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## Letter From The Portfolio Manager

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May 2009

### ***Has The Train Left The Station?***

*Is it too late to climb aboard the stock market rally, or can it continue?*



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The U.S. stock market's gain in April was its best monthly gain in nearly twenty years. Combined with a sharp three-week rally that finished the month of March, as of April 30, the broad market, as defined by the S&P 500 Index, is now up nearly 35% off its intra-day lows set only seven weeks ago on March 6<sup>th</sup>.

Given these sharp gains, everybody is wondering if the market recovery can continue. In other words, has the train already left the station? The intense gains of recent weeks aren't the only concerns that investors currently have. Other top of mind concerns include weak economic growth, continued troubles in the auto industry, a potential pandemic, and even the old market chestnut of "Sell in May, Go Away."

Despite these concerns, we retain our optimistic market outlook. While we recognize that anything can happen in the near term, and given continued elevated market volatility and investor emotion that could even mean a move back to, if not through the March lows, there are still some powerful reasons why equity investors should stay the course. If investors are not in the market, we recommend that they set up a plan to do so.

In this month's commentary, we will address the reasons we remain fairly upbeat. We will also comment on some of those concerns we listed above which are still keeping many investors on the sidelines.

### **Why the Market Can Keep Running**

#### **Investor Sentiment Remains Fairly Negative**

It has been said that bull markets, especially new-born bull markets, climb a "wall of worry." Despite strong gains in recent weeks, most investor sentiment surveys continue to be bearish. Most investors simply don't believe that the market can sustain the current rally. That's fairly remarkable. Generally speaking, investor sentiment tends to track price action fairly closely (albeit lagging), though this time it appears various concerns have prevented investors from actually recommitting to the market. Whether one measures what investors are saying or doing, investors remain worried that gains will not stick. Historically speaking, an imbalance of bearish opinion is typically a bullish signal for market direction.

One more point about sentiment. As of this writing, there are some loud voices that are currently saying "everybody is bullish." We simply don't agree. Sentiment and asset allocation surveys still reveal a mostly bearish mindset. Besides, for those who are actually bullish at present, most seem to say "bear-

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market rally” and don’t necessarily believe that we are at the beginning of an epic, multi-year bull run. To restate, this means that many investors who are actually positive on the market don’t necessarily have a lot of conviction. We believe this confirms our view that most market participants still doubt the rally. The wall of worry continues to stand tall.

### Corporate Earnings Are Coming In Better Than Expected

During the last few earnings seasons, earnings misses and negative guidance torpedoed the stock market. This earnings season, however, has been different as corporate earnings are actually coming in better than expected – or at least “less bad” than expected. Two out of three companies are beating expectations, and guidance for future quarters has generally been a lot less negative than it has been in recent quarters.

If the economy is indeed bottoming, then it should not be surprising that earnings are better than what many investors expected. That’s because earnings expectations tend to become too pessimistic near economic troughs. Add all these factors up, and earnings growth for 2009 could even end up looking kind of gaudy – even if GDP growth is below long-term averages (more on that later).

Currently, 2009 *reported* earnings (what gets reported to the taxman) for the S&P 500 are expected to grow over 90% from 2008 levels. And there is a good chance the numbers could be even better than that. However, this number should be taken with a grain of salt, since reported earnings numbers can sometimes be a bit whacky, especially during economic inflection points.

For an arguably better look at earnings growth, one could look at *operating* earnings. Operating earnings exclude one-time or other extraordinary items from the income statement. Though there are critics of operating earnings (the charge is that companies seem to have *one-time* write-offs *every* year), at least they tend to offer a less volatile read on corporate health and can ultimately provide a reliable read on underlying growth trends over time. Operating earnings for 2009 are expected to be more along the lines of 20% higher than 2008.

### While Higher, Valuations Are Still Attractive

Another bullish factor is valuations. While admittedly valuations are not nearly as attractive as they were at the beginning of March, the market is still cheap on a long-term basis. Using a five year average price/earnings ratio (to smooth out earnings peaks and troughs) we find that, even after the sharp rebound in prices, valuations remain well below the 50-year average, and suggest that the market is still approximately 30% undervalued.

### The Wall of Worry

Nonetheless, there are real concerns out there that are keeping many investors on the sidelines.

### Weak Economic Growth

The initial estimate for first-quarter GDP (Gross Domestic Product), released in the last week of April, was far worse than most had expected. The number came in at an annualized rate of decline of 6.1%, essentially matching the 6.2% decline in the fourth quarter of 2008, and well below the consensus expectation of a 4.7% drop. The largest hits to GDP were in business investment, inventories, home building, and government spending. Over-all, it was an ugly number.

That said, there were clearly some positive aspects to the report. First, consumer spending was positive and grew at its fastest levels in two years. The consumer may be weakened, but apparently isn't dead quite yet.

Second, much of the weakness came from a drop in business investment and a reduction in inventories. (Sales from inventory are not included in GDP, because products in inventory were produced, and counted in GDP, earlier.) However, a reduction in inventory is a positive for future GDP growth, especially with consumers spending more than expected earlier. When inventories are low, a pick up in demand is more likely to translate into increased production and business investment.

Third, it was somewhat surprising to see that government spending actually had a significant negative impact on GDP. This was mostly due to a sharp drop in defense spending. We think it is unlikely that government spending will continue to be a drag on GDP given the aggressive fiscal policies already put into place.

It is also useful to remember that the "headline" losses for GDP are more sensational than actual economic losses. That is because changes in quarterly GDP figures are reported as annualized figures. Real GDP did not actually drop 6% in the first quarter, but instead fell by about 1.5%. If that rate of decline persisted for the whole year, then GDP for 2009 would end up a little over 6% less than in 2008.

To re-state, the economy *did not* contract 6% during the first three months of the year. In fact, real GDP is now down only about 3% from its all-time high reached in the second quarter of 2008. And "nominal" (i.e., not adjusted for inflation) GDP is down only about 2% from its all-time high recorded in the third quarter of 2008 — a drop in our economy from \$14.3 trillion to \$14.1 trillion.

While GDP is still likely to contract further, the declines are nowhere near the massive losses witnessed in the depression in the 1930s, a period many investors are using as a comparison to the current environment. In the 1930s, nominal GDP dropped by nearly 50% while real GDP dropped nearly 30%.

Instead, today's GDP declines are more similar to 1982 in terms of real GDP and 1958 when one looks at nominal GDP contraction. Tough times for sure, but nothing like the Great Depression.

Coincidentally (actually it is not a coincidence at all), the years 1958 and 1982 were both excellent times to buy stocks.

### **Sell In May, And Go Away?**

Another concern is the perceived negative **seasonal pattern** in the stock market from May until the fall. The old saying is “Sell in May, and Go Away.” While historical data does indeed show that the winter months (November to April) tend to provide higher returns than the summer months (May to October), it is important to note that the summer months still tend to produce positive returns!

In addition, when just focusing on the month of May itself, the market’s performance in that month tends to reflect the trend of the market heading into May. In other words, if the market is trending higher heading into May (as it was this year), then it tends to end the month higher. If the market is trending lower, then the market tends to be lower in May. “Sell in May, And Go Away” may sound snappy and provide an excuse to get the summer started early, but it is generally not a profitable strategy.

### **Inflation Will Rear Its Ugly Head**

Given the extreme amount of fiscal and monetary stimulus the government has injected into the financial system, many believe that we are about to enter a period of extreme inflation. It’s a reasonable concern and clearly worthy of being a prominent part of public debate. That said, we’re not worried – at least not yet.

The reality is that the economy is still in a process of deleveraging. There is a massive amount of debt in the system that needs to be worked down. While — all else being equal — the historic amount of monetary and fiscal stimulus is indeed inflationary, we believe that the powerful forces of deleveraging will likely contain inflationary pressures until the economy can fully find its footing.

One very important market relationship that currently points to this view on inflation is the breakeven spread between the yields of nominal Treasuries and Treasury Inflation-Protected Securities (TIPS). Some consider this relationship to be a more effective forecast of inflation than the consensus view of flesh and blood economists, since the break-even spread is the result of real money invested on the outcome.

TIPS are Treasury bonds that have an inflation adjustment feature for protection against future inflation. The “cost” of this inflation protection is generally a lower yield than nominal Treasuries. The breakeven spread in yields is the rate of inflation that would equate the returns of

conventional Treasuries and TIPS. In other words, if the rate of future inflation is greater than the breakeven yield spread, TIPS will turn out to offer a higher return and vice versa.

Currently, the breakeven rate between 10-year Treasuries and TIPS shows the expectation for inflation over the next ten years is only in the neighborhood of 1.5%. While this number seems admittedly very low to us, it is still a powerful signal that hyper-inflation in the near-term is not necessarily a shoo-in, or even a few years away. Nonetheless, we remain on alert for any significant changes in inflation expectations.

### Summary

It is fairly remarkable that as of this writing, despite a massive amount of bad economic news, the broad U.S. stock market is nearly even with where it was last October after the Lehman Brothers bankruptcy ignited a panic sell-off. Since that time, we have seen economic growth come to a standstill, along with a bevy of other incredibly significant negative news items, yet the market seems to have taken the punch and is still standing.

Though current conditions in liquidity, credit and confidence are not back to normal, they are all improving. Couple this with improving earnings growth, and it's likely that we'll see some investors start to redeploy their cash back into risky assets (i.e. stocks). If that is indeed the case, the stock market could yet end up enjoying some pretty impressive gains in 2009.

Sincerely,



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