"Balance Is Strength"

Market Commentary – January 2010

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The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew by 2.2% in the third quarter of 2009. With the advance estimate at 3.5% and the second estimate at 2.8%, the third estimate, which is based on the most complete source data according to the U.S. Bureau of Economic Analysis, is the lowest of the three estimates for the third quarter. According to the December 16, 2009 press release by the Federal Open Market Committee (FOMC), "economic activity has continued to pick up" and "the deterioration in the labor market is abating". The FOMC sees improvement in the housing sector, household spending, and business inventories, while economic growth is constrained by the "weak labor market, modest income growth, lower housing wealth, and tight credit". Economists commonly view that GDP growth accelerated in the fourth quarter of 2009, but that this bounce will be temporary. As the government puts the brakes on its massive stimulus program in 2010, the economy will be swimming against the current.

In the coming months, the Federal Reserve will walk the fine line of reigning in its monetary stimulus while hoping to not drag the economy back into a deep recession. On December 16, the FOMC announced its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". While the Fed Funds rate will remain at rock bottom, the Fed expects its purchase of $1.25 trillion of agency mortgage-backed securities and $175 billion of agency debt to be complete by the end of the first quarter of 2010. It also plans to allow its special liquidity facilities to expire either in the first quarter or first half of 2010 (designed to help commercial paper, money market mutual funds, asset-backed securities, and more). The Fed is encouraged by improvements in the financial markets but maintains that it is "prepared to modify these plans if necessary to support financial stability and economic growth". The next FOMC interest rate decision will be announced on January 27.

A major risk to stock prices is the future of interest rates on U.S. Treasury securities, especially the 10-year U.S. Treasury note. The 10-year U.S. Treasury note yield has jumped from 3.28% on December 1 to 3.85% on December 31. This is a significant rise and indicates a disturbing trend. As described in our October market commentary, a higher 10-year U.S. Treasury note rate causes our financial models to compute lower intrinsic values for stocks. We are still using 4% as the risk-free rate in our models, which is higher and thus more conservative than the current 10-year U.S. Treasury note. However, if we need to bump up our risk-free rate to 4.5% or 5%, much of the attractive value we see in stock prices will evaporate. This is an important parameter to keep on the radar screen.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. Standard & Poor's expects operating earnings per share (EPS) to be $70.86 for the S&P 500 over the next 12 months, implying a price-to-earnings (P/E) ratio of 15.7 with the S&P 500 at 1115. The earnings yield (E/P) is 6.36%, which represents attractive value with the 10-year U.S. Treasury note at 3.85%. In 2009, the growth style consistently outperformed the value style across all market caps. Mid cap stocks performed strongest, lagged by small cap and large cap stocks. Looking forward, better deals may be found with small and large cap stocks while emphasizing the value style.

Investors who maintain a balance of cash and stocks, in line with their risk profile, should do well in this market environment. Views among financial analysts are diverging. Some think that the world is on the verge of another financial collapse, while others believe the economy is out of the woods. Add to this confusion the constant threat of a random terrorist attack. Risk should not be feared; rather, it should be embraced. Risk is the reason why investors have the possibility of earning a profit. A balanced portfolio allows an investor to confidently take some risk and enjoy potential upside, while also preserving a degree of buying power should something unfavorable happen. Balance is strength.