MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

2000's: Volatile Decade Ends on Upbeat Note

The US equity market, as measured by the S&P 500 Index, has generated a stunning 27.7% total return in 2009 as of this date. While such a gain is hardly unprecedented, it certainly would be considered excellent in any year, given the market's 10% long-term average rate of return. But considering the depressed level of investor sentiment and the rapid contraction in economic activity occurring at this time last year, "stunning" is indeed an apt description.

Vast tomes will be written that fully explain the financial and economic calamity that was 2008; we need not add to the word count on the subject. But it appears to us that investors remain quite fixated on the gut-wrenching decline that ended in March and are mistakenly on guard for a repeat performance. For example, cash withdrawals from equity mutual funds exceeded $50 billion this year, while cash flows into corporate, municipal, inflation-protected, and non-US bond funds were in excess of $180 billion[1]. This would have been appropriate behavior in 2007, but it is unlikely to be rewarding in most years, and even less so in a year when the equity market reached a truly historic low.

One complaint we frequently hear is that, considering the fragility of the economy, the market is now "ahead of itself"; that the rise from the market lows in March is unprecedented and unjustified; and that a better buying opportunity awaits. However,

- At nine months old, the current rally is unremarkable by the standards of the last ten bear markets – stocks have recovered 71% of their prior peak levels, compared with 72% on average at this stage[2]. Bank of America / Merrill Lynch draws particular attention to the rebound from the 1990 bear market and recession, which also was characterized by a collapse in credit conditions. At the age of nine months, that rally had already taken the market averages to new all-time highs, despite the fact that earnings were still declining, GDP had barely turned positive, and interest rates and P/E ratios were much higher than today.

- The fragile state of the US economy – characterized by high unemployment putting pressure on consumers – is important, but it is becoming less relevant to investors in US-based companies. Fully 40% of S&P 500 earnings emanate from overseas, more than double the share in 1999. As a result, earnings are becoming more correlated with global economic activity than with consumer-driven domestic economic activity. In short, investors buy earnings, not economic output – and those earnings are increasingly generated in faster-growing economies elsewhere.

- Finally, as long-time market commentator Laszlo Birinyi recently put it, "stocks are always 'ahead of themselves'". By that, he meant that stock prices reflect expected future prospects, not current results. There certainly may be times when such expectations are too high or too low, but it is fundamentally incorrect to say that investors should not be forward-looking, no matter how bad the recent past may have been.

Oddly, the risk of a market correction will increase once skepticism about the economy and earnings begins to subside and a consensus emerges that a new sustainable market cycle is underway. We believe that point will arrive sometime in 2010 when it becomes clear that employment has stopped deteriorating, the housing market has stabilized, revenue growth has returned to corporate America, and consumers bought plenty of gifts over the

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holidays. At that time, investor focus will shift from questions about the stability of the economy to questions about how quickly the Federal Reserve will raise short-term interest rates and drain excess liquidity from the financial system. *We believe the tug-of-war between gradually improving business conditions and gradually rising interest rates will be the principal "story" for investors in 2010, and a period of modest rates of return is therefore possible.* Nevertheless, the coming year will be part of an unfolding economic and stock market cycle that should be long-lasting after the significant "house cleaning" of the last 18 months. The resulting environment of steady, unspectacular economic growth is actually ideal for long-term investors.

But what constitutes "long-term"? How patient must one be if one hopes to earn a reasonable rate of return? The answer depends on many things, including the unpredictable actions of policymakers – a particularly critical issue at present. But the single most important factor influencing stock returns is the price one pays. Buying at bargain prices usually leads to good results; buying at high prices usually makes for a very long wait.

To wit: we are now ending the worst 10-year period for the S&P 500 Index ever. Its annual return of -1.0% was slightly worse than that of the disastrous period from 1928-1938 (-0.8%), and after inflation, its annual return of -3.6% left investors almost one-third poorer than in 1999. Could anyone buying at the beginning of the new millennium have expected such an outcome? After all, even though the decade began with the bursting of the dot-com bubble and ended with the financial market meltdown of 2008-2009, earnings and dividends still grew for the period at roughly 4% per annum. While this might have been enough growth under other circumstances to generate positive results for investors, unfortunately this decade began with stocks commanding their highest valuations ever, nearly 30 times earnings. With risk-free government bonds yielding 6.5% at that time, other assets offered stiff competition for stocks and left no room for the disappointment of 4% earnings growth.

The lesson of the last decade – one that investors surely understand but often forget – is that valuation matters: buying stocks at low prices, even when prospects seem questionable, offers the patient investor a chance to do well. Buying stocks at high prices, even when prospects seem limitless, ultimately will cause one to rethink the concept of "long-term".

Current valuations suggest the coming decade will be much more rewarding for equity investors than the last. The S&P 500 Index is valued at approximately 15-16 times the current run-rate of earnings, precisely in line with its long-term average. Therefore, while not at "bargain" valuation levels, stocks at least offer the prospect of average rates of return – a significant improvement over our recent experience. In contrast, the best performing asset classes of the last decade – gold (287% return) and US Treasury bonds (119% return) – are richly valued by any measure, and seem to reflect a "pessimism bubble". As pessimism fades against the backdrop of a return to more normal conditions in the economy and financial system, these asset classes may face their own "lost decade" ahead, while the environment for long-term investing in equities becomes relatively more favorable.

1. Wall Street Journal
2. Bank of America/Merrill Lynch

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