2011 Capital Market Forecast

Visit us online
jicinvest.com

Offices
331 Fulton Suite 429
Peoria, Illinois 61602
t 309.674.3330
tf 877.848.3330
f 888.301.0514

Summary
We believe the following eclectic mix of charts will help summarize current economic, stock, and bond conditions. Summary obersvations are:

- Global economic recovery is taking place, albeit at a slower than normal pace. There are still economic downside risks.

- Developed international stocks are more attractively valued than the U.S. or emerging markets. European budget/bond issues are a major overhang.

- U.S. valuation multiples appear to be in a fair value range. Stock investors should not expect future robust returns. In recent weeks, there has been significant improvement in bullish sentiment indicators. Investor complacency has increased.

- We expect short-term interest rates to remain stable but intermediate and long-term rates may slightly increase. Bond investors may "earn their coupon" during 2011, maybe a little less if interest rates increase. High yield bonds remain attractive.

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Economic Contiions

	2011 GDP	2010 CPI	Unemploy-ment Rate	10-Year Bond Yield	Budget Deficit
Developed Markets					
U.S.	2.6%	1.6%	9.8%	3.52%	-9.0%
Canada	2.5	1.7	7.6	3.44	-3.7
France	1.5	1.7	9.8	3.37	-7.8
Germany	2.2	1.1	7.5	3.02	-3.7
Italy	1.1	1.6	8.6	4.54	-5.0
UK	1.9	3.1	7.9	3.73	-13.5
Euro Area	1.4	1.6	10.1	2.97	-6.5
Australia	3.5	2.9	5.2	5.67	-3.1
Hong Kong	4.4	2.4	4.1	2.62	2.9
Japan	1.3	-0.8	5.1	1.24	-7.4
Emerging Markets					
Brazil	5.1	4.8	6.1	6.16	-3.0
China	8.9	3.2	9.6	3.82	-2.2
India	8.6	11.9	10.7	8.32	-5.5
Russia	4.3	7.0	6.8	5.78	-4.0

- Developed country economic conditions are gradually improving. Expectations for 2011 economic growth are generally in the 1.5% to 2.5% range (lower for Europe, higher for North America). The strength and stability of economic recovery is sub-par except for Australia and Hong Kong.

- Inflation appears to be contained and for most countries is less than 2%. Australia and Hong Kong have higher inflation rates.

- Australia and Canada have already increased short-term interest rates. It seems unlikely that the U.S. or European Central Bank will increase interest rates during 2011.

- Budget deficits in several countries are too high. The U.S., France, U.K., and Japan are noteworthy.

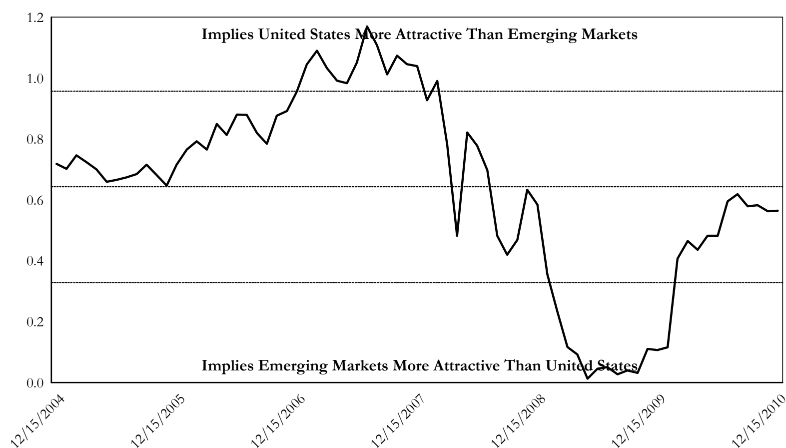
- The emerging markets continue to perform well from an economic perspective. Although, inflation is becoming more of a concern. Budget deficits remain manageable.

- China has already increased interest rates and has taken other measures to slow inflation. Other emerging market countries will likely follow.

- Downside economic risks are the European sovereign debt crisis, budget deficits, and emerging market inflation. China's property market appears to be in a bubble.

Stock Fundamentals As Of December 31, 2010

	United States		Developed		Emerging	
	Current	1 Year Ago	Current	1 Year Ago	Current	1 Year Ago
Price/Earnings Current	15.7	17.4	13.3	11.4	14.1	5.9
Price/Forecast Earnings	14.8	16.6	12.1	14.8	13.5	15.5
Price/Book	2.2	2.1	1.4	1.5	2.2	1.9
Price/Cash Flow	9.5	8.3	6.5	6.3	6.3	6.4
Price/Sales	1.3	1.1	0.9	0.8	1.3	1.3
Forecast LT EPS Growth	10.2	9.7	8.7	6.7	16.6	19.1

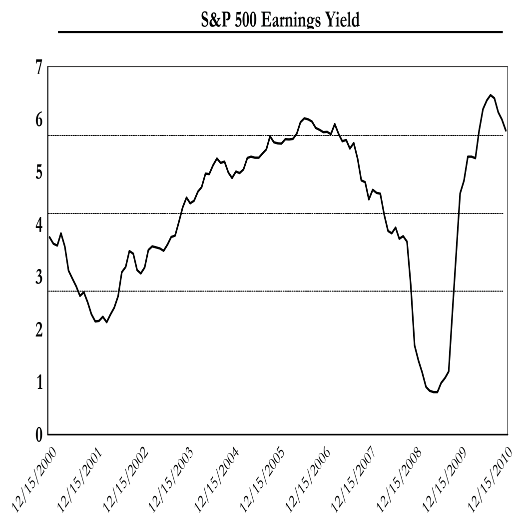


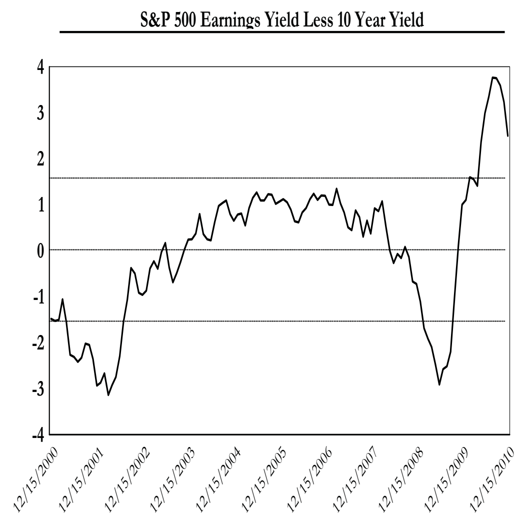
- Valuation multiples appear reasonable -- neither cheap nor overly expensive.

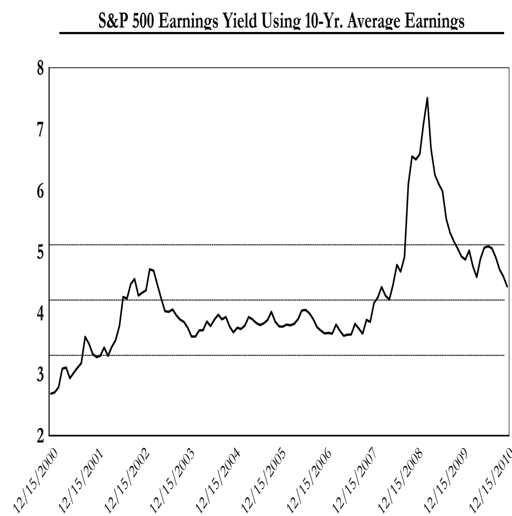
- Due to the European debt crisis developed international valuation multiples are more attractive relative to the U.S. and emerging markets. However, we expect further issues with the debt crisis. There is clearly the possibility that developed country markets become cheaper.

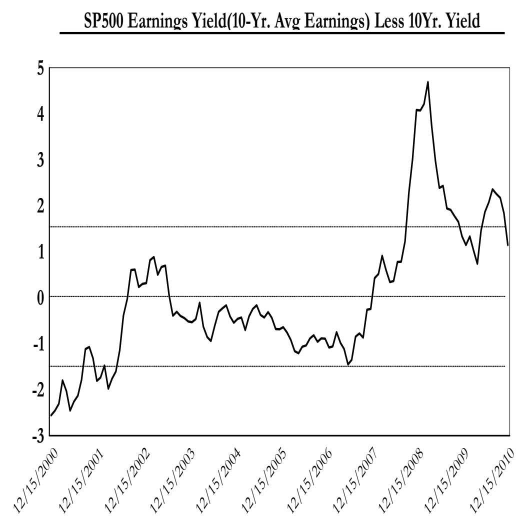
- Sales and earnings growth in emerging markets have generally kept pace with price growth as valuation multiples have been relatively stable. However, we do not believe emerging markets should be given the same valuation multiples as developed markets due to additional legal and political risks.

- The chart shows the relative price/earnings multiple between the U.S. and the emerging markets. This measure is designed to determine if one market is more attractive than another. Currently, we are near the six-year relative average implying no significant mis-valuation.









- These four charts are designed to determine the attractiveness of the S&P 500 using a few different measures.

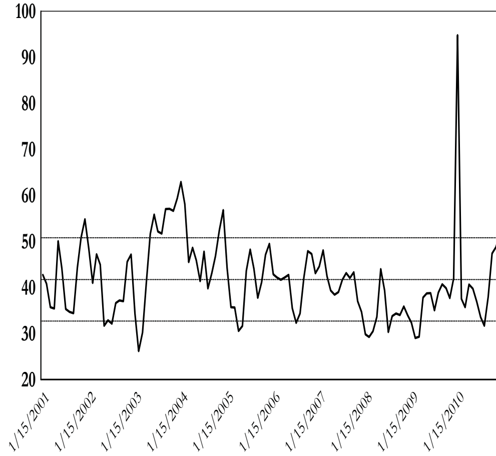
- The top two charts use the last 12 months earnings and divides it by the S&P 500 price. This is a measure known as the earnings yield and is the inverse of the familiar price/earnings ratio. The value of the earnings yield is that it can be compared to other types of investments such as bonds.

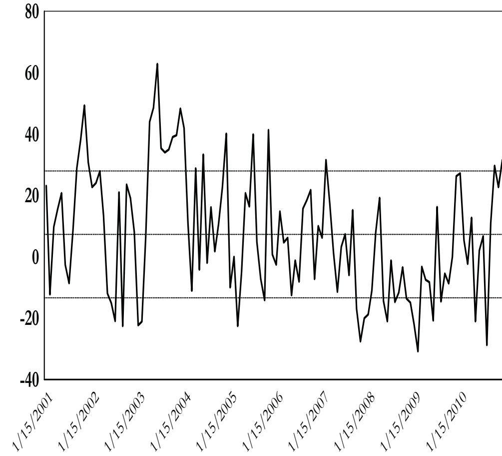
- Currently, the earnings yield is over 6%, which is substantially higher than the 10-year average, implying that stocks are attractively valued.

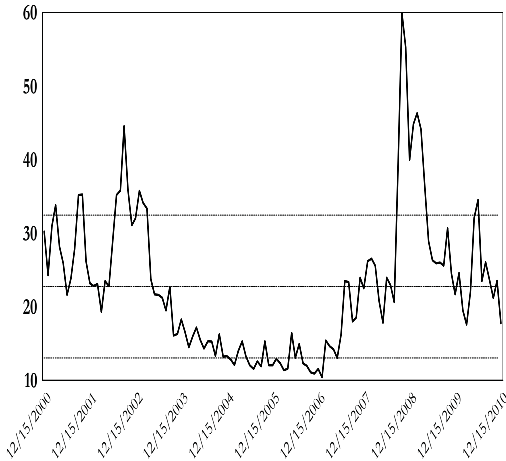
- Subtracting the 10-year treasury yield from the earnings yield (the top right chart) suggests that, when compared to interest rates, stocks are attractive as well.

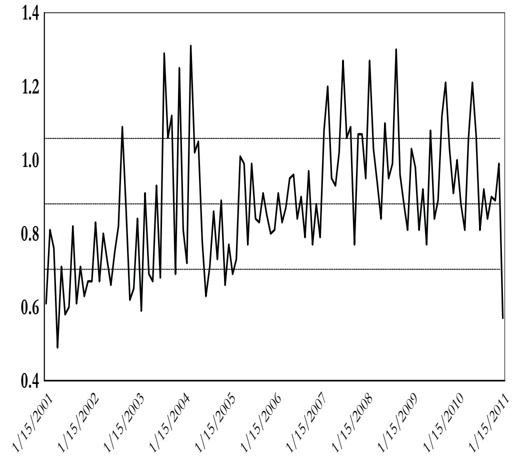
- Instead of looking at the last 12 months' earnings, the bottom two charts use what is called "normalized earnings. These are simply earnings averaged over a 10-year period and are intended to reduce the effect of the business cycle. While the numbers are different, the conclusions are the same -- relative to the past 10 years, stocks are attractive.

- A word of caution. If one were to use full capital market history, different conclusions might be reached. Today's earnings yields are below their long-term average implying a level of over-valuation. Our take is that we believe the market has some upside potential but is much closer to fair valuation than these 10-year charts suggest.









- These four charts are designed to measure investor sentiment and stock market confidence.

- The first chart measures the 8-week average bullish sentiment from the American Association of Individual Investors. It is currently one standard deviation above its 10-year average and has significantly increased during the past few months. Usually this is a contrarian indicator. When sentiment is abnormally high (low) future stock returns are low (high).

- The top right chart is similar in that it measures sentiment by subtracting the percent of bears from those that are bulls. Clearly bullish sentiment is evident.

- The bottom left chart is a measure of fear known as the volatility or VIX index. The historical average value is slightly above 20. Today's value is slightly below the historical average suggesting a level of calm in the marketplace. But not too much calm. One needs to worry about too much complacency creeping into the market.

- The last chart is another measure of fear. Puts are protection against declines. If this ratio is high, that suggests a lot of fear in the marketplace. Today the ratio is significantly below its long-term average suggesting a level of complacency.

- These indicators essentially tell the same story--investors have become a lot more bullish on the stock market. Perhaps too much so.

Potential Stock Market Return Scenarios						
		Earnings Multiple		**Potential Stock Returns If If Interest Rates Are:**		
2011 Operating Earnings	**Earnings**	**15x**	**17.5x**	**5%**	**6%**	**7%**
20% Above Consensus	$114.54	36.6%	59.4%	82.2%	51.8%	30.1%
10% Above Consensus	$105.00	25.2%	46.1%	67.0%	39.1%	19.3%
Consensus Earnings	$95.45	13.8%	32.8%	51.8%	26.5%	8.4%
10% Below Consensus	$85.91	2.5%	19.5%	36.6%	13.8%	-2.4%
20% Below Consensus	$76.36	-8.9%	6.3%	21.4%	1.2%	-13.3%
10-Year Average Earnings	$71.86	-14.3%	0.0%	14.3%	-4.8%	-18.4%
Forecast Reported Earnings						
2011	$74.91	-10.7%	4.2%	19.1%	-0.7%	-14.9%
2012	$87.46	4.3%	21.7%	39.1%	15.9%	-0.7%
2013	$88.48	5.5%	23.1%	40.7%	17.3%	0.5%
2011 Operating Earnings						
Large Consensus	$95.45	13.8%	32.8%	51.8%	26.5%	8.4%
Mid Consensus	$53.82	-11.0%	3.8%	18.6%	-1.1%	-15.3%
Small Consensus	$23.03	-16.9%	-3.1%	10.8%	-7.7%	-20.9%

- Investing would be easy if there was one valuation metric that always worked. Unfortunately, that is not the case. While this page has a lot of numbers, it is designed to calculate expected returns using a variety of scenarios.

- The first set of data shows 2011 operating earnings. We calculate expected returns using a historical multiple and what is known as a "capitalization rate". The 5%, 6%, and 7% are essentially discount rates.

- Assuming consensus operating earnings are correct, the table suggests that the S&P 500 is undervalued by about 14% (multiple of 15) or by 8% if a 7% discount rate is used. We also provide returns if 2011 operating earnings are 10 and 20% above/below consensus.

- The same calculation is shown using 10-year average (or normalized) earnings. This methodology suggests the market is about 15% overvalued.

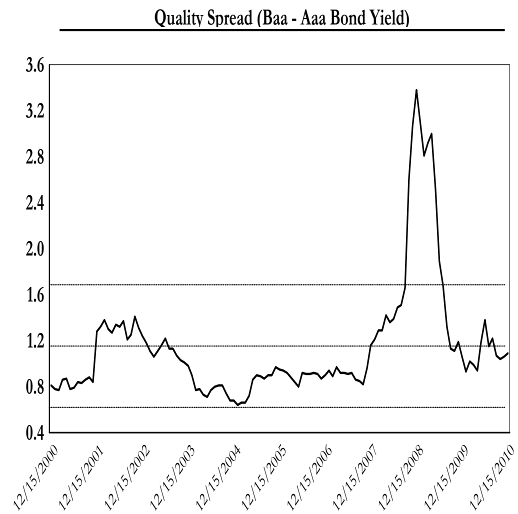
- The primary difference between operating and reported earnings are writeoffs. A large one-time writeoff would lower reported earnings but have minimal effect on operating earnings. Reasonable people disagree over which is the most appropriate measure to use.

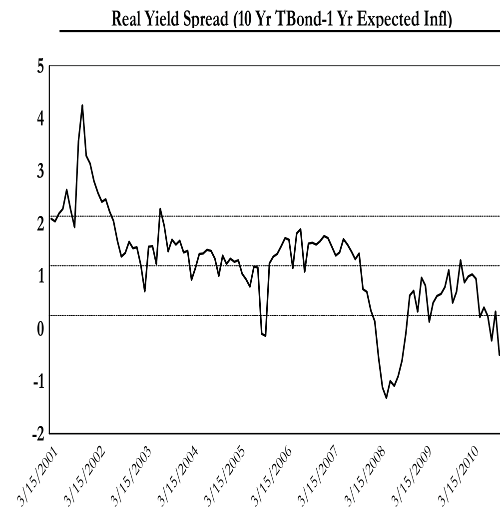
- We show forecast reported earnings for the 2011 to 2013 time period. Using the same methodology as before, we find that the market is either slightly overvalued or at fair value based on 2011 earnings. The market is either fairly valued or slightly undervalued based on 2013 earnings.

- To highlight the differences between company size segments, we calculated expected returns for large, mid, and small-cap stocks using 2011 consensus operating earnings. Mid and small stocks appear to be overvalued while large stocks are undervalued.

- In sum, we believe the market is within a reasonable fair value range. We do not believe stock investors should expect robust future returns. Likewise, we do not predict significant declines. We would suggest that much of the 4th quarter stock market rally was "borrowed" from 2011.

U.S. Bond Yields	4th Qtr	Last Qtr	1 Year-Ago
Fed Funds	0.19%	0.19%	0.11%
Prime Rate	3.25	3.25	3.25
3 Month Treasury	0.12	0.16	0.05
1 Year Treasury	0.29	0.27	0.45
3 Year Treasury	1.07	0.67	1.65
5 Year Treasury	2.06	1.28	2.61
10 Year Treasury	3.38	2.52	3.80
30 Year Treasury	4.43	3.69	4.61
Aaa Corporate	4.96	4.51	5.30
Baa Corporate	6.05	5.58	6.36
Spreads Versus 10-Year Treasury			
Barclays Aggregate	0.11	1.02	0.09
Barclays Credit	1.17	1.97	1.16
Barclays Treasury	-1.4	-0.55	-1.61
Barclays Mortgage	0.08	1.06	-0.23
Barclays Municipal	0.31	1.07	-0.04
Barclays High Yield	5.89	7.64	8.41
Barclays TIP	-1.05	-0.17	-1.93
Citi Intl Treasury	-1.11	-0.45	n/a
JPM Emerging	1.81	2.41	1.91
Aaa Corporate	1.58	1.99	1.50
Baa Corporate	2.67	3.06	2.56
Maturity (10yr-3yr)	2.31	1.85	2.15





- During 2010, interest rates declined. The current 10-year treasury is yielding 3.4% while Aaa corporate bonds yield just under 5%. After adjusting for inflation (assumed to be 2%), investors are receiving a zero or negative inflation adjusted yield for treasury bonds of less than five years to maturity.

- We expect longer-term interest rates to either stay the same or mildly increase during 2011. We do not expect significant interest-rate movements at the short-end of the curve since the FED is almost certain to keep short-term rates low (remember, the FED has much more influence over short-term rates). As the economy strengthens, intermediate- and long-term rates may modestly increase from current levels.

- For investment grade bonds, we would expect 2011 bond returns to be equal to their coupon with little change in price (maybe a little price depreciation if interest rates rise). We expect investment grade bond returns in the 2.5% to 3.5% range for 2011, depending on portfolio structure.

- While the spread between lower quality (Baa) and higher quality (Aaa) bonds has significantly narrowed, it still remains near its long term average. This implies that high yield bonds are in a "fair value" range from a price standpoint. Given the current economic backdrop, we think it makes sense to have a high yield bond allocation and, while appreciation may be limited, investors could "clip" a significantly higher coupon.