



Market Comments - Year-end 2010  
January 17, 2011

From an investor's viewpoint, there is usually something satisfying about starting over - that is, starting over in terms of the calendar. 2010 was a surprisingly good year for stocks, especially coming on the heels of 2009. The gain in domestic markets certainly surprised us - near mid-year we wrote that these markets would likely see returns somewhere near mid-single digits. Well, we will just have to live with that sort of error and if we make an error this year in terms of a forecast, we hope any such miscue is similar.

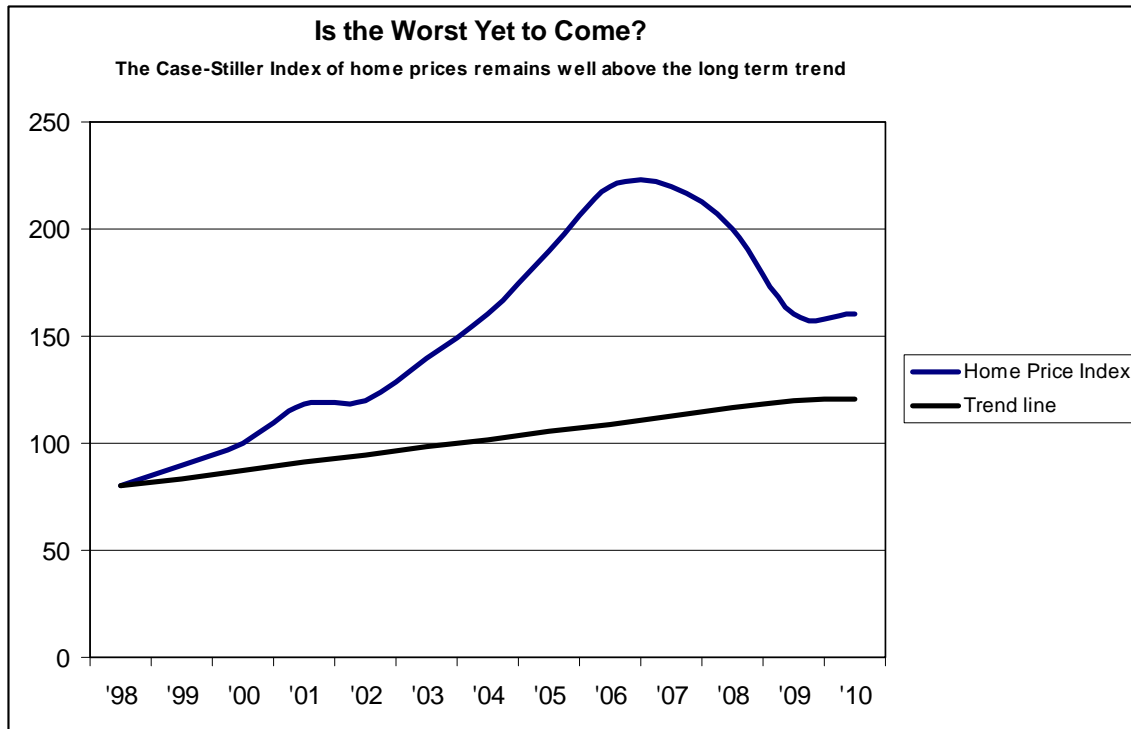
The S&P 500 total return for the year gained 15.08% percent, international developed markets 8.25% (many managed international growth funds did substantially better) and developing markets were out in front, gaining 19.42% as measured by the Vanguard Emerging Markets Index. Again, this is pretty handsome in view of the earlier-in-the-year gloom of many professionals. We have to wonder if market performance in 2010 borrowed from whatever investors might anticipate in 2011. We doubt that, but there are some analysts and strategists asking this question and raising that as a possibility.

As we can all agree, the case for another successful year for equity investors hinges upon a recovery that continues to gather strength and is not cut short or weakened by (a) poor decisions by policy makers, and/or (b) events in other parts of the world that have the same impact. There still exists the same cloud hanging over markets worldwide - that of the necessity of a period of de-leveraging by governments, central banks, individuals, and on and on. This is the much debated (and in many cases, hard to address and confront), "medicine" portion of all the leverage created in the recession of 2008. Some day, some time, leverage must be addressed and reducing the leverage run-up will be painful in many quarters, not only as an economic issue, but from a social standpoint as well. This reality will

also be a drag on the level and pace of economic activity. There is always the nagging fact that we just never know the precise effect economic policies that, at present, are aimed at healing balance sheets, especially sovereign debt and central bank balance sheets, will have on output levels. Looking at past periods of deleveraging suggests that these periods are more characterized by lower output levels than those where debt pay down is not central.

So what are the basics of the ongoing health of an economic recovery? Although there are many, the most obvious would be a period where (1) lenders step up lending, (2) consumers step up consumption, and (3) employers step up hiring. All these need to occur in a period where governments and central banks are forced to pursue policies that would neither be stimulative nor necessarily conducive to any of those three.

There is also the real estate/housing drag. Most analysts continue to suggest that we still face some years of recovery in these markets before we reach previous levels of starts and new construction. This longer-term threat is not insignificant in terms of a hurdle for this recovery. Peter Schiff of Euro-Pacific Capital recently wrote in the Wall Street Journal that home prices are still well above the longer-term trend line and that some realignment with that long-term trend line is likely many years away. (see chart 1 below) He also points out that the home price boom, as measured by the Case-Shiller Index, which began in 1998 and topped out in 2006 was extraordinary, gaining 173%, or about 19% annually, over those nine years. This greatly contrasts with the 3% or so over much longer periods. We now know that this explosion in prices had very little to do with market fundamentals, but rather, with what he terms “distortionary government policies” that mandated loans to marginal buyers, accompanied by a torrent of easy credit. Again, weakness in housing prices will be a problem as policy makers continue to reach for ways to push economic activity towards trend line growth.



Source: Standard & Poor's Case-Shiller 10-City Home Price Index. Data for the log-term trend line extrapolated from Robert Shiller's 2005 book, "Irrational Exuberance."

In spite of the de-leveraging and real estate headwinds, the news is not all bad: inflation is not yet the problem that may well develop later on, interest rates are still very low, and, most importantly, earnings are growing. We have pointed out many times that periods like this - that is, when these three elements are present, have almost always been periods of very attractive equity markets. S&P 500 operating earnings for 2010 should be in the neighborhood of \$86.00 and estimates for this year are somewhere near \$96.00 and as high as \$105.00 in 2012. One thing about earnings estimates - they will no doubt be wrong - either better or worse, but likely not the so-called consensus number. But if these are close, markets currently are trading about 14 times the estimates for 2011 and this level still suggests very attractive expected returns for the intermediate. We would tie market returns expectations to that earnings growth figure. 2011 returns could well be in the low double-digit range for U.S. stocks, and somewhat better in developing country markets. We think international developed markets will be more constrained for this year.

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