2010 Capital Market Overview

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Summary

We believe the following eclectic mix of charts will help summarize current economic, stock, bond, and real estate conditions. We examine a variety of fundamental and technical characteristics. Summary obersvations are:

- Emerging markets offer a compelling investment story, but valuations appear to be a little high.
- The recent strength in stock prices may have more upside (on a technical basis). Although, the strongest part of the rally appears to be over.
- The stock market is near fair value. Unless earnings estimates are too low, we would expect single digit returns.
- Large-cap stocks offer the largest expected return of the company size segments.
- Reits are no longer attractively valued. Housing affordability is quite high.
- Bond yields are not attractive. Within the bond market, corporate bonds remain somewhat attractive.

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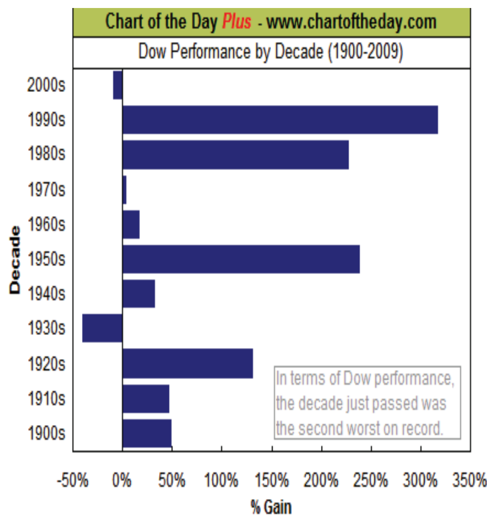
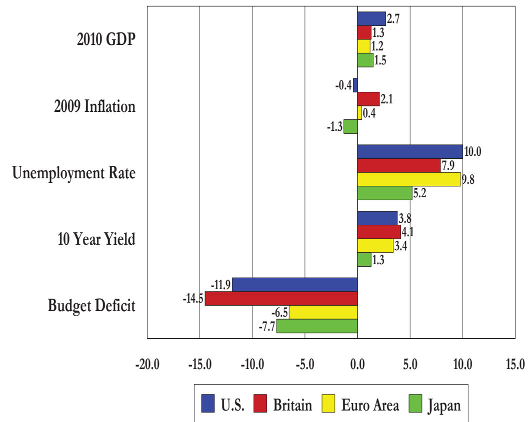
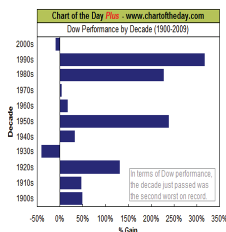
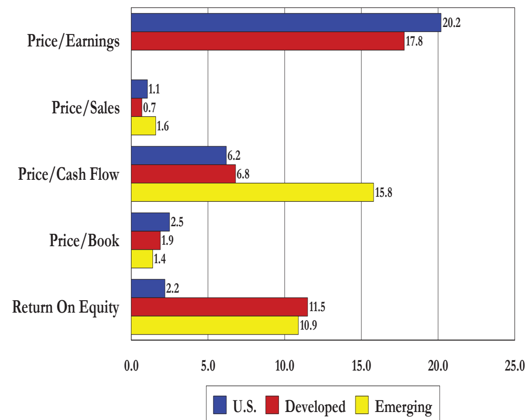




Source: Economist



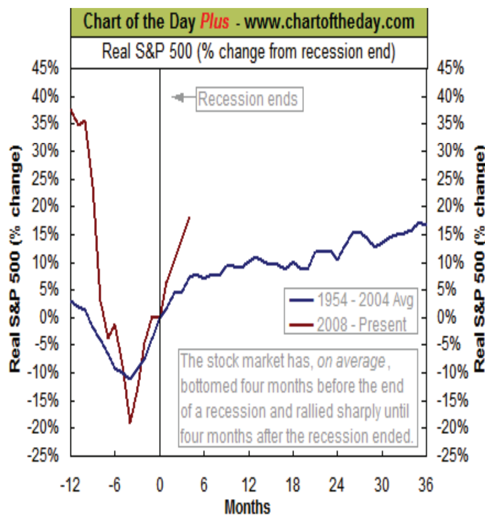


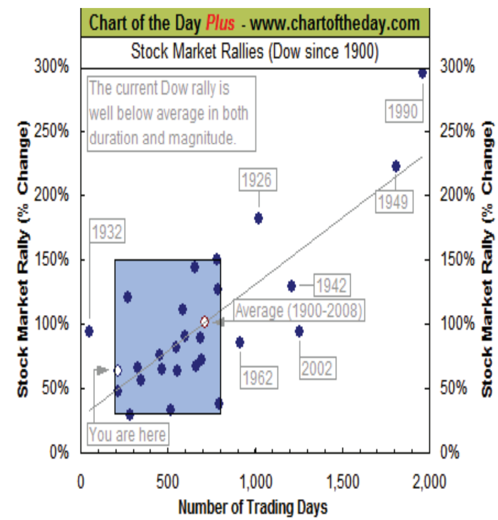
Source: Standard & Poors

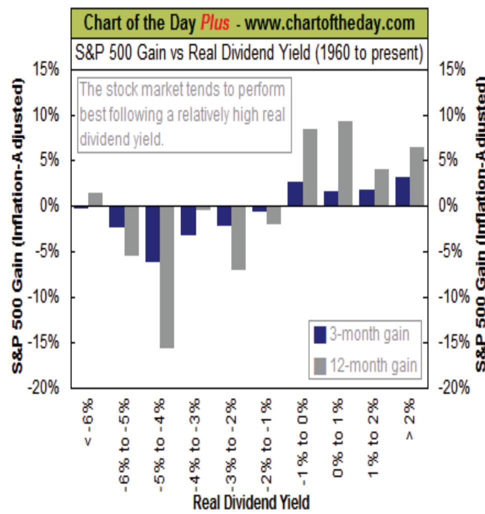
The last decade, as measured by the Dow, was the second worst decade in stock market history. Given the valuation levels at the start of the decade, it is not too surprising that decade results were sub-par, but no one predicted that they would be negative. Today, we would say valuation levels are in "fair value territory". This implies that earnings growth and dividends will be the primary driver of future returns and not multiple expansion. Rising interest rates will likely be a headwind.

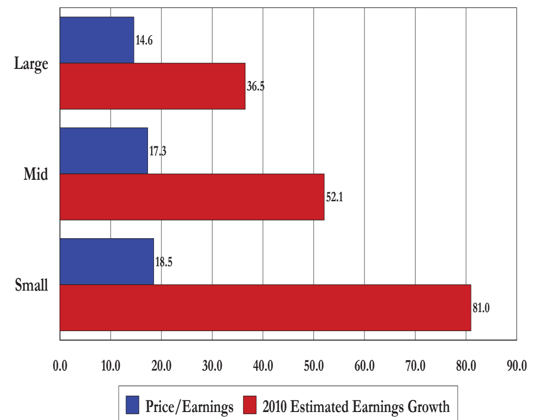
Economically speaking, we see the emerging markets are, not surprisingly, expected to have much higher GDP growth as well as inflation vis-à-vis the developed markets. Unemployment rates are similar. What is somewhat surprising is in how much better shape the emerging market budgets appear to be in. During the past decade, in many emerging market economies, fiscal discipline greatly increased. We will see if that discipline continues under a future environment that appears more constrained (particularly for export-related countries).

While not extreme, emerging market valuations appear to be on the high side when compared to developed markets. Given their early-stage economies and, in some case, non-democratic political systems, an arguement could be made for emerging markets selling at a discount to developed markets. Nevertheless, the allure of the story is quite attractive (billions of new middle class consumers) and investors are clearly interested. One must simply pay close attention to economic, political, and valuation developments.









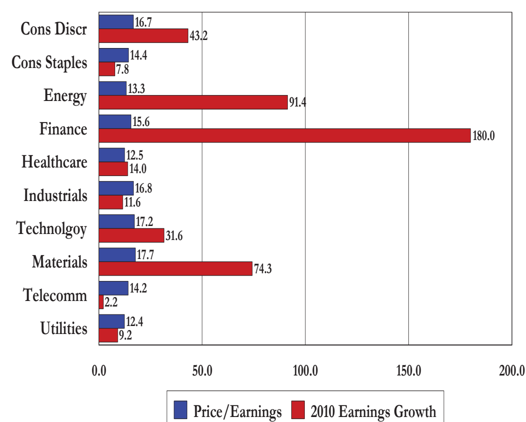
Source: Standard & Poors

Historically, the S&P 500 has tended to to rally four months prior to the end of a recession with the strongest part of that rally lasting up until four months after the recession has ended. While more volatile than in the past, the current rally has followed a somewhat similar pattern. Although, we expect future gains to be more moderate.

All major stock market rallies (as measured by the Dow) of the last 110 years are plotted on the second chart. During this time, the Dow has started a major rally 27 times (one in every four years). Most major rallies (73%) resulted in a gain between 30% and 150% and lasted between 200 and 800 trading days (blue box). The current rally (labeled "you are here") has entered the low range of a "typical" rally and could be classified as short both in terms of duration and below average in magnitude.

The S&P 500 has generally performed well when the real dividend yield (SP500 dividend yield less inflation) was relatively high (greater than -1%) and somewhat poorly when the real dividend yield was below -1%. Currently the real dividend yield is right around zero which, if history is a guide, implies a reasonable 12-month return in the S&P 500.

In terms of valuation, small stocks are more expensive than mid-cap stocks which are more expensive than large-cap stocks. Small- and mid-cap stocks both have higher expected earnings growth. Expected earnings growth obviously reflects an earnings rebound following the recession. While small stocks may have higher earnings growth compared to large- and mid-cap stocks, we are skeptical that they will produce two to three times the earnings growth.



Source: Standard & Poors

	Estimated 2010 Earnings Per Share	Estimated 2010 Return If P/E Multiple Is: 15x EPS	18x EPS
15% Above Consensus	87.94	18.3%	42.0%
10% Above Consensus	84.12	13.2%	35.8%
Consensus Expections	**76.47**	**2.9%**	**23.4%**
10% Below Consensus	68.82	-7.5%	11.1%
15% Below Consensus	65.00	-12.6%	4.9%

	Estimated 2010 Earnings Per Share	Fed Valuation Model Estimated 2010 Return If Interest Rates Are: 5%	6%	7%
15% Above Consensus	87.94	57.7%	31.5%	12.6%
10% Above Consensus	84.12	50.8%	25.7%	7.8%
Consensus Expections	**76.47**	**37.2%**	**14.3%**	**-2.0%**
10% Below Consensus	68.82	23.4%	2.9%	-11.8%
15% Below Consensus	65.00	16.6%	-2.9%	-16.7%

Estimated Returns By Company Size Using Consenses Estimates	Large	Mid	Small
15x Consensus Estimates	2.9%	-14.1%	-20.2%
18x Consensus Estimates	23.4%	3.1%	-4.2%
Fed Model: 5% Interest Rate	37.2%	14.5%	6.4%
Fed Model: 6% Interest Rate	14.3%	-4.5%	-11.3%
Fed Model: 7% Interest Rate	-2.0%	-18.2%	-24.0%

Most economic sectors have price/earnings between 14x and 17x -- within a historically normal range. Expected 2010 earnings growth is particularly high for the Consumer Discretionary, Energy, Finance, Technology and Materials sectors.

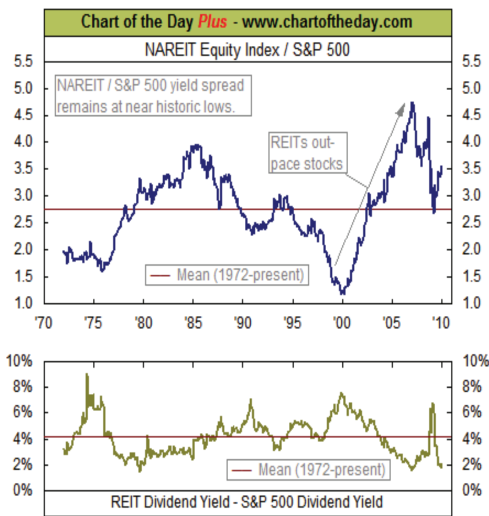
The three tables summarize estimated market returns using two-well known models.

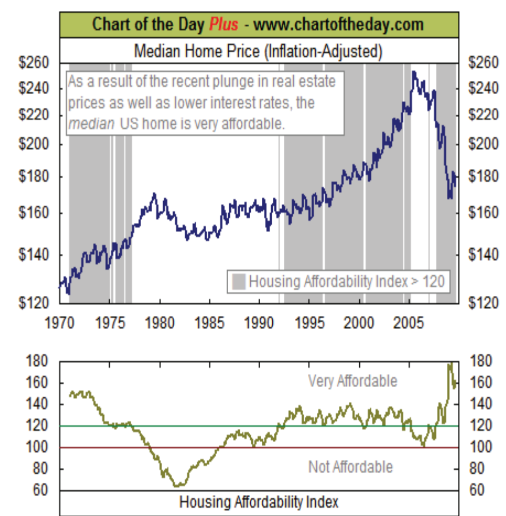
Historically, stocks have generally traded in a range of 15-18 times estimated earnings. Using consensus earnings estimates suggests that the market is essentially fairly valued at 15x earnings but there is 20% upside if multiples would expand to 18x earnings.

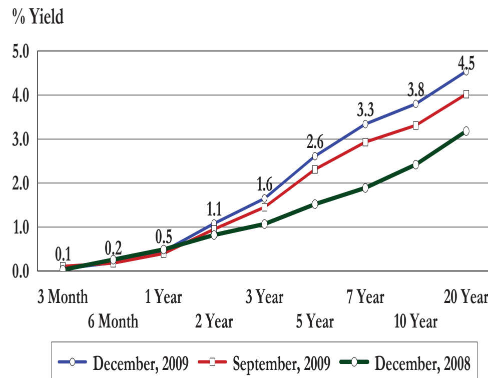
The Fed model compares the earnings yield of stocks to interest rates. The theory is that higher interest rates provide more competition for stocks. In the current environment, we prefer to use a "normalized" interest rate instead of existing market rates.

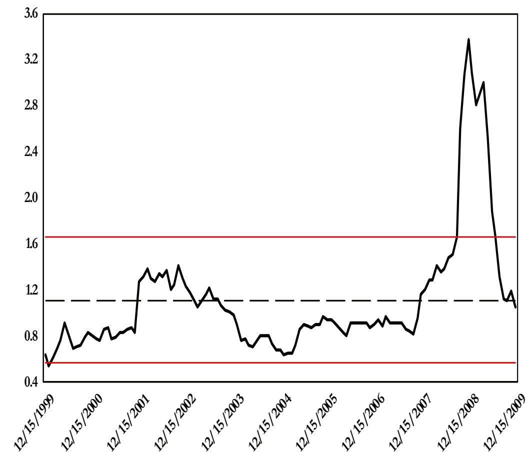
Assuming an "appropriate" interest rate of 7% and using consensus earnings estimates, the market is essentially fairly valued. Using a lower interest rate implies some stock market upside. Overall, we believe the market is somewhere between fairly valued and offering limited upside potential.

The last table uses the same methodology and applies it to various company size segments. In all cases it appears that large-cap stocks offer the best return potential compared to mid and small-cap stocks.









In 2000, when the reit yield spread (the reit yield – SP 500 yield) was over 7%, reits started to outperform the SP 500. Reits relative outperformance lasted for several years until 2007. At that time, the reit yield spread had declined to an extremely low 1.6%. In early 2009, the reit yield spread increased to over 6%. Today, following the strength of recent reit returns, the reit yield spread has, once again, declined to very low levels.

The housing affordability index (HAI) measures whether or not a family earning a median income could qualify for a mortgage loan on a median-priced, single-family home. When the HAI equals 100, it means that a family earning a median income has exactly enough income to qualify for a mortgage on a median-priced home. Today, due to the historic reduction in the median price of a single-family home as well as a significant decline in interest rates, the median single-family home is very affordable.

The yield curve is extremely steep as short-term interest rates are very low. Investors will receive less than 0.5% for maturties less than one year and will only receive 1.6% for a 3-year bond. Intermediate- to longer-maturity bond yields are nearly double short-term yields.

The quality spread (the yield of lower quality investment-grade bonds less high quality bonds) rose to historic highs toward the end of 2008 during the height of the financial panic. As depression fears receded, the quality spread has narrowed back to its historical average. While the "easy money" has already been made in corporate bonds, we believe they still offer an attractive investment opportunity.