
LETTER FROM THE PORTFOLIO MANAGER

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Year-End Outlook - Trick or Treat?



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Key Points:

- *Many investors remain on the sidelines due to concerns that the market has gone “too far, too fast.” While the returns have indeed been sensational since March, the sharp rally is consistent with recoveries from past panic sell-offs.*
- *The last three months tend to be the best quarter of the year for the stock market – and even more so when the market is strong entering the fourth quarter.*
- *The yield for the stock market is low relative to historical standards – or is it? Compared to interest and inflation rates from the last 50 plus years, the stock market yield could be considered attractive.*

The third quarter of 2009 was a keeper. The Dow Jones Industrial Index was up 15% and had its biggest calendar quarter gain since 1998 as well as its best third quarter since 1939. The S&P 500 had its best third quarter since 1970. Smaller companies and international stocks performed still better on an absolute basis. Even fixed income securities posted some decent gains, especially high yield bonds which were up over 14%.

Despite these gains, many investors remain skeptical that the rally can continue. Numerous investors expect more trick than treat from the stock market in the foreseeable future. The question is how much gas can possibly be left in the tank given the robust gains over the last six months? While it’s safe to say that the “easy money has been made” – after all the over-all market is up nearly 60% off the March intra-day lows – that doesn’t mean the market can’t keep moving higher into year-end.

Frankly, it’s not certain how “easy” the gains have really been during the last six months. Many investors have not fully participated if one looks at investor sentiment and allocation surveys. Investor sentiment entering the last week of September remained net bearish, as it has been for most of the rally.

The gains since March have been driven by multiple factors, including improvement of the economic situation. A big factor, however, is that risk appetites are starting to improve. Actually, it’s more about fear dissipating than greed returning, as the desire for perceived safe harbors (such as U.S. Treasuries or the U.S. dollar), is waning.

As a result of the unwinding of the safe harbor trade, we have seen some market movement that has provided fresh ammunition to market bears, but it is more likely that this market movement is simply misinterpreted. A case in point is the U.S. dollar. The dollar put in a price bottom several weeks before the stock market went into a panic sell-off last fall, then it reached its 2009 market peak the same day the stock market reached its intra-day low. To many, the falling dollar this year suggests upcoming doom, but in reality, it could just be last fall’s panic trade reversing.

This is not to say the entirety of the gains have been driven by the concept of less fear. The economic data is getting better, or perhaps better put, “less bad.” Many note that we may be inside a V-shaped recovery (in other words a sharp rebound in economic activity after a sharp contraction) and there are plenty of charts of various economic data ranging from housing data to manufacturing data to prove that there has clearly been a large bounce since the

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start of the year. This is not to say that the economy is as strong as it was a few years ago – it’s definitely not – but it has vastly improved from the lows.

It should also be noted that a sharp uptick in GDP growth later this year should not be a surprise. The four deepest recessions since WWII were immediately followed by two quarters of sharp economic growth. Despite most economists still expecting a mild recovery at this point, if that were to actually happen, it would be unprecedented. To re-state, sharp recoveries usually follow sharp contractions.

Recently, there was an article written by James Grant that was published in the Wall Street Journal entitled “From Bear to Bull.” It really was an exceptional read, sort of like reading about how a person of a certain religious or political viewpoint may change their point of view. To be fair, James Grant surely does not consider himself a “perma-bear”, though it has sure seemed that way to many observers for a long time. At any rate, the essence of the article was that it made the case that history has taught us an important lesson about the deepest economic contractions: *“the deeper the slump, the zippier the recovery.”* Within the Grant article, another choice quote was from Michael Darda the chief economist at MKM Partners: *“The most important determinant of the strength of an economy recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period.”*

The current recession, which many call “The Great Recession,” is in fact the deepest and longest economic contraction since The Great Depression (though the current recession is clearly more similar to recent recessions in terms of actual economic contraction than the Great Depression which was truly in a league of its own). The current recession has witnessed nearly a 4% loss in real GDP and is starting to approach two years of age. Looking at the last ten recessions, the average recession has lasted closer to 10 months in duration, and the average loss in real GDP has been about 2%. The recent recession was twice as painful as those averages. *“The deeper the slump, the zippier the recovery.”*

Nonetheless, how normal is this intense stock market recovery that we have seen since March? Surely a 60% price gain from low to high — and that’s just for the S&P 500 which has lagged more speculative fare — qualifies as unsustainable. While volatility this sharp is indeed more the exception than the rule, it is also somewhat normal to see strong recoveries following deep sell-offs.

As the market sage Barton Biggs wrote in Newsweek a few weeks ago: *“it’s not the percentage change from the lows that matters; it’s the amount of the lost altitude recovered. In judging how high a tennis ball dropped from a height should bounce, you would expect a ball dropped from 20 feet up to rebound significantly higher than the same ball dropped from 10 feet.”* In the same article, Biggs cited a study by Morgan Stanley of 19 major secular bear markets (as defined by losses of more than 40%) in a variety of international stock markets and gold. The average loss was 57%, which is approximately the same amount that the U.S. (and Europe for that matter) was down from its October 2007 highs to its March 2009 lows. The study found that each bear market was followed by dramatic rebounds with the smallest rally being 41% and the shortest rally lasting 8 months. The average was 71% and 17 months. The current rally is approximately 60% in 6 months. The current rally qualifies as fast to be sure, but the gain is still below-average compared to past bears.

Next, let's consider the ten worst 12-month rolling returns for the S&P 500 over the last fifty year (excluding the last bear market). In short, the stock market was able to post a sharp recovery over the next twelve months nine times and average a price return of 25%. To put recent market action into perspective, the worst twelve-month return of the recent bear market was nearly -50% (back in early March). The gain of 60% since then surely qualifies as yet another sharp recovery, though prices still need to rally nearly another 20% by next March for a full recovery.

Fourth Quarter Seasonality

October is a month that scares many investors. Last year witnessed a 17% sell-off in the S&P 500 index. There are other famous market sell-offs that also took place in October, including Black Monday back in 1987. The reputation for the month, however, is much worse than what the actual experience should suggest. The month tends to finish higher approximately 60% of the time. And, over the last 20 years, October has produced an average monthly return approximately twice the average of the other eleven months.

The fourth quarter as a whole, however, does deserve its reputation as being the strongest consistent quarter of the year for stock market performance. Whether or not one is looking at data from the last 20 years, the last 50 years, or the last 100 years, the final three months do tend to produce the highest average returns.

A common rebuttal to this of late is that the gains from this September (which on average is the weakest month of the year) will dampen the fourth quarter effect. According to the BeSpoke Investment Group though, this is not typically the case. In short, the fourth quarter tends to be even stronger than average when the first three quarters of the year posted gains.

Stock Market Yields

Another common knock against the market these days is that the current indicated dividend yield for the S&P 500 is just a smidge over 2%, while the 50-year average is about 3.1%. In absolute terms, when just looking at yields, the market doesn't look cheap. And this is true even if the current yield is actually higher than what the market has generated in any year going back to 1996 (with the exception of 2008).

In relative terms, however, the dividend yield looks more attractive. Versus the ten-year Treasury, for instance, the current relative yield (and excluding the readings since last October) is more attractive now than it has been at any other time going back to 1967. At the end of February of this year, the stock market dividend yield versus the ten-year U.S. Treasury yield was the most attractive it had been since 1958.

Versus three month Treasury bills, the current relative yield is still more attractive now than it has been at any other time going back to 1958 (again excluding the readings since last October). At the end of February of this year, the stock market dividend yield was the most attractive it had been versus three month Treasury bills since 1954.

Looking at the real dividend yield, in other words adjusting the current yield by the latest inflation reading (the Consumer Price Index, otherwise known as CPI), the current real yield is near 4%, which is the highest it has been since 1955.

Bottom line, yields may be low in absolute terms, but relative to the current level of interest and inflation rates, it can be reasoned that stock yields look appealing – not to mention they retain the ability to grow over time. For the long-term investor with long-term investment objectives, owning stocks should look a lot more rewarding than holding an inordinate amount of cash.

Summary

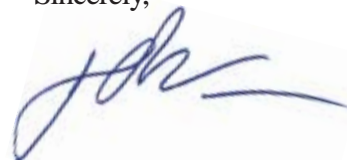
In sum, we are retaining our bullish bias heading into the final months of the year. Beyond what was mentioned above, earnings are improving, price momentum remains positive, the interest rate environment is constructive, and investor sentiment remains doggedly skeptical.

As for our portfolio positioning, we are maintaining our basic themes. We favor higher quality exposures within our equity holdings, though we favor lower quality exposures within our fixed income holdings. Those are the broad themes.

With that said, there has been some modest shifting of views underneath those broad themes. For instance, while our shift earlier in the year from a slight growth tilt to a modest value tilt among our equity funds has been rewarded, we are now looking to neutralize that view as relative valuations have shifted again. In addition, within fixed income, we recognize that investment grade corporate bonds have lost a bit of their attraction versus other fixed income sectors, including higher quality high yield bonds. We are already overweight higher quality high yield bonds (in those client accounts where we feel the holding is appropriate), but we may tactically add to the position in the near future depending on market conditions.

As always, these views are subject to change depending on the various market factors we monitor, some which can change fairly quickly. And those factors, at least at the end of the quarter, suggest that investors could expect more treats than tricks in the coming months.

Sincerely,



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