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Charting a Course for the Future

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Market Outlook

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The unbridled optimism we embraced one year ago was based on what we thought were absurdly low asset prices and the Depression-era sentiment that accompanied them. That optimism has tempered in consideration of the percentage gains we have seen since that time. Our outlook is still a positive one, but we now think it is prudent to be more selective with respect to asset class weightings and in regard to entry points for new investment. It is also sensible to maintain the liquidity that would be required to capitalize on corrections in market prices as we move forward. The Dow Jones Industrials (+5.1%), Standard & Poor's 500 (+5.4%) and Nasdaq Composite (+7.1%) all finished the month with substantial gains. Industrials led sector performance for a second month in a row with a gain of 12.4%, while the telecom sector was the worst performer, posting a loss of 5.6% (source: Bloomberg.com).

We believe the Labor Department's announcement that employers added 162,000 jobs last month will be the catalyst that finally draws individual investors back into domestic equities, providing the incremental demand necessary to achieve our fair value estimate of 1350 for the S&P 500 in 2010. The irony is that today's payroll number is the caboose of economic indicators rather than the engine. It has limited value as a forecasting tool with respect to the stock market. The jobs created today affirm that our bullish outlook a year ago was an accurate one, and they validate the increase in stock prices to date. In contrast, the media and most investors will likely view this news as a sign that the coast is finally clear to take on risk in equities, and it will raise their hopes that the recovery is sustainable.

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Just as the majority of investors buy into the recovery theme, we believe it is coming to an end, giving birth to a new economic expansion. The momentum in economic activity continues to gain strength. Corporate profits are on pace to exceed record highs in the second quarter. The four-week moving average for unemployment claims is now down to a new cycle low, and we expect job creation will average 100-200,000 per month through the remainder of this year. Railcar loadings and trucking activity are both on the rise, reflecting the increase in industrial production necessary to rebuild depleted inventories. The rise in consumer net worth, due to increases in home prices and financial asset values, has revived consumer spending. We believe nominal GDP will exceed its 2008 high in the current quarter, indicating the transition from recovery to expansion. Why then are we tempering our enthusiasm?

The largest percentage gains in a bull market accompany the recovery. This period is best defined by a steep uptrend in leading economic indicators. We believe this period is nearing an end, and we expect the uptrend in leading indicators to stall in coming months. The economic expansions that followed previous recoveries have lasted an average of five years, and while we have no expectations yet for the one we believe is underway, we suspect the rate of asset appreciation is likely to slow and become more discriminatory. In May 2009 we established a target of 1200 for the S&P 500, which implied a forward return of 30% and marked the level at which the index was valued just prior to the onset of the credit crisis. We increased our fair value target to 1350 in January, which implies approximately 15% upside from current levels. We arrive at this target by applying a multiple of 16 to our revised estimate of $85 in earnings for the S&P 500 in 2010. While our forecasts for economic growth, employment gains and corporate earnings remain well above consensus, we believe the next phase of this bull market will be far more chal-

lenging for investors than the 75% surge we have seen over the past year.

Our caution stems from several developments, which we expect to unfold between now and year-end. These should cause an increase in volatility. China's economy is likely to slow from what we believe was the peak rate of growth (we estimate 12%) in the quarter just ended. Inflation should rise well above the 3% target established by the central government. In response, interest rates and regulatory reserve requirements should increase as lending slows throughout the year. Sovereign debt issuance by EU member nations with heavy debt loads will present risks for the European financial markets in coming months, probably necessitating intervention by the IMF. With developing economies, led by China, simply running too hot, while Europe's economy runs far too cold, the risks in foreign equity markets are elevated at this time.

We expect the Federal Reserve to begin increasing short-term interest rates at its August meeting in response to stronger than expected gains in consumer spending and monthly payrolls, and we estimate the Fed funds rate will end the year in the 1.5 – 2% range. While this change in policy should be viewed as a return to normal market conditions, implying that the economy is improving, previous rate-hike cycles have led to modest price declines in stocks. But we are far more concerned with what we believe will be a significant rise in long-term interest rates and its consequences for the bond market.

Investors have been willing to take almost any risk to obtain an attractive fixed-income return in lieu of investing in the stock market. There is an avalanche of new Treasury supply required to fund our budget deficit. Perhaps most disconcerting is that the Social Security trust fund is projected to pay out $29 billion more in benefits than it collects in taxes this year. As a result, the Treasury will need to begin paying back the approximately $2.5 trillion that Congress has borrowed from the trust fund over the past 20 years by issuing even more public debt. The fact that China has been a net seller of Treasuries for three months in a row raises the question, "Who will fund this public debt?" The negative returns for utility stocks this year, which serve as an interest rate proxy for equities, are indicating that rates are headed higher. We expect 10-year Treasury yields to approach 5% by year-end, and the yields on other categories of taxable debt to rise in concert, resulting in negative returns for bond fund investors in the year ahead.

Our investment strategy could not run more contrarian to the fund flows we have seen in recent weeks. The weekly data provided by the Investment Company Institute (ICI) shows that investors continue to purchase taxable bond funds at more than 10 times the amount being invested in stock funds, and the stock fund purchases that are occurring are predominately foreign funds. We have reduced our exposure to international equity markets and largely eliminated or hedged our exposure to fixed-income vehicles that are susceptible to principal loss in a rising interest rate environment. We have addressed the market risks we believe lie ahead and the potential for an increase in volatility by raising our cash levels. We do not believe these issues will undermine the bull market. They simply necessitate a more tactical approach. In fact, the rise in interest rates may ultimately lead to a reallocation from fixed-income to common stocks.

We have been consistently bullish on financials dating back to the supposed insolvency of our banking sector. It comes as no surprise to us that this group has led S&P 500 sector performance over the past year, and we continue to believe financials offer investors the best risk-reward moving forward. We recently highlighted the data point that the 30-day delinquency rate for home mortgages declined in the fourth quarter of 2009. Now we find that the number of borrowers who have caught up on delinquent loans (cure rate) in the month of February exceeded the number of borrowers newly delinquent, for the first time in four years. We expect these numbers to improve as payrolls grow, and we anticipate financials will continue to outperform, if not lead, the broad market in 2010. ■

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