July, 2012

In my January letter, I predicted that the 2012 market would have a similar amount of volatility, but have higher lows and higher highs. The S&P 500 index had an almost 240 point spread between its high and low during 2011. So far, the volatility has been less, with a 140 point spread between the high and low. We have seen higher lows and higher highs.

Companies have continued to improve their earnings through the period. It is true that earnings expectations have been coming down for the second quarter and for the full year. These earnings expectations are not down from last year, but represent a smaller increase than expected. Over the next few weeks, companies will be announcing their second quarter earnings, and many will comment on their expectations for the rest of the year. It is quite possible that there might be some disappointments in these comments. It is also fair to ask what impact this might have on the markets.

The market is forward looking. Investors always have two questions: What am I paying up front, and what am I going to get back. This is a straightforward question with bonds. You buy the bond for a set price, receive contracted interest payments while you hold the bond, and receive a contracted amount upon maturity.

With stocks, there is similar analysis, but it is a bit more opaque. You purchase the stock for a set price and as a result have an interest in the future earnings of the company. These earnings can be received by you in two ways. The company might distribute some of these earnings in the form of dividends. This is cash in your pocket. They are not contracted like bond interest payments are but can represent an important source of return. If a company pays out to shareholders a consistent percentage of their earnings, then you can expect your dividend payments to increase over time. This increasing source of cash flow can be more attractive than a flat interest payment from a bond.

The second way you can receive an economic benefit from a stock is an increase in its value over time. Why should the value of a stock go up over time? Remember, as a shareholder, you share in the earnings of the company. The price you pay today will reflect the markets perception of the future earnings of the company today. If you sell the stock in 10 years, the price you receive when selling the stock will reflect the market's perception of the company's earnings going forward from that point. If the company in question is growing, chances are the price for which you sell the stock will be higher than the price you paid.

Why does this matter today? The price of a stock or an index is observable. The earnings of a stock or index are also observable. With these two numbers you can calculate the Price/Earnings ratio (PE). The PE tells us how much we have to pay

for each dollar of earnings. It can indicate to us how expensive the market is. As a result, it can tell us how euphoric or fearful a market is. For you algebra fans out there, note that if you tell me the earnings for a stock, and its PE ratio, I can tell you the price that the stock will sell for. Of course, this is difficult to do. What if we think about changes in these values rather than precise numbers? Can they help us assess the markets and where they might lead?

If things happen that are better than expected, we could have higher earnings, a higher (more enthusiastic PE ratio), or both. If things are worse than expected, we could have lower earnings, a lower (more fearful PE ratio) or both.

Consider September of 2000. Over the following 12 months, we were heading into an economic slowdown (influenced by the technology bubble bursting and the 9-11 terrorist attack). How prepared were we entering into this market? Earnings were headed down. Before this happened, the S&P500 PE ratio was 26 times earnings. Not only did earnings fall for a time, but the market went from euphoria to despair. Both the market and the PE ratio fell over 40% over the next two years. Over the subsequent two years, earnings rose by 92% yet the market only increased by 37%. The market rose, but was less euphoric than before (as indicated by a lower PE)

Consider June of 1990. The economy had been sluggish, and there were problems in real estate. Iraq's invasion of Kuwait was to happen in August, causing a jump in oil prices and tougher economic conditions. How prepared was the market then and what happened?

In June of 1990, there was less investor enthusiasm. The PE for the S&P500 was 16.8 times earnings. While earnings would in fact decline over the next two years (about 20%), the market would actually rise (about 14%). I am sure that the level of enthusiasm around the end of the first Gulf War helped, as did growing hope for economic growth. The PE rose to about 24 times earnings.

What about today? We have experienced a nice increase in earnings, along with a decent amount of fear. The current PE ratio is 14.7 times earnings. Given today's expectations for next year's earnings, the PE ratio would be 12.5 times earnings at current price levels. Of course, we do not know that those earnings will actually occur. We have an election to wonder about in this country and all of the problems in Europe. Given today's PE ratio, how prepared are we to deal with any negative news over the next 12 months?

The potential negative events are pretty big (sovereign defaults, break up of Euro), but I think that the current valuation of the market makes us reasonably well prepared to deal with what happens. Another way to say this is that I believe that in many potential outcomes, the downside risk to stocks is limited due to the current reasonable valuation (by limited, I mean 15%).

There are several groups of people that can move things in the right or wrong direction. Businesses and consumers (the private sector) are one group. They have money, but are currently choosing to hold back. Their current contribution to economic weakness is by choice. They are choosing not to spend. This is easier to solve than if they were not able to spend.

Monetary policy makers, aka central banks are another group. These entities have gone a long way towards using the tools they have to help. Our Fed Chairman Bernanke has been telling Congress for a year now that it is now their turn to adopt good policies. The European Central Bank is doing more now since the change in leadership last year, but they too now need the cooperation of politicians.

The fiscal policy makers (the politicians) are the third group. Include the regulators in this group as well, since they are enabled through the legislative bodies. What are the odds that the world's politicians will get things right? How does this answer relate to the current state of the market?

I would say that the current valuation of the market suggests that the politicians will not get things totally correct. If we assumed that they would, I think we would see a higher PE ratio today. My hope is that they do not really screw up.

Six years ago, the S&P500 ended June earning $74.49 per share in the prior 12 months. This June, the S&P500 ended June earning about $92.40 in the prior 12 months. This is a 24% increase over 6 years, or 3.65% per year. The price level of the market is about the same. Earnings are up 25% and the market is flat. This result is after all of the mistakes made by the private sector and politicians. Will the current mistakes be just as bad or better?

I would argue that given the current valuation of the market, it is possible for the politicians to make some mistakes, and for the markets to generate positive returns over the next 3 to 5 years.

Sincerely,

Peter B. Harre, CFA