"Embrace Capitalism"

Market Commentary – February 2010

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The advance 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 5.7% in the fourth quarter of 2009. While this is the highest growth rate since the third quarter of 2003, more than six years earlier, dissecting the 5.7% reading reveals more modest growth. An improvement in inventories accounted for 3.4 percentage points of GDP growth, and this improvement is essentially a short-term effect. Consumer spending, which comprises roughly 70% of GDP and is thus a robust driver of economic growth, grew at a tepid 2% annual rate. The economy is expanding again, but not at a red-hot rate that investors may expect given the extensive monetary and fiscal stimulus in place.

The Federal Open Market Committee (FOMC) announced on January 27 its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". The Federal Reserve is encouraged by the strengthening of economic activity and a labor market which appears to be stabilizing (with unemployment at 10%), but these factors are not favorable enough for the Fed to raise interest rates. The next decision on interest rates will be announced on March 16.

Politicians in Washington D.C. are on a witch hunt to identify those who "caused" the recent economic collapse. They are determined to heroically prevent such a severe recession from happening again in the future. Fingers are being pointed at the banks, Fed Chairman Ben Bernanke, former Fed Chairman Alan Greenspan, Treasury Secretary Tim Geithner, and others who had to make difficult decisions in the thick of the economic fog. While politicians will identify parties who end up being scapegoats, there is ironically little dialogue about the true cause being rooted deep in the heart of capitalism itself. Boom and bust cycles are natural and cannot be prevented. Successful investors accept them, adapt to them, and embrace them. Farmers know that there is a time to plant and another time to harvest. Investing is similar. The seeds of profitable investments are planted during times of economic despair, while the time to harvest is when the economic outlook is rosy. We are planting right now.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. Standard & Poor's has raised its forecast for operating earnings per share (EPS) over the next 12 months for the S&P 500 from $70.86 to $77.17, implying a price-to-earnings (P/E) ratio of 13.9 with the S&P 500 at 1074. The earnings yield (E/P) is 7.19%, which represents attractive value with the 10-year U.S. Treasury note at 3.61%. Sales for S&P 500 firms are estimated to have declined by 13.7% in 2009 and they are expected to grow by 7.2% in 2010. While 2010 will not make up for sales lost in 2009, revenues are growing again.

Now that a correction is taking place in this cyclical bull market, market participants are debating about how deep this correction will go. The S&P 500 has pulled back 6.6% from the peak to 1074. Breadth, a comparison of rising stocks to declining stocks, has been overwhelmingly negative in recent days. Momentum is still to the downside. However, there are support levels to watch, including the October and November lows around 1025 to 1030 and the 200-day moving average at 1013. Coupled with attractive valuations, we view this dip as a buying opportunity (depending on the portfolio and keeping in mind that the stock market is still in the grip of a secular bear).

The concept of "margin of safety" is useful to investors in all market conditions, and the current market environment is no exception. By investing in assets calculated to be undervalued, there is theoretically less downside and more upside potential in the future prices of those assets. Buying at a discount to intrinsic value yields a margin of safety; the larger, the better for the investor. Investors who have a degree of liquidity in their portfolios are able to profit from volatility by having buying power ready to deploy…incrementally.