"Attractive Value"

Market Commentary – October 2009

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The third estimate of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. fell by 0.7% in the second quarter of 2009. According to the September statement of the Federal Open Market Committee (FOMC), "household spending seems to be stabilizing, but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit." They anticipate "a strengthening of economic growth" while "substantial resource slack" contains inflation. Some economists believe that GDP resumed positive growth in the third quarter of 2009 after shrinking for four consecutive quarters. Moreover, according to a poll conducted by *The Economist*, GDP is expected to grow by 2.5% in 2010. The economy has turned the corner.

The Federal Reserve is slowly retracting its accommodative policies as it attempts to wean the economy of its medication. The Fed will complete its purchase of $300 billion of Treasury securities by the end of October. This program, designed to keep Treasury rates low, is one of the first to sunset. However, the Fed also decided to extend to the end of the first quarter of 2010 its commitment to buy up to $1.45 trillion in agency-related mortgage securities and debt. This commitment was originally set to expire at the end of 2009. As for the Fed Funds rate, the FOMC announced on September 23 that the target range remains 0% to 0.25% and that it expects to keep the rate in this low range "for an extended period". Futures markets still do not see the Fed Funds rate at 0.5% until May 2010.

Our recent research of individual stocks shows that with interest rates at such consistently low levels, many stocks are undervalued. We use the discounted free cash flow to equity model to compute the intrinsic value of a stock. The interest rate used to discount future cash flows to present value is a function of the risk-free rate (such as the 10-year U.S. Treasury note), equity risk premium, and beta for the individual stock. With the 10-year U.S. Treasury note currently yielding 3.3%, we are assuming 4% for the risk-free rate in our models. The resulting discount rate is low, which in turn leads to higher stock valuations. If interest rates stay near current levels, there is the potential for stock prices to move up before they become too expensive. If interest rates rise, however, the stock market will feel pressure.

Intuitively, this trade-off between interest rates and stock valuations makes sense. If interest rates are low, investors must seek riskier assets to earn a reasonable economic profit (i.e. sell bonds and buy stocks). This pressures bond prices down and drives stock prices up. Since interest rates move inversely to bond prices, lower bond prices mean higher interest rates. At some point, rates on fixed income investments are attractively high again and money is lured from stocks to bonds. The pendulum swings back and forth.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. A technical indicator that is "too bullish" can ironically be interpreted as bearish. Indeed, our sector analysis shows that 76.6% of the 209 industries spanning the entire stock market are in strong uptrends. This has never happened in our research, which dates back to December 2001. Stock prices do not move up or down in a straight line; rather, they tend to move in waves.

While our short-term expectation is for stocks to pull back, we still believe that there is more upside potential for stock prices in this cyclical bull market. We continue to utilize covered calls in some of our portfolios as a way to profit from volatility and instill a discipline of "selling high". In September, we were called out of a couple of stocks and also sold some new calls expiring between October and December. Purchases of additional stocks will be made incrementally, preferably into some short-term market weakness. While we exhibit patience, this is an excellent opportunity to research more stocks.