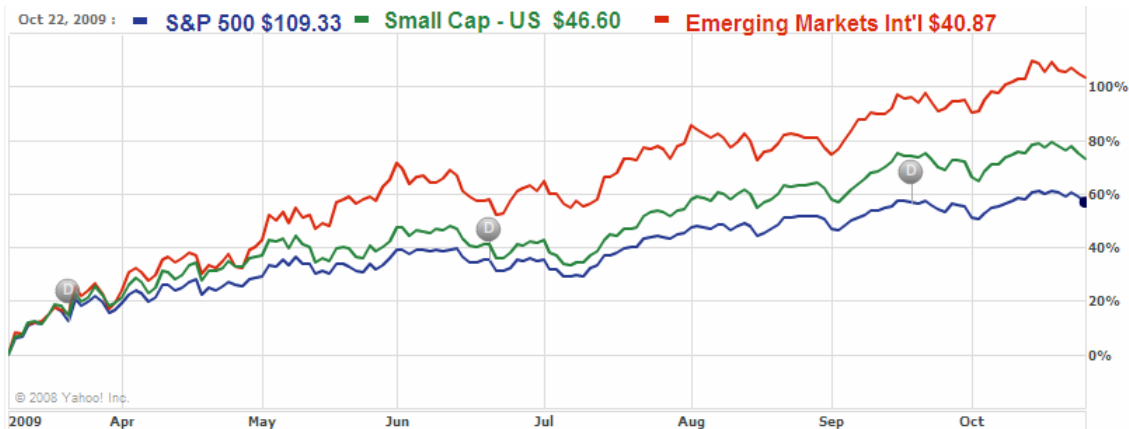




Market Comments October 28, 2009

It has been some time since I have had the opportunity to put some thoughts on paper, and as I look over my shoulder, I am still stunned at what has transpired much of this year. This has been the most dramatic and swift triumph of greed over fear that I can ever remember. Below is a chart showing two of our more volatile asset categories, emerging markets and the small cap basket, compared to the S&P 500 since March's market lows. Of course, all of you know this story by now, but seeing it in graph form is an eye-opener. Broad-based measures of domestic stocks are ahead almost 60% since the March lows, and during the same period small cap stocks are up 75% and emerging markets have advanced almost 100%. The September quarter was the best three months for domestic stocks since 1998.



For the moment, most indicators seem to suggest that the U.S. economy is continuing the recovery from the recession brought on by the financial crisis, and investors are conditioned to view the future in terms of all the metrics of past contractions and expansions. This is to be expected, and after the trauma of 2008, those same investors can also be excused for perhaps being a little over exuberant. Tobias Levkovich, the chief U.S. equity strategist for Citigroup, recently pointed out just how extraordinary the move since early March has been. Since 1929, stocks have risen an average of 47 percent in the *two years* from the trough reached in a recession, while the almost 60 percent gain this time has occurred in about *six months*. So, we might conclude that either the earnings rebound is still under estimated or stocks are ahead of themselves based upon estimates for 2010. Speaking of earnings, it now appears that the trough in earnings for the S&P 500 will be about \$60 for calendar 2008, will likely be around \$66 this year, and estimates for 2010 are

already in the \$78 range. So, if we use these numbers, the S&P is now selling for about 16 times trailing 12 months earnings and about 15 times these estimates for next year.

This sort of exercise is just what analysts and strategists go through in trying to determine if current prices are justified, and in going through the process of formulating estimates, they have to employ some sort of economic framework on which to base those estimates. But what if what lies ahead is not in keeping with all the history of past contractions and expansions? This possibility increasingly has been talked about by strategists, and given its own handle by the likes of Mohamed El-Erian of PIMCO – the “new normal”. His view is simply that because of the severity of the world wide recession and the economic turmoil that gripped the world last year, the world may be facing a period of more permanent restrained rates of growth with investment, employment and productivity at lower levels than before. Steering clear of this sort of environment will very probably be a very tricky maneuver –for governments and policy makers and for corporations. El-Erian and others worry that growth will be subdued, unemployment will remain high, and the banking system will remain a shadow of its former self, resulting in more costly financing and weaker investment, placing pressure on plant and equipment spending.

Looking back on the events of the past year it certainly appears that there are big differences in how governments responded to the crisis, with some markets (countries) more in doubt and some on the road to recovery with less stress. Emerging markets may well be the surprise in terms of resilience, and China seems at the front of that group. Fareed Zakaria of Newsweek International wrote about this recently, and he points out that not only has China survived, but it has actually thrived. The Chinese economy will grow in excess of 8% this year, exports have rebounded to where they were in 2008, foreign exchange reserves have hit an all time high of \$2.3 trillion, and Beijing’s stimulus package has launched the next great phase of infrastructure building in the country.

Zakaria also points out that almost every government in the Western world entered the crisis poorly prepared. Governments were spending too much and running high deficits, so when they had to spend massively to stabilize their economies, deficits exploded. Three years ago, European countries were required to have a budget deficit of less than 3 percent of GDP in order to qualify for EU membership. Next year, many will have deficits of about 8 percent of GDP. The U.S. deficit will be higher, in percentage terms, than at any point since World War II. China, on the other hand, entered the period in a different position. It was running a budget surplus, had been raising interest rates to address excessive growth, and its banks had been reining in consumer spending and excessive credit. China adopted a much more “enlightened” approach to its stimulus spending, earmarking money for ports, airports, high speed rail and roads – in short, real spending for the future. This has the look of our being “out-free-enterprised” by the Chinese, and then almost “out-government-policied” – sort of embarrassing.

Whether or not the reality of a “new normal” will prevail, we might reasonably conclude that the return to operating levels in the U.S. economy that has taken place after past contractions may well be different and take longer. Yes, earnings are recovering nicely, but strategists have emphasized that much of those gains have come from cost savings rather than top-line growth. That may be okay – earnings growth is good regardless of origin, but

we should recognize the difference. For our part, we will make sure our account objectives are closely monitored, and that cash is held to minimum levels. In addition, this is a good time to stay invested according to our Model, which maintains exposure to additional asset categories, especially international and emerging markets. We need to continue to own stocks with lower Betas, higher yields, and more visible earnings. In short, we need to stick to our disciplines. The next few years should see a return to the out-performance of stocks compared to bonds (unlike the last ten years) and may well be one where large cap value returns to the head of the class.

Allan Keyes
Chief Investment Officer