October 2009 Market Commentary

The month of September saw the S&P500 gain about 3.5%. Historically, September has produced the worst monthly performance of any of the 12 months, losing 0.9% on average from 1990 through 2008. So, a September gain is always welcome. Adding September's gains to previous month's produces a market recovery of well over 50% from March's market lows, and puts the S&P500 up over 17% for 2009.

As we pointed out during the depth of the market lows, the market priced tremendous fear into stock prices very similarly to how it priced in expectations of seemingly unending prosperity just a few years earlier. During the November and March lows, the stock prices, as measured by market indices implied 5 year annualized sales growth of the S&P 500, was –8.6% and -6% respectively. In effect, investors priced stocks at levels that assumed that corporate America would shrink by 36% and 27% respectively over the next 5 years. To us, that simply was not realistic.

Based on current market value, we estimate the S&P 500 is priced at an implied sales growth of a bit under 5% per year for the next 5 years. While this is below the long term average of 7%, more conservative pricing appears appropriate given various economic and policy challenges facing us. Regardless, some level or rationality has returned to the markets. While stocks may still represent good long term value, they're no longer priced at earlier panic levels.

With that said, now is not the time we would suggest changing your portfolio strategy to chase stocks. That boat has sailed. Our fundamental advice remains the same. Stocks are usually a valuable part of many portfolios. Positions allocated to stocks need to be long term in nature. Stocks will be volatile in the short term. Chasing short-term performance often backfires.

Growing confidence in various sectors of the economy appears to be overcoming many investor fears. More than 80% of the 52 private forecasters polled say the recession that started in December 2007 has ended. They look for gross domestic product to expand at a brisk 3.0% annual rate in the third quarter of 2009 and rise 2.4% in the fourth quarter. Third quarter corporate earnings are expected to be higher than analyst's original projections. This latest adjustment to expectations has helped drive the market higher in the last days of third quarter. Even the IMF jumped on the bandwagon saying the U.S. economy is mending more quickly than anticipated.

Progress has been made in the financial sector, too. September 25th of last year saw the largest bank failure in history with the demise of Washington Mutual. Since then, there's been tremendous progress in stabilizing the financial system. However, we will hear more about struggles in the banking sector, even if problems are not as severe as news reports suggest.

At the end of June, the FDIC announced that it had 416 banks on its "problem" list, up from 305 at the end of March. The FDIC has already closed 87 banks this year adding to the 25 banks closed in 2008. However, the total assets of banks on the problem list were just $299.8 billion which is approximately 15% of the total assets of Bank of America, the nation's largest bank in terms of deposits.

While bank failures grab headlines, the bigger impact is likely to result from decreased lending, not outright failures. The FDIC is heavily pressuring banks to avoid loans perceived as risky, and in many cases, simply forcing loans in various sectors ranging from real estate to small business to be removed from the bank's balance sheets. As a result, various borrowers and especially small businesses are finding themselves shut out of credit markets. So, while we should be well past the major dangers to the financial system, the effects of recent problems will be with us for years to come.

Another bubble appears ready to burst. Fixed income (bonds) is likely nearing or even past its peak ending the three decade bond bull market. Investors seeking safety in Treasuries could be in for a major disappointment. Furthermore, most analysts feel that a combination of economic recovery, heavy borrowing by the government and inflationary policies will drive up interest rates — and push bond prices down. Even Bill Gross, the industry crowned bond king, is recommending that investors avoid bonds and instead purchase dividend paying stocks.

The 28-year bull market in bonds combined with the corresponding collapse of the equity markets in 2000 and 2008 produced an exceptional market anomaly. During much of the first half of 2009, the long-term performance of bonds and stocks, for all periods of more than 25 years, was roughly the same, according to a June report from The Leuthold Group LLC, a market research firm in Minneapolis.

In past periods when stock/ bond performance differentials were at the fifth percentile or higher, as they are now, median 10-year subsequent annual compound total returns on the S&P 500 were 18.1%, versus 10.8% for the other periods, according to Leuthold. "We are early on in the new cycle of this regression to the mean," Leuthold said in its June report. Since this report, the market has already climbed over 20%, and it's likely wise to temper future expectations. Although we may see strong long-term returns, averages achieved during past recoveries may be less indicative of our likely future for various reasons. Regardless, I'll reiterate our conviction that stocks are usually a key component of a balanced portfolio with the proper time perspective.

While we're seeing many improvements, various issues remain that cause concern. High unemployment will hinder growth for the foreseeable future. Private economists polled for the Blue Chip Economic Indicators September survey say the unemployment rate will reach at least 10 percent in early 2010 and "recede from that level only grudgingly over the second half of the year". Job losses are slowing, but haven't reversed. Housing also remains a problem. While sales and housing starts have picked up in recent months, default rates continue to rise and fears persist regarding possible overhanging supply.

Various policy issues also concern economists. The possible costs and associated taxes of any new health care plan weigh on projections for a future recovery. Cap and trade and the tremendous costs associated with the original energy proposal create many reasons for concern. In addition, proposals for regulatory overhaul of the financial services sector have all leaned toward curtailing lending and risk taking. The expected result of these changes is slower growth. Obviously, these events have yet to unfold, and may or may not adversely affect the economy. However, the lack of definition around their future affects introduces significant uncertainty into corporate planning, and in the near term, is slowing recovery. Ironically, the situation has been created that we could see positive economic effects from the implementation of harmful economic policies simply because people know what to expect.

However, in light of all these issues, we believe that stocks still represent a solid long term investment and present good long term value - as even Bill Gross the Bond King has publicly stated. However, now is probably not the time to decide that stocks are no longer risky and will only go up. Instead, equity markets likely represent a solid holding for some portion of an investor's long term portfolio, as is usually the case.

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