



Market Rally has Priced In a V-shaped Recovery.

Monthly Outlook: August 2009 The global equity markets resumed the “green shoots rally” on “less bad” news in July. The 2nd quarter earnings came in “9% above expectations” but 31% less than 2Qtr of last year – that’s a “green shoot”? At this point, the market rally has priced in a hefty “V-shaped recovery” in the economy and corporate earnings. Let’s hope the market is right, but as we’ll discuss below, the actual data does not yet show growth in any key indicator. Just as economists have predicted 10 of the last 3 recessions, the markets have consistently predicted 10 of the future 3 recoveries. (Don’t invite economists to your parties.) We only have to go back to the last bear market of 2000 – 2003 to see 3 surges of 20%+ within the bear market that proved to be too early and ended up with lower lows. Other important bear markets show similar false rallies. As of the end of July, the S&P500 is now priced at 987.48. With 2nd quarter earnings behind us, we can see that the S&P500 is on track to earn about \$55/share operating earnings and \$30/sh reported earnings for 2009. Market analysts are looking for \$65/share operating earnings and \$40/share reported earnings for next year, 2010. That means that “the market” is trading at about 17x and 26x the next 12 months operating and reported earnings. For what it’s worth that is about what it was trading at in the Fall of 2007 when this whole bear market started! The bottom line is that the recovery is great and we’ll hope for more. But the equity markets are priced for near perfection and any hiccup in the optimistic forecast and recovery could leave the markets vulnerable from here.

Newsweek magazine declared “the recession is over” on their cover last week. Unfortunately, they are not the official keeper of the scorecard. That rests with the National Bureau of Economic Research (NBER). Now everybody knows that the NBER is painfully slow to call the turns and so aren’t really useful to equity investors. But in retrospect, we can see that equity markets have historically turned up just 2-5

months before the economy actually does – before the recession ends. So if the equity markets turned up in March 2009, is the recession ending now, 5 months later? Is Newsweek right this time? Or are equity investors too soon like the 3 false rallies of the 2000 – 2003 bear market? No one can know yet. The NBER is very clear in what they measure to make the call on the recession end. They look for growth in personal income and employment and secondarily at production levels and wholesale sales. This is it, not home prices, not consumer sentiment, not even stock prices. And of the 4 indicators they watch that require growth, NOT ONE of them shows any. That’s right. At best, they show less bad news, and possibly that the turn will come. But for the record it isn’t here yet, at least not through July. My heart wants to believe the TV and media, but the facts are the facts.

But with all that said, it is clear that every recession has passed, and the equity markets have led the way. Sometimes the equity market is wrong / early, and sometimes it gets it right. This recession is now nearly 2 years old, long by recent standards, and eventually time heals all. But after the biggest monetary, credit, and fiscal stimulus in 70 years we still have the following over the past 2 years: Fed Funds have fallen from 5.25% to 0%, the deficit / GDP has risen from 2.0% to 13.1%, and unemployment has risen from 4.7% to 9.5%. Today, more than 6.4 million jobs have been lost in this recession and there are now about 14.5 million people unemployed. Many more are working part-time or are under-employed. Household debt ratios are still incredibly high – it just take a long time (many years) to pay down those mortgages and credit cards even if you cut way back on spending. For this key reason, we think employment, specifically personal income and aggregate hours worked are the metrics to watch for the real up-turn in the economy that will lead us to a sustained bull market. We’ll invest in every rally, but remain skeptical that is the “real deal”.