



2010 – Recovered Markets Need Confirmation of Economic Recovery

Annual Outlook: January 2010 2009 was a mixed year – a good recovery for global stocks on hopes of an economic recovery from “The Great Recession” but only mixed proof of that economic recovery from the data. Said another way, the markets are doing much better than the economy. The S&P500, for example, is up 23% in 2009 (though it’s still down 29% from its 2007 peak). As for the economy, unemployment remains high at 10%+, home prices are down 30%+ from their peak 2 years ago although *may* be stabilizing, corporate earnings are improving slightly but mostly from cost cutting and not from revenue growth. The bursting of the credit bubble (too much cheap & easy credit) is still working itself out – borrowers have too much debt and want less, not more, and banks have too much risk already on their books and don’t want to lend more yet. There’s just a lot of economic uncertainty and it’s natural for people to “do nothing” (cut spending, hold off on that “new house”, don’t hire) until some certainty appears. Our read is that 2010 will be the year of just that – more certainty. We’ll likely see that the sky is indeed not falling, that there is stability and even tepid growth, and we’re all going to be “okay”. The big unknown is whether the equity markets have already priced in a bit too much optimism at today’s level. Remember the investment “game” is not about predicting the future; it’s about determining the difference between the consensus (that’s embedded in the price) and the eventual reality.

In our regular monthly *Outlooks* we comment on current events in the markets and the economy. But once a year in January we go out on a limb and look further out to the year ahead. Why should anyone care about our market predictions? Well it turns out that somehow we get it right – or at least closer than most. As you can see on page 3, our past predictions have been within 95% or better of the actual results for the past 5 years. So we’ll try again, below, using the same process of prior years. We’ll review and consider what the stock market “gurus” are predicting and then we’ll calculate our own estimated range for the S&P500 this year. As we said, our own estimates have proven to be pretty good, but what’s important is to compare what the consensus is (the “guru’s estimates”) compared to the most likely reality (our estimate). Last year most of the gurus were not optimistic enough in their price predictions of the S&P500. Of the 12 analysts, their predictions ranged from 950 to 1,100 and one was at 1,250. The S&P500 ended up at 1,115 so practically none of them really saw this year’s rally in advance. Our own guess of the S&P500 for 2009 was a range of 700 – 1,075 which compares to the actual range of 677 – 1,127, so pretty close.

With that said, let’s get on with the process of predicting the markets for 2010! We’ll use the same 3-step process: review the 12 analysts included in the *Barron’s* annual outlook, consider the outlook of *Value Line*, and then perform our own calculation of *S&P* expected earnings and price multiples. Let’s walk you through the numbers and see what our work is showing for 2010.

The first survey we consider is the year-end survey from *Barron’s* (Dec 19, 2009). Each year they honor 12 leading analysts, or at least the chief analyst at 12 leading firms, to predict the 12/31/2010 level of the S&P500 and the 10-year U.S. Treasury bond interest rate. It’s clear that no single analyst is consistently “right” and that *Barron’s* changes the analysts pretty regularly as well (Apparently, if you’re wrong, you don’t get asked back). Last year, the forecasts ranged from 950 – 1,250 and the actual year-end was 1,115. We’ll indicate in our table, below, who the Top 3 were and give them a big more credibility for this year. In this year’s survey, all 12 analysts are predicting higher equity markets, although their predictions are wider than usual, ranging from

1,120 to 1,350, a 20% spread. In the text of the Barron's article, we noticed that their S&P500 earnings forecasts were all surprisingly high, mostly around \$75. For the record, that compares to about \$56 for this year, which is already a recovery year from the wipeout earnings of just \$49 in 2008. While we're optimistic that the economy is actually recovering and 2010 will be better, a prediction of a 34% jump in earnings just seems crazy to us. So if that's what is embedded in the expectations, we're a bit concerned for prices if the earnings come in less than +34%. This is what they are guessing for 12/31/10:

<u>Analyst</u>	<u>Firm</u>	<u>Top 3</u>	<u>S&P500 Prediction</u>	<u>10-year T-Bond %</u>
James Paulsen	Wells Capital		1,350	4.25%
John Praveen	Prudential		1,350	4.50%
Thomas Lee	JP Morgan	2008	1,300	4.50%
Christopher Hyzy	US Trust		1,300	3.50%
Michael Hartnett	BofA Merrill Lynch		1,275	4.25%
David Kostin	Goldman Sachs	2008	1,250	3.30%
Robert Doll	Black Rock		1,249	4.49%
Jeffrey Knight	Putnam Investments		1,200	4.25%
Henry McVey	Morgan Stanley		1,170	5.50%
Tobias Levkovich	CitiGroup	2006, 2007	1,150	4.45%
Francois Trahan	ISI Group		1,150	3.50%
Barry Knapp	Barclays Capital		1,120	4.50%

The second part (of 3) in our process is to review and consider the *Value Line Investment Survey*. It remains highly ranked for risk-adjusted returns according to The Hulbert Digest, a service that ranks newsletters. The specific part of their research that we find useful is their "Median Appreciation Potential" (MAP) that estimates the return potential over the next 3-5 years for the markets. A high number is bullish and a low number is bearish. In the past five years, the MAP has ranged from 35% (a recent market top on 7/13/07) to 185% (at the 3/09/09 recent low) and 115% (another market bottom on 10/09/02). Last year at this time the MAP number was a bullish 140% which proved to be accurate (remember S&P500 was up 23%). Although Value Line, itself, cautions that the MAP is intended to be more of a 3-5 year return "potential" and not a short-term or year-ahead predictive tool, we find it useful as a read on the overall tone of the market. The "MAP" is currently at a level of 55% which is neither high nor low (perhaps a bit closer to a market high level but not extreme). So we see this number as a green light for market gains in 2010, but it is not indicating a screaming bargain, either.

Lastly, our 3rd step is to do our own "old school" homework. Our goal is to calculate our own range forecast for the S&P500 based on two estimates - expected earnings and the price/earnings multiple. Each year we look at the unbiased S&P website, www.spglobal.com, to look at earnings forecasts, both "operating" and "reported". We then tweak their unbiased estimates with our own biases based on all the research we read from many, many sources and our own experience. As is always the case, analysts (like the 12 in the Barron's survey, above) and the analysts surveyed in the S&P website, are too optimistic. Last year (2009), S&P website analysts were predicting \$82.27 for 2009 earnings. They came in at just \$56.02. Our own revised earnings estimate for 2009 was \$60.00 – much closer. This year, the S&P website analysts earnings consensus is for \$75.52, not too different from the \$75 estimate of the *Barron's* analysts, above. And once again, we see these earnings estimates (34% growth!) as just wishful thinking given the data. Based on our analysis of all the research we've read, we're going to use a more modest and, we think, realistic estimate of Operating Earnings of \$64 (and Reported Earnings of \$45). Our estimate is still optimistic, calling for earnings growth of 15% over 2009, but we think is more realistic given the data that shows a slow-growth economic recovery and lack of

pricing power required for revenue growth to take hold. The second required estimate is the proper year-ahead price/earnings multiple range based on current levels, interest rates, and historical averages. This is actually the trickier part and the part most subject to judgment. We start 2010 with the S&P500 trading at 1115.10 or 19.9x trailing price/earnings ratio, which is actually quite expensive based on historical multiple ranges. Clearly, the S&P500 is trading on lofty 2010 earnings estimates and not on past earnings. Putting it all together, we calculate the following results as our own 2010 forecasts:

	2003	2004	2005	2006	2007	2008	2009 4Q Est.	2010 Est.
Operating Earnings	\$54.69	\$67.68	\$76.89	\$87.72	\$88.13	\$49.51	\$56.02	\$64.00
Reported Earnings	\$48.74	\$58.55	\$69.69	\$81.51	\$76.62	\$14.88	\$49.25	\$54.00
Op. Earn Multiple	14-20x	16-18x	15-17x	14-16x	15-18x	15-29x	12-20x	14-18x
Rep. Earn Multiple	17-25x	18-21x	16-18x	15-17x	18-20x	50-97x	14-23x	17-22x
S&P500 Range:	789-1109	1063-1213	1136-1268	1224-1427	1374-1565	752-1447	677-1127	920-1190
Our High Guess	1200	980	1250	1325	1525	1550	1075	
How Close?	92%	81%	99%	93%	97%	93%	95%	

To summarize, **we forecast that the S&P500 will be in a 920 - 1,190 range for 2010.** Our earnings forecast of \$64 is clearly lower than the consensus of \$75, but is still calling for a more realistic 15% growth over 2009. One point we'd like to make is regarding the low in our price range. As you can see, above, we're predicting a 14-18x multiple on operating earnings, which is very normal for the past 8 years, except for the unusual plunging year of 2008. Given the 14-18x multiple that means that at some point in 2010 it is likely the S&P will hit a low of 920. That's 17% below today's price. On the other hand, our calculations also call for a high of 18x earnings or 1,190. And from our low price estimate of 920, that would indicate a 29% gain potential. **So we actually see our range prediction as being quite optimistic and we believe we will be able to create nice gains for our client's portfolios in 2010.** As for our 10-year US Treasury rate prediction, we have to consider the struggle between inflationary pressures as a result of the US Federal Reserve printing money at will versus the deflationary impact of the busted credit bubble. Balancing both arguments we'll go on record with a **10-year US Treasury rate prediction of 4.25%**, slightly higher than today's 3.84%.

As we conclude this annual exercise, we caution readers that forecasting is a treacherous endeavor and probably more useful for framing expectations than anything else. Additionally, we need to remember that our portfolios include so much more than "the S&P500". In fact, a "growth" portfolio only has about 25% in the S&P500, and is further diversified with US Bonds, International Bonds, US Small caps, International & Emerging stocks, Commodities & REITs. Also, remember that our "Grow & Protect" strategy is not dependent on accurate forecasting, but rather on our ability to follow the actual trends where we strive to be "in" the up-trending markets and under-weighted or "out" of the down-trending ones. As we begin 2010, some markets (mostly the International markets) are already in down-trends and we are underweighted those markets. On the other hand, some markets remain in up-trends (mostly US equity markets) and so we remain invested. Whatever 2010 actually brings, we're confident our strategy will deliver the risk-adjusted returns you expect.