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Double Dip or Market Correction?

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The U.S. stock market has been experiencing its first correction of 10% or more since an 80% run-up in the S&P 500 beginning with the March 2009 bear market low.

The big question is, are we experiencing a correction of the boom after the 2008 market crisis or are we having a relapse?

Let's look at the various catalysts for this recent correction.

First, China is clamping down on its easy money policy and several European countries are in the midst of a liquidity/solvency problem. Now add in U.S. jobless claims unexpectedly rising last week and the Conference Board reporting a surprising drop in its index of leading economic indicators. These reports raised concerns that the economic rebound in the U.S. may be losing some strength.

On the other hand, there is a real case for optimism. A U.S. News and World Report detailed two new surveys out last week that suggested, "We might be on the verge of experiencing the Great Shopping Comeback of 2010."

Higher consumer spending could propel the economy and create jobs. In corporate America, first quarter earnings for the S&P 500 companies grew 55% from a year earlier and 77% of them beat their Wall Street estimate, according to a Bloomberg report.

Federal Reserve Bank of New York President William Dudley reported that the U.S. economy is recovering and we are now seeing the first signs of significant employment growth.

I truly believe we are simply having a healthy market correction, not a relapse of the near-Armageddon we experienced in 2008. Even expected market corrections can generate sensational headlines. One minute the sky is falling and the next it's a beautiful sunny day. Maybe it was just a flock of birds that flew over.

It's been said that we can always count on death and taxes. How about we add "market crises" to the list? Those, oh so talented, "Talking Heads" make it seem like the market is either in a crisis, recovering from a crisis, or anticipating the next crisis.

According to a January 2010 Morningstar article, we've experienced numerous crises over the past forty years including the following:

- In the 1970s we had stagflation, oil shocks, high inflation, and a stock market that dropped 44% in 2 years.
- In the 1980s, there was the collapse of Drexel Burnham Lambert and the stock market crash of October 1987, which sent the Dow Jones Industrial Average down more than 20% in one day.

- In the 1990s, we had the savings and loan crisis, the bailout of hedge fund Long Term Capital Management, and the Asian financial crisis.
- In the 2000s, we had two bear markets, the subprime mortgage meltdown, and the financial crisis of 2008-2009.

Despite these market crises, the Dow Jones Industrial Average rose from 800 at the beginning of 1970 to 10,044 on 5/25/10. That's over a 1,256% increase.

My case for equities is based on the fact that the S&P's forward price-to-earnings multiple on normalized earnings is below what it was in October of 1990 and November of 1987.

If you can deal with the volatility, there is more value in equities today than there is in investment grade credits, Treasuries, TIPS, commodities, and especially gold.

After a 10-year run of the worst returns since the 1931-1941 bear market, stocks are probably poised to do better than most believe during the coming 5 to 10 years.

At just over 12 times the five-year average for forward estimate, the S&P 500 has an earnings yield in excess of 8% against long-term investment grade corporate bonds trading at about a 6% yield and Treasuries at 3.2%.

If inflation averages 1.9% over the next decade, as the inflation breakeven spreads suggest, long-term TIPS would return about 3.2% along with Treasuries and long-term general obligation municipal bonds which are trading at tax-equivalent yields of 7.4%, also below the earnings yield on equities.

Now, let's normalize interest rates as the economy grows stronger and the Fed policy shifts to tightening. Those long-term debt instruments would be heavily discounted to substantiate market rates. The 30-year Treasury is yielding 4.5% as of 5/25/10. Ten years ago it was yielding 8.64%. When, not if, interest rates return to pre-crisis levels, the 30-year AAA Treasury would be worth substantially less than par.

This pretty much leaves real estate and commodities. With China slowing, however, the outlook for commodities is somewhat riskier than normal.

Inflation fears have gotten out of hand and gold, which has become the asset class and global currency of choice, in my view, is an unattractive long-term investment.

It's easy for you to let "the crisis of the day" rule your emotions and cloud your thinking. However, successful investors take a broader view and realize that crises happen, crises get resolved, and while they can sometimes be scary, they should not lead you to panic mode.

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