"Investing In A Dynamic World"

Market Commentary – December 2010

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The second 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 at an annual rate of 2.5% in the third quarter of 2010. This is higher than the advance estimate of 2.0% announced in October. The Federal Reserve recently lowered its forecast for 2011 GDP from 3.5%-4.2% to 3.0%-3.6%, with long run GDP growth in the 2.5%-2.8% range. In terms of 2011 unemployment, the Fed raised its forecast from 8.3%-8.7% to 8.9%-9.1% (the unemployment rate measured 9.6% in October), with a long run unemployment rate in the 5%-6% range. Personal consumption expenditures (PCE) inflation is expected to average 1.2%-1.4% in 2010 and 1.1%-1.7% in 2011, with a long run projection of 1.6%-2.0%. Growth is frustratingly slow, unemployment is stubbornly high, and inflation is uncomfortably low.

On November 3, the Federal Open Market Committee (FOMC) announced its plan to buy an additional $600 billion in longer-term Treasury securities for a second round of quantitative easing, dubbed "QE2". The $600 billion will be spent as $75 billion per month through the end of the second quarter of 2011, subject to any adjustments needed. The FOMC also kept the benchmark Fed Funds rate at a record low target range of 0% to 0.25%. These moves are designed to boost growth, add jobs, and fight deflation. The next FOMC decision on interest rates will be announced on December 14.

The news of QE2 was met with mixed reviews. Market participants against QE2 believe that in the long run, a lack of fiscal discipline by the U.S. government will weaken the U.S. dollar and trigger inflation. Once investors lose faith in a government's ability to act responsibly with its finances, investors require higher returns on government bonds at the worst time – when debt levels are high. Following in Greece's footsteps, Ireland is the latest country in the European Union (EU) to lose credibility with investors. Spiking government bond yields suggest that Portugal, Spain, and Italy could be next in the contagion. Governments worldwide, including the U.S., have the tricky task of getting spending under control while trying to avoid spinning their economies back into recession.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $90.99, which implies a price-to-earnings (P/E) ratio of 13.0 with the S&P 500 at 1181. The earnings yield (E/P) is 7.71%, representing attractive value with the 10-year U.S. Treasury note at 2.81%. Equity valuations still present solid upside potential.

Momentum from the mild November pullback may continue in the first part of December, but support should win the battle in the coming weeks. The S&P 500 made it as high as 1225 in early November, but then retreated slightly. Ample support should come from the 50 day moving average at 1178, the 200 day moving average at 1134, and price support at 1125. So far in 2010, small and mid cap stocks have drastically outperformed the large caps (+16.2% and +17.3% versus +5.9%). Likewise, growth stocks have done better than value stocks in 2010 (+7.7% versus +4.0% for large caps, +22.8% versus +12.0% for mid caps, and +19.4% versus +13.2% for small caps). Some stock prices, especially in the small and mid cap growth categories, have increased exponentially in recent months, which is not a sustainable pace. In a low-growth world, investors must be careful to not overpay for growth.

We continue to favor large caps over small and mid caps, as well as favor value over growth. Slow and steady wins the race. We prefer to buy stocks that have not raced ahead of reality. While at times the global news can be alarming (such as the EU bailout of Ireland or North Korea attacking a South Korean island), the risk-reward parameters for buying large cap value stocks are compelling. Solid dividend yields and ample free cash flow help to make investing in this dynamic world a bit more comfortable.