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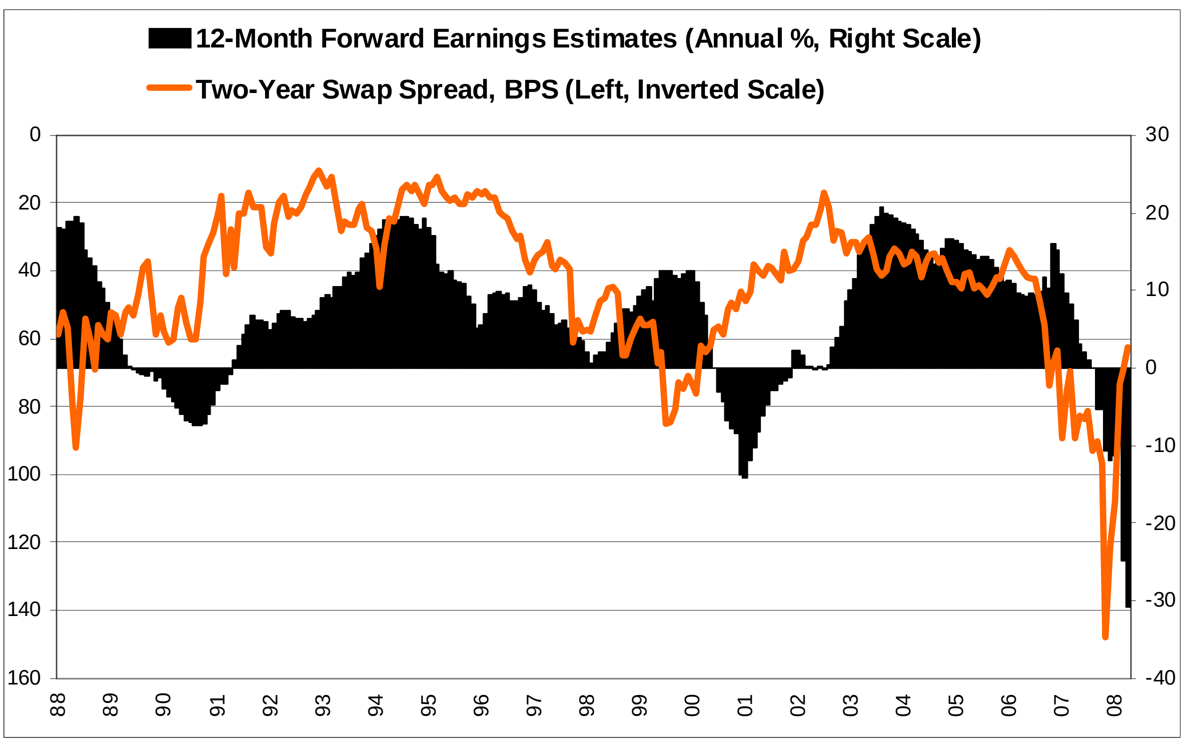
Economics & Strategy

Getting More Constructive

Several indicators that caused us to go bearish on equities last summer have recently improved, despite the sputtering stock market. When equities were rallying in July and August of 2008, we were increasingly concerned that credit markets were not participating in the upswing -- a red flag in our view. We also asserted that consensus earnings estimates were way too high -- potentially 25-30% north of what was likely given the stressed state of credit markets. Now, with forward earnings estimates down by one-third from last year's levels, and equities down more than 50% from the peak, *leading indicators of credit are starting to turn*. Indeed, our call last year for forward-earnings estimates to plunge from the $90s down to the high $60s now appears complete. **We now believe forward estimates are in the right ballpark, which means the stock market should begin to act better as we head into the spring and summer.**



Source: MKM Partners; Bloomberg; Thomson

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A look back at 127 years of stock market data suggests that equities are now in a range in which they may well bottom. Every stock market analyst seems to have a different number for “trough” or “recession” p/e multiples. Those with a bearish bias seem to use a trough multiple against trough earnings. We think the most conservative way to compare apples to apples is to look at where *cyclically-adjusted* p/e ratios were during recessionary troughs in the stock market over time. We are using Robert Shiller’s data on S&P earnings and stock prices back to the late 1800s. What our study found was that the median p/e ratio during recessionary “troughs” is about 13X cyclically-adjusted earnings with a standard deviation of +/-3.7. The lowest trough multiple was seen in 1932 when the stock market fell to 4.7X cyclically-adjusted earnings. Such an event today would place the S&P 500 at 289. The highest multiple the market has bottomed at was seen after the 2001 recession when the market bottomed at a lofty 21.3X cyclically-adjusted p/e ratio in late 2002. With cyclically-adjusted p/e ratios below historical norms (but not massively), we feel comfortable getting more constructive *as long as the credit markets and other leading indicators remain on an improving track.*

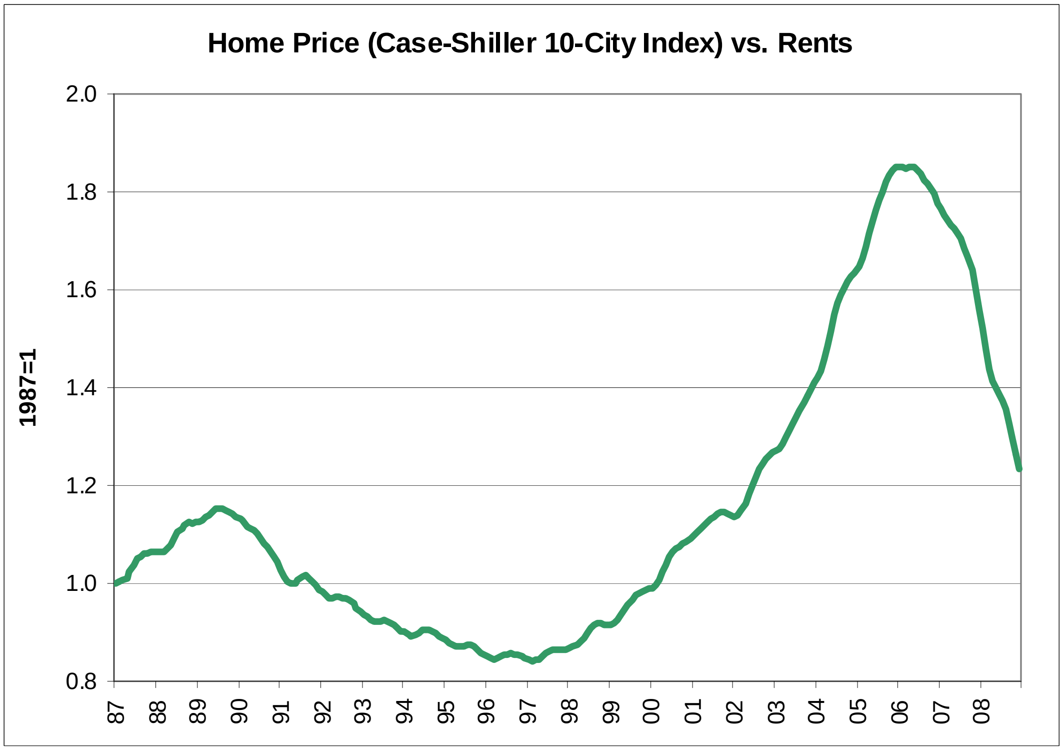
Stock Valuations At Recession Troughs

Date	***P/E Ratio* at Recession Trough***
1885	11.3
1888	13.5
1890	13.2
1893	12.7
1896	13.2
1900	18.9
1904	16.7
1907	11.7
1911	13.8
1915	11.5
1918	9.1
1921	7.5
1923	9.8
1927	14.1
1932	4.7
1938	11.6
1945	14.6
1949	11.7
1953	13.4
1958	15.3
1960	18.5
1970	16.7
1974	11.2
1982	9.9
1990	18.1
2001	21.3
Descriptive Statistics	***P/E***
Median	13.2
High	21.3 after 01' recession
Low	4.7, 1932 Depression Trough
Standard Deviation	+/-3.71

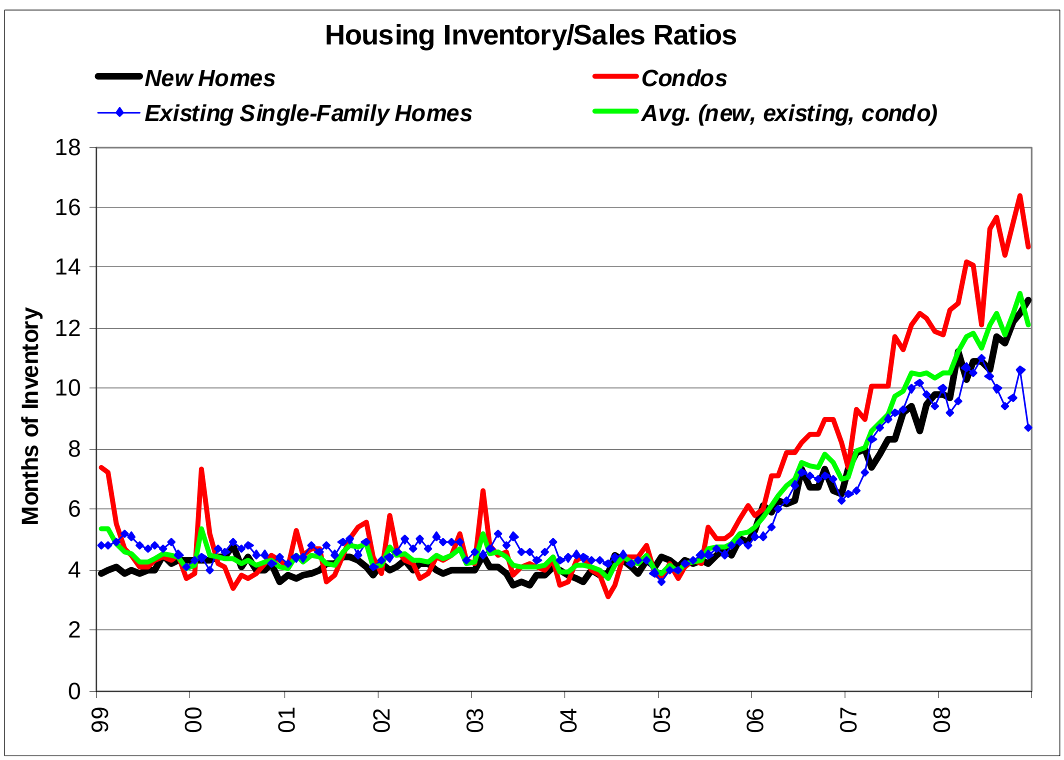
Source: Robert Shiller; Bloomberg; MKM Partners

**Cyclically-Adjusted P/E*

We continue to have a problem with falling home prices, but even here there's a silver lining. The December Case-Shiller data continued to show *rapid* declines. The CS 10-City Index fell 2.3% m/m, the fastest monthly fall since March 2008. The 20-City Index fell 2.5%, the fastest decline since February 2008. The 10-City Index is now down 28.3% from the 2006 peak while the 20-City Index has fallen 27%. The bad news is that home prices on a CS basis are still about 19% above rents, and history shows they tend to revert to the mean over time. The good news is that *this adjustment could be complete by year-end 2009 or early 2010 if prices continue to adjust down at a rate close to what we've seen over the last few months.*



Inventory-to-sales ratios for housing (which now average about one year) are also likely to be in much better shape by year-end. With leading indexes beginning to level out and credit spreads beginning to narrow, this could be a fairly constructive setup for 2010. It is also important not to overlook the fact that the

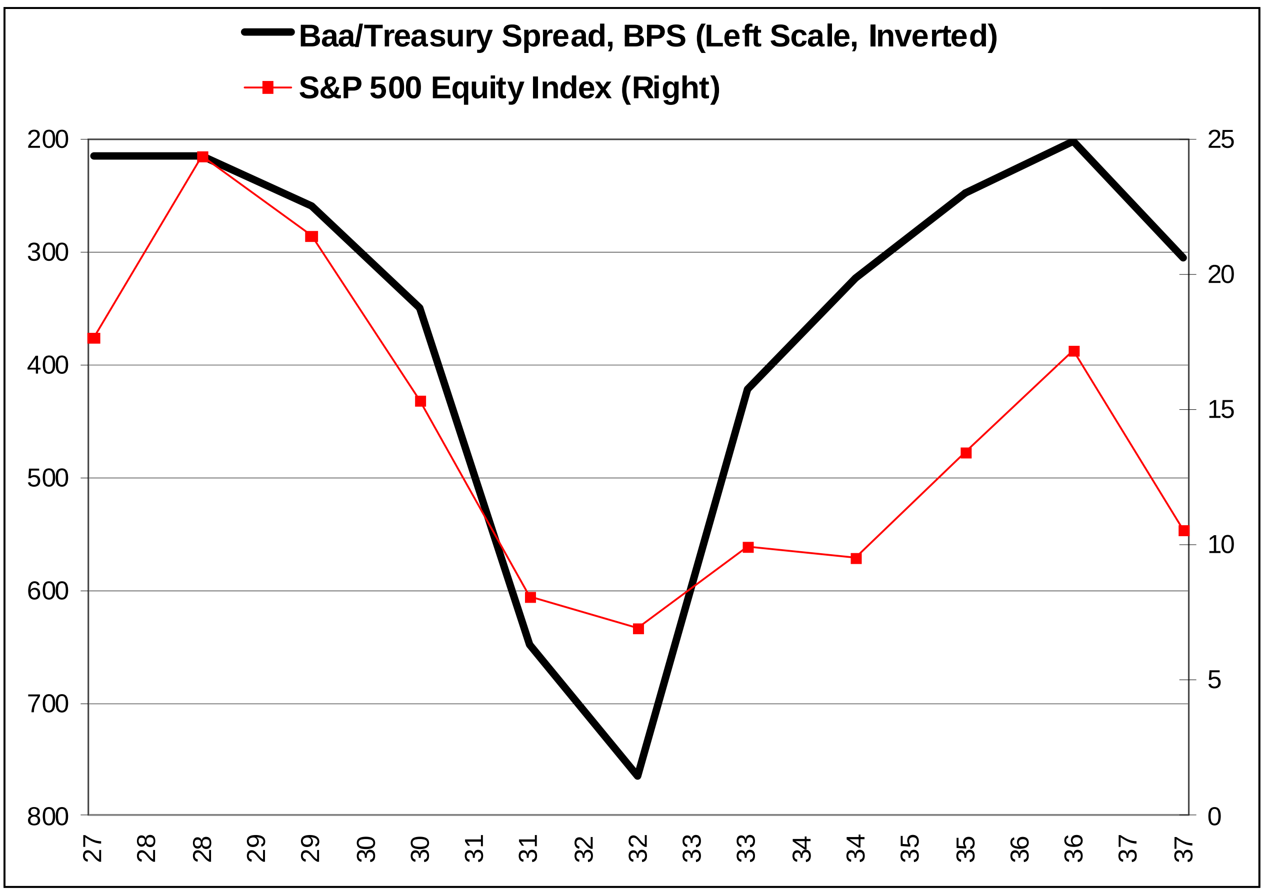


Source:Bloomberg

Fed is highly likely to be compelled to hold short rates below-market levels through 2010, which means money growth is likely to remain robust as lending programs and large deficits increase the demand for funds (and the Fed monetizes more debt in order to keep short rates from moving above the targeted level).

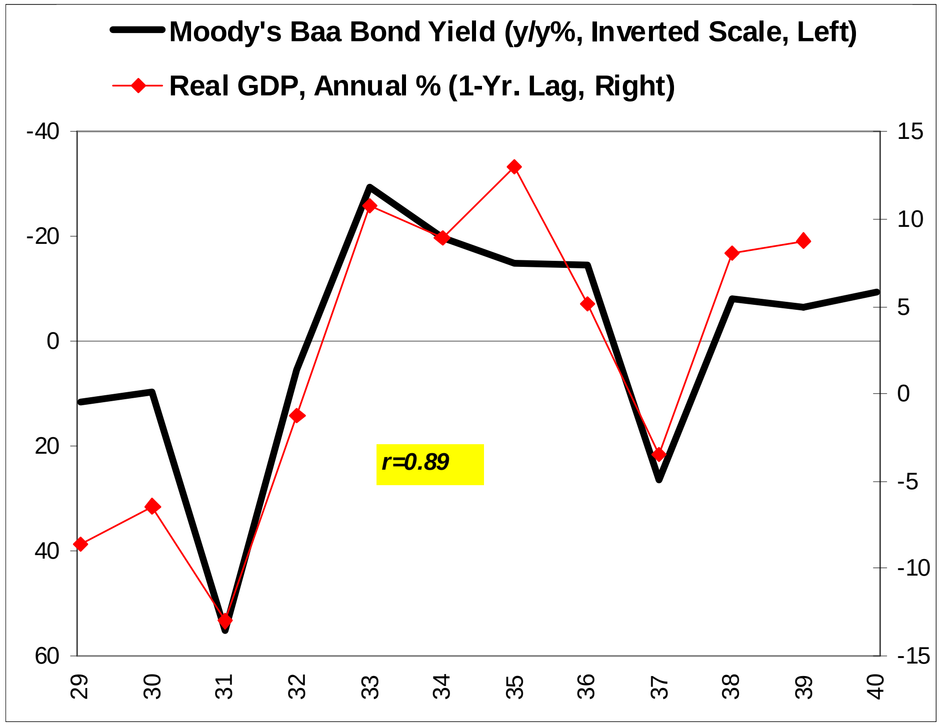
An improving corporate bond market marked the end of the 1929-1932 bear market and presaged the 1934-1936 recovery. While corporate bond yields are still too high and spreads remain too wide, *we have to start from somewhere and change takes place at the margin, not the average.* Indeed, we started from higher yield levels and spreads in 1932 than we saw late last year (although we got disconcertingly close to the 1932 peaks). In any event, if the corporate bond market continues to improve, it would likely be a strong bottoming signal for the stock market (and eventually) the economy. Corporate spreads now are 529 bps, down about 93 bps from the 2008 highs. However, interest rate swap spreads (pictured on page 1) have narrowed dramatically, to 65 bps from a peak of 165 bps in October, and they tend to *lead* corporate spreads. The interest rate swap market didn't exist during the Depression.

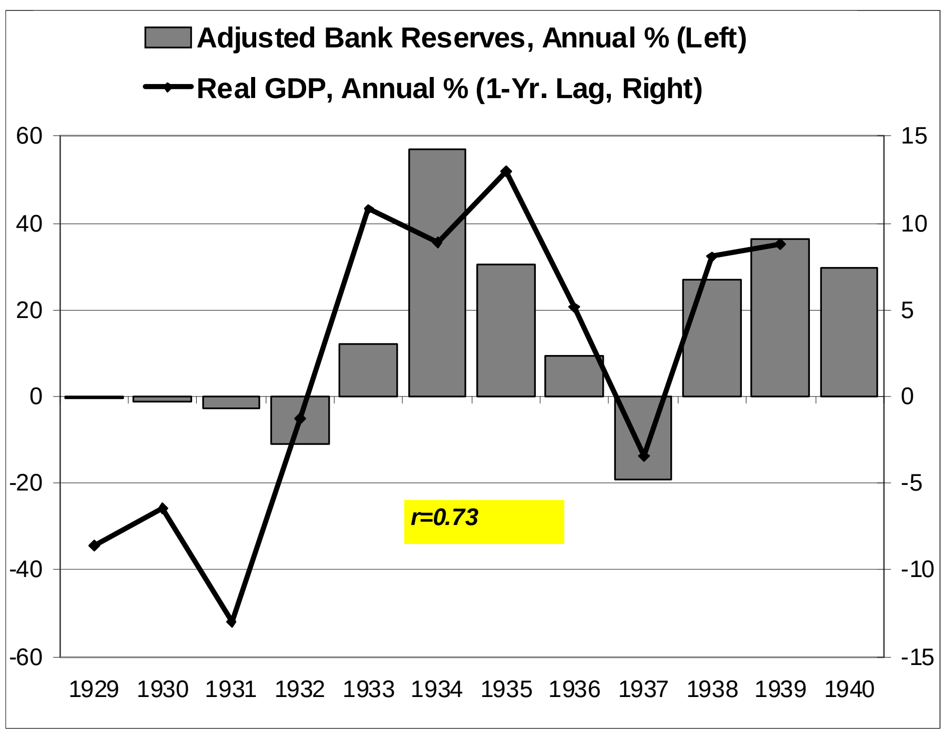
An Improving Corporate Bond Market Marked the End of the 1929-1932 Bear Market



Source: Bloomberg; MKM Partners

Conclusion & Investment Implications: Several indicators that caused us to go bearish on equities last summer have recently improved despite the sputtering stock market. Indeed, we now believe that bottom-up earnings expectations have fallen enough and are probably in an acceptable range (at about $68.7 for year-ahead expectations), a key ingredient for equity market stabilization. A look back at 127 years of stock market data shows that on average, equities have bottomed at about 13X cyclically-adjusted earnings. After yesterday's rout, the market had fallen to 12X cyclically-adjusted earnings. In other words, equities are now in a range in which they may well bottom, although it may take until later this spring to see the stock market acting better on a consistent basis. We continue to have a problem with falling home prices -- the *source* of the current duress in the household and financial sectors -- but even here there's a silver lining. If home prices continue to slip by about 2% per month, they would be back at 2000 levels vis-à-vis rents by year-end, a necessary adjustment in our view. We continue to believe it will be important to watch leading indicators (which appear to be bottoming) and the corporate debt markets (which are off their worst levels). An improving corporate bond market marked the end of the 1929-1932 bear market and *presaged* the economic recovery of 1934-1936, which was more robust than anyone thought possible in 1932. As Mark Twain once said, "history doesn't repeat, but it rhymes." Although there will be bumps ahead, we believe 2010 will turn out to be more robust than widely believed. The market should begin to discount this ahead of time.





Source: Federal Reserve Bank of St. Louis; MKM Partners

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