
LETTER FROM THE PORTFOLIO MANAGERS

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Are New Highs A Signal To Buy?



Eric M. Kobren

The big story of late in the markets has been the Dow Jones Industrial Average breaking to new all-time highs. CNBC breathlessly devoted hours of coverage to the Dow's run towards record territory – even to the point of “naming” the days after it, such as “Watchful Wednesday” and “Threshold Thursday,” or something like that. It actually became embarrassing after a while as the Dow refused to breakthrough for several days, but finally on October 3 (after they had dropped the naming bit), the Dow complied with its much anticipated new all-time high.



Rusty Vanneman

This has prompted many investors to wonder if they should be increasing their exposure to stocks. But is this really a cause for celebration? Investors who have been around for a while might remember November 14, 1972 when the Dow first broke through 1000, reaching its then all-time high of 1003.16. Shortly thereafter, however, a recession set in followed by the crushing bear market of 1973/74 that took the index down to 578. In fact, it would take over 10 years for it to move past 1000 for good, in late 1982. And of course, its current new high has come more than six years since the last one in January of 2000.

So a new high in the Dow alone should not get investors eager to drain their money market accounts! But we have to acknowledge that there are some positive fundamentals that are behind the market's recent surge to new highs.

Reasonable Valuations

Over the past 25 years, the P/E ratio for the S&P 500 has averaged roughly 20 times earnings. Many commentators have noted that based on expected earnings for the next 12 months, the S&P is valued at just 15 times earnings – a relative bargain. It is even less than the long-term (80+ year) average of 16 times earnings.

In fact, since the market bottomed in 2002, with a P/E of 24, the market is up over 70% in price even though P/Es are now approximately 40% lower.

Lower Interest Rates

Longer-term interest rates have dropped nearly $\frac{3}{4}$ of a percentage point since late June. The bond market is pricing-in the expectation that the Federal Reserve is done raising interest rates. In fact, “built-in” to today's bond prices are expectations that the Fed will start cutting interest rates next year (although that expectation has recently started to diminish a bit). Not only are lower interest rates good for the economy, all else being equal, but they are also good for stock market valuations.

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Bullish Seasonals

Historically, the fourth quarter has been the strongest quarter of the year for the stock market, and the last five years have conformed very nicely to that pattern.

However, there are some real risks to the current rally in stocks.

A Slowing Economy

The economy is slowing. GDP growth dropped sharply in the second quarter to a 2.6% annualized rate, from the first quarter rate of 5.6%. While that first-quarter figure was pushed upward by post-Katrina rebuilding, the 2.6% of the second quarter is also below the last twelve month average as well as the longer-term averages.

The primary source of slowing was from a contraction in residential investment, which was the result of a slowdown in home sales. There was also weaker growth in personal consumption. Depending on the statistic used, at best, one could say the housing market is no longer growing, and at worst, that it is headed for a steep correction. For example, existing home sales eased again in August, for a fifth consecutive month, falling to its lowest total since January 2004. As a result, the inventory of unsold homes rose 1.5% in August, pushing supply at the current rate of sales to 7.5 months, the highest level since April 1993. The supply of condominiums is now at 8.6 months. Also, home prices have fallen 1.7% over the last year; the worst price performance for single-family housing since March 1993.

Unrealistic Earnings Expectations

As we noted earlier, the P/E for the S&P is 15x based on *expected* 2007 earnings. However, if we use *actual* earnings for the past 12 months, the P/E is 18x. That implies an earnings growth expectation over the next 12 months of 20%. But earnings growth expectations by sell-side analysts for the fourth quarter of this year are only 16% and for 2007 they are generally in the single digits (moreover, sell-side analysts are notoriously over-optimistic!).

Given this earnings expectation, it seems as if the market may be getting ahead of itself.

This same pattern is observable in the Nasdaq (an imperfect proxy for technology) and the Russell 2000 (small caps). The implied earnings growth rates there are 31% and 42% respectively. Again, both of these implied growth rates are well above long-term averages and current analyst expectations.

While these sort of earnings expectations might be sensible when the economy is in expansionary mode (particularly early in the expansion cycle), they are not so reasonable when the economy seems to be on the verge of a contraction, even if it is a mild one. In sum, we expect earnings expectations to fall.

On balance, we do not feel this is the right time to increase our equity exposure and are comfortable staying with our current allocations, focusing on those areas in the equity markets we find most attractive.

Large Caps Still Attractive

While the Dow has made new highs, the S&P 500 is still some 10% below its peak (and the Nasdaq is more than 50% below). Using some interesting data calculated by JPMorgan, we see that large cap growth stocks are still down 40% since the last market peak in March 2000, while mid- and small-cap growth stocks are down nearly 25%. (None of this should really come as too much of a surprise given that valuations and sentiment were nearly off the charts in 2000.) Value stocks meanwhile, particularly the small- and mid-cap variety are up substantially over this time frame.

Performance Since Last Market Peak 3/27/00 - 9/30/06			
Market Cap	Style		
	Value	Blend	Growth
Large	57.6%	-2.6%	-39.9%
Mid	138.9	55.5	-23.6
Small	150.9	37.4	-24.6

Source: JPMorgan

That is one reason why we have shifted our portfolios a bit towards larger caps and away from small- and mid-caps. And we now have a slight tilt towards large-cap growth over value. Fund flows are another reason we favor large-caps. Fund flows into small, mid, and multi-cap funds have been strongly positive this year. Using data from JPMorgan and Lipper through the end of August, these funds are bringing in money at an annualized rate of \$114b. Large cap funds on the other hand, are seeing money *flow out* at an annualized rate of \$39b. In

fact, flows into large cap funds have not been positive on a calendar year basis since 1999. Of course, back in 1999, flows into large caps were over \$100b and nearly the same in 1998, while flows into small- and mid-cap funds were flat to negative. The cycle always turns.

Energy Down But Not Out

One area that we like has seen strong inflows of late. Annualized flows into energy stocks for 2006 are running at \$17b through the end of August. Despite these flows, we don't think it signals the end for the run in energy stocks. As we mentioned in prior commentaries, we recognize that commodities and natural resource stocks are volatile. As we have seen recently, they may give back some gains — sometimes sharply — before resuming their upward slope in price.

Our argument for maintaining exposure to this sector basically comes down to the belief that we are in a long running bull market for commodities, primarily due to the lack of capital investment in prior decades, as well as a continued increase in global demand, especially from emerging economies such as China and India.

In addition, commodity prices don't necessarily have to go higher for natural resource firms to make money. For instance, even though the price of oil has fallen sharply from its recent peak of about \$80/barrel, energy companies are still making a lot of money with oil currently trading around \$60/barrel. In fact, the current valuations in energy stocks, imply a forward expectation of less than \$50/barrel.

Lastly, exposure to this sector provides a degree of "portfolio insurance" owing to both its diversification benefits and its ability to do relatively well when there is geopolitical stress. All in all, we think it makes sense to maintain positions here.

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Internationals Remain Attractive, If Less So

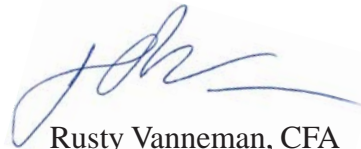
Foreign stocks have also attracted a lot of investor attention. Through the end of August this year, the annualized inflow into international stock funds is running at a whopping \$154b. Despite their growing popularity, we still like international stocks, though we'll admit we don't quite have the same degree of enthusiasm we did a handful of years ago. Along with the fund flow data, two other reasons for our waning appetite for international stocks are a narrowing gap in both relative valuations and relative growth rates. Both factors still favor international over domestic stocks, just not as much as they once did.

We continue to expect a weaker U.S. dollar longer-term which also favors non-dollar exposure to international securities. But while there are solid fundamental factors (deficits) and intermarket relationships (interest rate differentials) that favor a weaker dollar, the contrarian in us notes that it seems like everybody is a bear on the dollar, so we may see strength in the short-term. Again though, in sum, there are enough factors in place for us to maintain our positions.

Sincerely,



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