11

times projected earnings and sporting cash dividend yields in the vicinity of 4%. The dividends look especially compelling: they begin at rates above those currently available on comparable-quality bonds, and have a reasonable likelihood of growing over time.

If U.S. stocks are beginning to look attractive, the bargains verge on eye-popping overseas. Substantially larger price declines in Europe have brought that region's 'cyclically-adjusted P/E ratio' (i.e., current prices divided by 10-year average earnings) close to the lows reached in early 2009, with dividend yields of 5% being common. Meanwhile, most emerging market stocks have been battered as much or more than those in Europe, even though emerging economies, as a group, have stronger underlying fundamentals that include trade surpluses, ample foreign-reserve stockpiles, and low levels of government debt, to go along with superior growth prospects.

President Kennedy once famously remarked that the Chinese translation of 'crisis' combines two characters: one representing 'danger' and the other 'opportunity.' Despite abundant economic uncertainties and unsettling market turbulence, rarely have we been more confident that carefully selected stock investments made near current prices will reward patient investors with long-term returns substantially above those offered by popular 'low-risk' alternatives like money-market funds, bank certificates of deposit and U.S. Treasury notes.

We encourage you to let us know if you have questions about our management of your investments.

Sincerely,

Alan Purinton, CFA  
Principal & Portfolio Manager

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