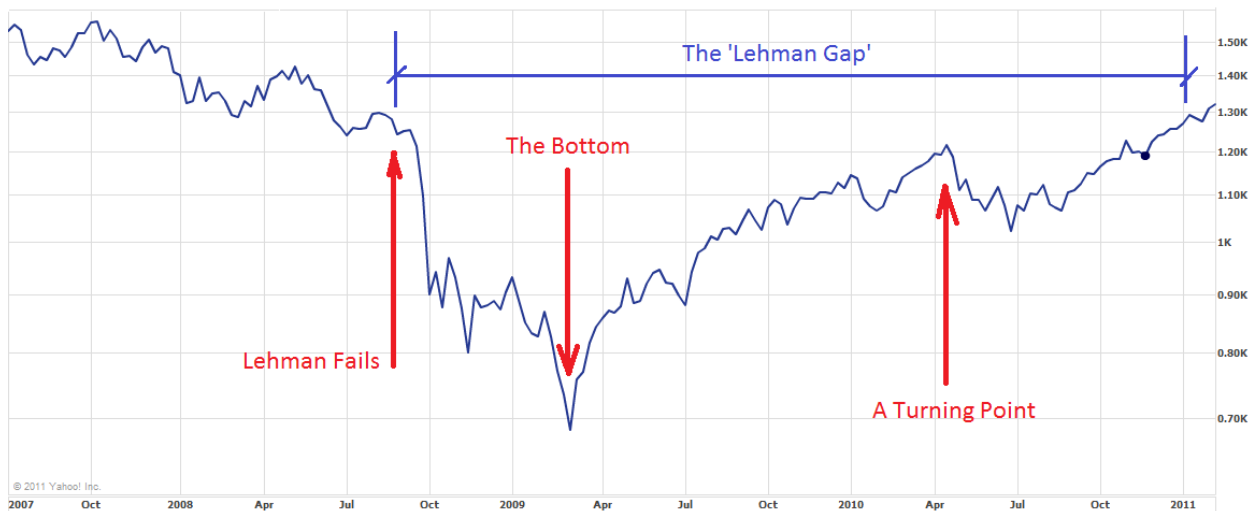


## Thought for the Week: Tuesday, February 7th, 2011

### Where Next for Equities?

Given the remarkable recovery of equity indices since the bottom in March 2009, we seem to have **reached a point similar to April 2010**; a point where many **investors are questioning the sustainability of equities at these elevated prices**. The chart below shows how far the S&P 500 has come in nearly two years.



We are back at the level where Lehman failed; **can the market really go any further?** Has the economy really healed or will all the debt, unemployment and housing insolvency push it back over the edge?

At these levels, **we are exercising caution** as markets rarely head straight up for too long, as can be seen in the chart above. Sudden, sharp corrections are a feature of bull markets. Although we do not predict another year where equity returns will be in the 'teens', we can see **a number of reasons to remain invested in equities**, even through a potential correction:

#### Goldilocks Inflation Scenario

Most economists feel comfortable with inflation at current levels. Given that the same economists were worried about falling inflation last year, we are in the range of **"not too hot and not too cold"**. Should inflation stay in this range, it will help support economic recovery.

One way in which inflation helps equities is by **creating increased demand for 'risk' investments**. Say inflation is 1% and you can buy a Government bond yielding 4%, is this attractive? Yes – your capital is growing at a real rate of 3%.

Does this reduce the attraction of equities? Yes – why subject your capital to higher levels of perceived risk when you can enjoy such a high level of real return?

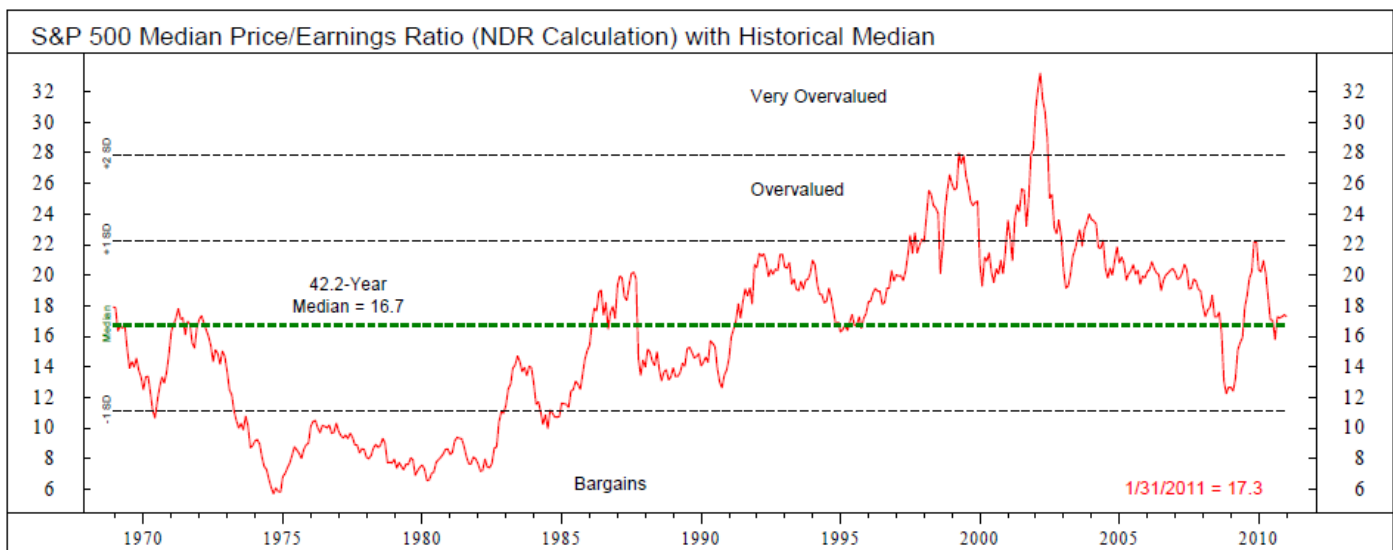
However, if inflation rises to 4%, is the same bond still as attractive? No, the investment does not appreciate in real terms – (yield minus inflation). So, an investor must now pursue higher levels of risk in order to beat the negative effects of inflation. Higher levels of return and risk typically require investment in company-related investments such as corporate bonds and equities.

**The control of inflation remains one of the biggest challenges** for the world economy.

## Valuation

Although it may feel like the stock prices that comprise the S&P 500 have shot into the clouds, **underlying Price/Earnings valuations still have their feet on the ground**. Assuming \$93 in S&P earnings (a consensus P/E for 2011) you are looking at a market P/E of 15.4 which is fairly valued on a historical basis. However, at 1.82%, the average yield on equities are somewhat below their historical average; not surprising given the capital appreciation of recent years.

The chart below shows the Ned Davis Research view of Historical current P/E Ratios.



## Company Earnings & Revenues

Of the 290 S&P 500 companies that had reported fourth-quarter earnings as of last week, 236 saw higher earnings per share than in the previous year's report. That's a big number — and worth noting, since the easier year-over-year comparisons are gone, now that we are farther removed from the worst of the financial crisis. Also noteworthy is that **more than 70% of S&P 500 stocks topped Wall Street earnings-per-share forecasts in their fourth quarter**.

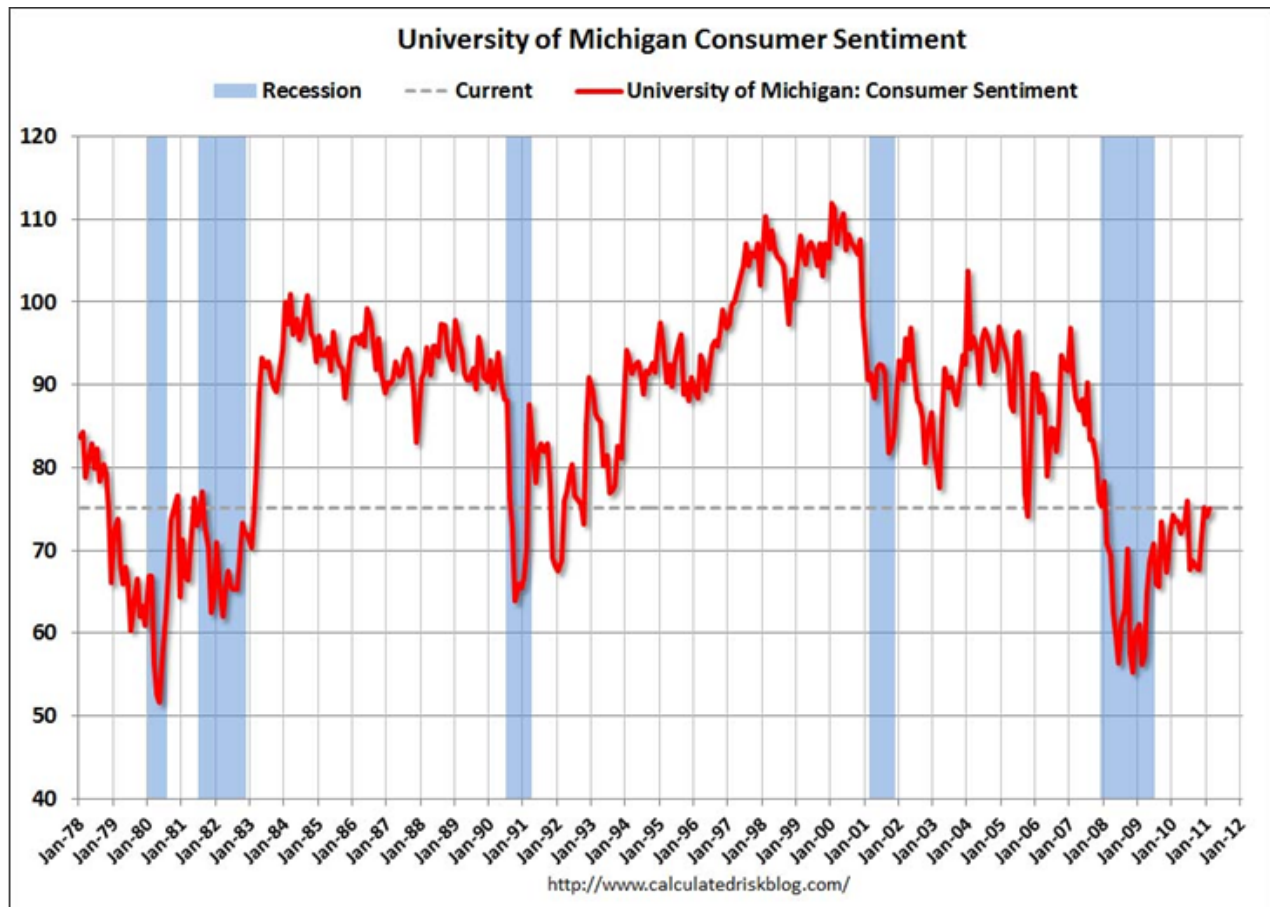
However, as earnings rise higher, the risk of disappointment rises exponentially. We see **a number of concerns regarding future earnings** increases including:

- **Producer prices are increasing significantly** within certain sectors and commodities. Those companies with the power to raise prices will be able to cope but those companies who cannot control their prices will be faced with a difficult decision: raise prices and risk lower revenues or keep prices low and suffer reduced profit margins.

- **Low interest rates have lowered corporate cost of borrowing**, thereby increasing margins and allowing investment in expansion, to some degree. Low interest rates may be a thing of the past and higher borrowing costs are on the horizon, **thereby putting pressure on profit margins**.
- **Earnings growth, and many of the factors which improve earnings, has finite limits**. You can only cut so many jobs and improve productivity to a level; this level may have been reached.

### Welcome back Consumer; we've missed you!

Credit conditions and consumer sentiment for stock-buying (as measured by cashflows into equity based mutual funds, for example) are improving at the same time as **consumers are 'hitting the stores' again**. Consumer spending is a very important leg which economic recovery depends upon for stability. For a long time, lack of consumer participation was used as a reason to question recovery; now **the consumer 'leg' is solidifying, the whole economy feels less wobbly**.



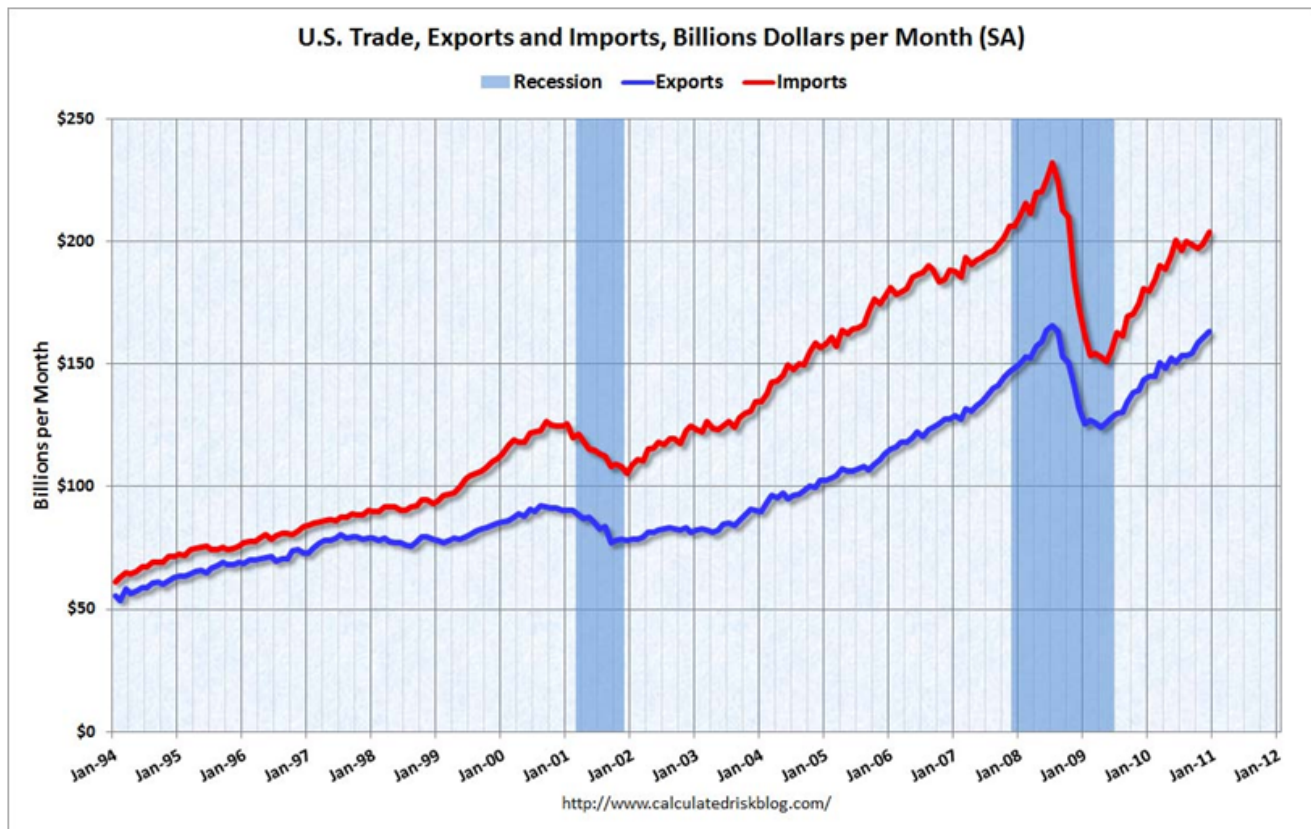
**Note:** there are those, including certain members of our investment team, that will tell you **consumer sentiment is a contrarian indicator**. The higher this indicator rises, the riskier equity participation becomes. You have been warned!

## Imports and Exports

**Exports are rapidly growing.** January U.S. gross domestic product grew at an inflation-adjusted annual rate of 3.2% in the fourth quarter as Americans spent more and exports ticked up. The headline number alone is cause to be optimistic, but the fact that the **gains were driven in large part by the consumer** instead of business spending is a very encouraging sign.

Unfortunately, imports are growing quicker which is **not good news for the U.S. balance of payments.**

***But who can look at the chart below and say the economy isn't expanding?***



## One last Warning - Volatility

So, plain sailing ahead?

Let's end how we started. **This is a time for caution. Most of our indicators are showing the potential for a correction in the next few months.** For those who sit tight and weather that storm, should it appear, we would expect acceptable returns for the remainder of the year based, to a large degree on the factors above.