The Oarsman Outlook

Fourth Quarter 2009

Following 2008's horrific declines, every major investment category recorded strong gains last year. Domestic stock benchmarks rose 20% or more, real-estate and commodity-related securities posted gains of 30% to 40%, and many non-U.S. equity markets surged more than 50%. In the fixed-income market, gains were strong and broad-based, with many corporate and municipal bonds posting double-digit gains; practically the only losses to be found were among the safest of safe-havens: longer-term U.S. Treasury notes and bonds, whose value fell as yields rose from the abnormally low levels that prevailed at the end of 2008 (the 10-year Treasury yield, which began the year at 2.24%, finished at 3.83%).

Among U.S. stocks, the strongest 12-month gains came from those in the Basic Materials, Capital Goods, Consumer Cyclical, Energy and Technology sectors; more modest but still positive returns came from Communications Services, Consumer Staples, Health Care and Utilities. Financial Services were a wildly mixed bag, with many "too-big-to-fail" banks and insurance companies producing triple-digit gains, while some "too-small-to-bail-out" concerns saw their stock prices decline by half or more. Small-company stocks performed slightly better, on average, than the blue chips. Overseas markets, with the notable exception of Japan, mostly outpaced the gains from domestic stocks, with especially strong results coming from emerging-market heavies like China, Brazil and India – each up more than 75%.

Benchmark Performance – Equities

	Fourth Quarter 2009	Last Twelve Months
S&P 500 Index	+6.0%	+26.4%
Dow Jones Industrial Avg.	+8.1%	+22.7%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+5.6%	+27.1%
Small-Cap Stocks (Russell 2000)	+3.9%	+27.2%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+3.6%	+41.0%

Benchmark Performance – Fixed Income

	Fourth Quarter 2009	Last Twelve Months
Barclays Intermediate Gov't/Credit Index (taxable)	+0.3%	+5.2%
Barclays Municipal Bond Index (tax-exempt)	-1.4%	+12.2%

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 4)
2) +/- Change in Earnings Per Share* (average for S&P 500 Companies)
3) <u>+/- Change in Valuation (Price/Earnings Ratio</u>)

= 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 +6.0% S&P 500 total return?

Fourth Quarter (October-December) 2009		
Dividend Income	+0.5%	+6.0%
+ Change in Earnings	+10.2%	
+ <u>Change in Valuation</u>	<u>-4.7%</u>	
=Total Return	**+6.0%**	

Our read*: Unlike the second and third quarters, the market's late-year gains came entirely from rising earnings (in fact, the contribution from valuation was negative; i.e., valuation* <u>*improved*</u>*). These are welcome developments that we think could be sustained in the months ahead.*

<u>Review of 2009</u>

Looking back, 2009 divides into three distinct periods: January through mid-March, which saw the culmination of the crisis/panic inaugurated by the collapse of Lehman Brothers in September 2008; mid-March through approximately July, during which it gradually became clear that the worst of the economic implosion had passed and the operation of financial markets improved steadily; and August through yearend, as economic data began to improve (as opposed to merely getting worse at a decelerating rate, which for a while qualified as good news!), and many observers began to opine that the recession had probably ended during the summer.

As the perceived level of risk diminished, the value of all but the safest financial assets rose substantially. Stocks gained 60% or more from their early-March lows. The change in (non-government) bond markets was perhaps even more dramatic, with many lower-quality and high-yield ("junk") bonds providing gains that exceeded those of stocks. Although many investors remained justifiably skittish throughout the year, near-zero yields offered by safe-haven investments encouraged a gradual return to risk-taking, fueling the powerful advance.

The 2009 rally seems sure to go down in history as one of the most distrusted in memory. After the carnage of 2008, there was a near-universally held notion that 2009's gains were being built on shaky foundations. The financial media contained so many stories identifying new "bubbles" sure to deflate in short order that *Barron's* stock-market writer Kopin Tan quipped that the only sure bubble was in bubble-calling. Mutual fund statistics indicated retail investors sold stocks into the rally month after month – highly unusual in an upward moving market. On the year, $11 billion exited stock funds, while bond funds collected more than $350 billion. Institutional investor "sentiment," though noticeably less bearish than early in the year, remained relatively cautious after six, seven and even eight months of rising prices (at an October conference, only 44% of managers polled were overweight stocks *vis a vis* their benchmarks).

Despite the year's solid gains, U.S. stock benchmarks ended 2009 more than 25% below the peaks reached in 2007. Moreover, as widely reported, 2009 capped a trying decade: the broad U.S. stock market (S&P 500 Index), having begun the period at an overvalued extreme following the late-1990s growth-stock bubble, produced a cumulative 10-year return of *minus* 9.3% (including dividends). However, too much emphasis on this ugly statistic seems inappropriate, as most investors had at least some holdings of corporate, municipal and/or Treasury bonds, small-company and non-U.S. equities, real-estate and commodities, all of which provided substantially positive 10-year returns.

Outlook for 2010

If 2009 marked an important inflection point between financial/economic crisis and stabilization, 2010 seems likely to be a year of becoming comfortable with the trajectory of the post-crisis economic recovery and new price-levels in financial markets. If that process goes without too many hitches, investors may also find time, as the year progresses, to begin worrying about daunting longer-term problems that confront the economy and markets.

Despite still-widespread skepticism, most of the elements that supported the markets over the past 10 months – very low interest rates, improving economic news, the prospect of rising profits – seem likely to persist through much of the new year. The Federal Reserve has repeatedly communicated a firm belief that the fragile economic situation calls for an extended period of unusually low interest rates, and most observers believe that it will be the second half of 2010 or later before the Fed feels comfortable nudging short-term rates higher.

At the same time, the economic news should continue to brighten. (Despite still-gloomy unemployment reports – almost always a lagging indicator – practically every economic statistic we follow improved markedly during 2009, with the gains becoming more consistent after around August.) A substantial portion of the $787 billion federal stimulus package passed in February 2009 will continue to flow into the economy during the first half of 2010. Meanwhile, normal, cyclical rebound mechanisms will likely bolster growth: companies will rebuild depleted inventories, postponed capital expenditures will be implemented, and any upturn in business volumes should spur new hiring, given the massive layoffs of the past two years.

The outlook for corporate earnings is also quite solid. As we have noted previously, the business sector responded to the economic downturn (and perhaps to an even greater degree the financial panic) by rapidly and aggressively cutting costs (including labor) and investments. As a result, profit margins remained unusually high even as sales declined. With the likely resumption of revenue growth over the next couple of quarters, earnings seem set to rise fairly dramatically in a wide range of industries. Although they are known as an optimistic bunch, the individual-company analysts at Standard & Poor's project a year-over-year jump of around 35% in profits at the large companies that make up the S&P 500 Index.

Another positive, reflecting lingering investor caution, is the huge amount of cash currently “on the sidelines” in short-term deposit accounts. At nearly $10 trillion, this figure is up more than 25% since 2007 and currently represents an unusually high proportion of total financial assets. This “cash mountain,” like another that accumulated during and after the disappointing stock-market results of the 1970s, represents a huge source of potential demand for riskier investments like corporate bonds, stocks, commodities and real estate: each month of improving economic news and falling market volatility is likely to entice more investors to embrace incremental portfolio risk in search of yields higher than 0.01%(!).

Finally, although 2009’s advance means stocks are no longer the bargain they were 10 to 14 months ago, valuation seems far from extreme. Having reached a multi-decade low of less than 11-times forward-12-month earnings in February, the S&P 500 Index finished the year valued at around 15-times projected earnings for calendar 2010. While marginally above the long-term average, this seems appropriate given currently low levels of inflation and interest rates. The 10-year-trailing P/E favored by Yale economist Robert Shiller paints a similar picture: the latest reading of 20.1 is well above the March nadir of 13.3, but remains lower than at any time since 1992. Perhaps noteworthy from a risk-control perspective, both forward and trailing-10-year figures remain far below levels that prevailed at the end of the bull markets of the 1990s and 2003-2007.

The foregoing suggests to us that for a good part of 2010 the path of least resistance for stocks may be a continuation of 2009’s gains. Nevertheless, after a remarkably smooth 10-month climb, a garden-variety correction of -10% to -15% is beginning to seem overdue. (The current rally has seen four dips of 5% to 7%, all of which were followed by new post-crash highs.) Despite the positives cataloged above, few would argue there is a shortage of acknowledged worries (not to mention the omnipresent potential for unpleasant *surprises*) that could set off such a fall. The market will face an interesting test the next time a decline reaches the psychologically important 10% threshold. The past year suggests that, at that point, many seers will emerge calling for a crash to new lows. While, obviously, specific circumstances will inform our reaction, we would be inclined to be skeptical of such visions.

One final note: the history of investment returns – though a limited data series – <u>suggests</u> the miserable, decade-long under-performance by large-company U.S. stocks sets the stage for better performance in the years ahead. It seems prudent to maintain substantial exposure to this investment category, despite the plausibility of calls for a “lost decade” of sub-par economic growth and (even longer-term) horror stories of fiscal Armageddon and out-of-control inflation. But we are also mindful of the <u>proven</u> benefits of multi-asset-class diversification, and believe the years ahead will continue to reward a balanced approach that is not too reliant on any single investment category. In particular, we remain favorably disposed toward investments that provide relatively direct exposure to vibrant overseas economies that seem to face fewer of the long-term challenges confronting the U.S., Japan and much of Europe. The gradual, long-term shift of global economic might from the “developed” to the “developing” world has only been accelerated by events of the past two years. And while that fact seems at least partially reflected in today’s prices, we believe this is a trend with multi-decade implications.