

June 30, 2009 Market Commentary and Outlook

Been Down So Long It Looks Like Up to Me

--Title of book written by Richard Farina, 1966

Investors must have had the title to this book in mind given their reactions to much of the news that drove the financial markets in March, April and May. The events of the prior six months were so mind-numbingly scary that any news that wasn't disastrous was interpreted as something to be enthusiastic about. For instance:

- On April 9, initial jobless claims drop 20,000 though they remain up 73.2% year-over-year. And continuing jobless claims move up by 95,000 (a smaller number than expected). The S&P ends up 3.81% on the day.
- On May 8, Fannie Mae reports a 1st Quarter loss of \$23.2b compared to \$25.2b in the prior quarter. The S&P is up 2.41%.
- On June 1, GM declares bankruptcy and is scheduled to receive an additional \$30.1b in federal aid (on top of \$19.4b already received). The S&P rallies 2.58%.

Investors had simply been looking for anything to cheer about. But as Bob Dylan used to sing back in the '60s, "*The times they are a-changing.*" Investors are now likely to be more circumspect in their response to economic data.

On June 12, the Dow Jones Industrial Average recouped all of its losses from earlier in the year, only to close down 3.75% at the end of the 2nd Quarter. Terrific news given that the S&P at one point in the 1st Quarter was under water by 21%. *Is there a message to investors in the manic-depressive nature of the markets here in 2009?*

Investors should not view the recent recovery of the financial markets as evidence that the economy is rebounding. Certainly, the immediate impacts of the financial shocks of 2008 have been diffused (although the long-term effects of fiscal and monetary policy will still play out in the years ahead.) The market here in July is definitely awaiting evidence that the economy is in

recovery--and the extent to which it is recovering, will come from reports on corporate earnings.

Corporate earnings are important because they are one of the variables in the pricing of stocks as embodied within the Price-to-Earnings Ratio (or P/E Ratio.) A stock earning \$5 and selling at a 15 P/E Ratio would be priced at \$75 ($\$5 \times 15 = \75).

Subsequent increases in stock prices can come from earnings increase alone. If the stock earns \$6 and is still selling at a 15 P/E, the stock is priced at \$90. A stock's earnings need not change for its price to rise or fall; the P/E multiple can change instead. If the stock earning \$5 sells at an 18 P/E, it would sell for \$90; or \$50 if the P/E is 10. Investors dream of owning stocks in which both earnings increase as well as the P/E multiple!

Current estimate of operating earnings for the companies within the S&P 500 for the four quarters starting July 1, 2009 is \$66. Given the S&P 500's closing price of 919.32 on June 30, the Price/Earnings Ratio for the S&P 500 is 13.93. Historically, this is a reasonable, if not inexpensive,

price to pay for the S&P 500. In other words, stocks are slightly under-valued if in fact earnings come in at \$67 over the next 4 quarters.

How reasonable are these estimates? Consider that reported earnings of the S&P for the four quarters ending March 31, 2009 were only \$7. But remember, stocks are generally priced based on future earnings and not what earnings have been recently.

Qtr Ending	S&P	P/E Ratio	Qtr Ending	S&P	P/E Ratio
Q4 '07	1468.36	29.66	Q4 '04	1211.92	15.85
Q3 '07	1526.75	23.55	Q3 '04	1114.58	15.02
Q2 '07	1503.35	21.56	Q2 '04	1140.84	15.79
Q1 '07	1420.86	18.51	Q1 '04	1126.21	16.13
Q4 '06	1418.30	17.18	Q4 '03	1111.92	16.43
Q3 '06	1335.85	14.96	Q3 '03	995.97	15.42
Q2 '06	1270.20	13.89	Q2 '03	974.50	15.68
Q1 '06	1294.83	14.49	Q1 '03	848.18	14.60
Q4 '05	1248.29	14.23	Q4 '02	879.82	16.09
Q3 '05	1228.81	14.30	Q3 '02	815.28	15.75
Q2 '05	1191.33	14.58	Q2 '02	989.81	20.22
Q1 '05	1180.59	14.91	Q1 '02	1147.39	24.07

Current S&P estimates for the 3rd Quarter of 2009 are within sixteen cents of the actual operating earnings in the 4th Quarter of 2007. *Have the financial shocks of this recession had no impact on the earnings capabilities of corporate America?* With each passing quarter, companies within the S&P are expected to earn increasingly more money. *Really? Are there to be no headwinds to rising profits, say from further potential write-downs in residential and commercial real estate, to name just one concern?*

There is usually a huge disparity between the P/E Ratio based on forecasted earnings and the P/E Ratio based on actual earnings. The table on the previous page shows the closing price on the S&P 500 at various calendar quarter ends over the past several years. The P/E Ratio reported in the table is the multiple that the closing price reflects given the actual earnings that were reported in the subsequent four quarters (these being calculated with the benefit of hindsight!)

Note how much investors paid for the S&P 500 based on actual earnings in the quarters running up to the start of the Bear Market in 2007. It's not surprising that P/E Ratios were high at the height of a bull market. What would be surprising is if investors knew they were paying that high of price!

Put the current 13.93 P/E ratio in context of what has been paid historically. It's a very cheap multiple to pay if earnings materialize.

The June employment report was met with disappointment and concern by investors, translating into a loss of 2.91% for the S&P 500 the day of the report. According to the U.S. Bureau of Labor Statistics, the unemployment rate rose slightly from 9.4% to 9.5%. (Keep in mind that these statistics do not fully reflect pay-cuts and trimmed hours that many workers are experiencing.) The average duration of unemployment is at an all-time high. During the last two recessions, job losses continued for at least a year and a half after the recession was over. Some pundits are estimating unemployment will reach 11% in early 2011.

Normally considered a lagging indicator, some are arguing that the unemployment rate should in this economic climate be regarded as a leading indicator. *How many of the unemployed have mortgages that exceed the value of their houses? How many are burdened by high credit card debt?* In no previous, recent recession have we seen the consumer so saddled with debt, or so much negative home equity.

Weak conditions in the labor market mean problems for the U.S. consumer. If increasing job losses lead to further delinquencies on loans and securities, banks' earnings will be negatively impacted. We have already seen banks aggressively increase their loan loss provisions. Mounting job losses will have a significant effect on consumer confidence and consumption in the months ahead. Businesses will be more hesitant about increasing production. The housing market will continue to be weak.

Some pundits are forecasting the recession to continue through the end of the year and into the beginning of 2010. Still others see a slight recovery given the huge amount of government stimulus, but it will be short-lived and the economy will slip back into recession (a W-shaped economy). Regardless of the timing on the recovery, most agree the economy when it does show growth will likely be anemic, subpar and below trend. Not the best environment in which corporate earnings can increase. Nor the best scenario for increasing stock prices.

We would not be at all surprised if the stock market traded lower from current levels. Investors will not settle for news that is "just good enough" for this rally to be sustained. There needs to be real evidence that the recession is about to end. Unfortunately, any real disappointments will be met with weakness in stock prices. *Does that mean investors should sell all their stocks and buy at a lower price?* Absolutely not.

The average investor should remember that he or she is investing, and not trading or speculating. The success of your stock portfolio needs to be measured in terms of years, not months or quarters. Keep invested in stocks only that percentage of your portfolio you can afford to have at risk for upwards of a five to ten year period of time. And be certain you have the temperament to maintain that investment when the markets get ugly as they recently have. Only then will you own stocks that will participate in the rallies such as we saw in March through May.

We cannot rule out that stocks will get cheaper in the near term. But long-term, stock valuations are reasonably priced. In this market climate, one needs to keep a focus on the long-term.

Since we started off this Commentary with a flashback to the 60's, let's end with another oldie, this time from the TV show "Hill Street Blues." Sergeant Phil Esterhaus used to send his patrolmen from their daily briefing with a warning investors should today take to heart: *Hey, let's be careful out there!*

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