Weekly Commentary
March 22, 2010

The Markets

Earnings drive stock prices, right?

It's easy to say that the stock market is nothing more than a "casino" that is driven by "speculators," but over the long term, earnings do drive stock prices. So, how do corporate earnings look these days? Actually, pretty good.

We've just wrapped up the fourth quarter 2009 earnings reporting period and 72% of the companies in the S&P 500 beat earnings estimates, according to Thomson Reuters, as reported by *The Wall Street Journal* on March 14, 2010. For all of 2009, S&P 500 earnings came in at about $57, up from $49.51 in 2008, but below the peak of $87.72 in 2006, according to Standard & Poor's article on March 18, 2010.

For 2010, Wall Street strategists expect S&P 500 profits of about $75, according to Barron's March 8, 2010 online article. With the S&P 500 closing last week at 1160, this means the index is selling at a price-to-earnings ratio (P/E) of 15.5 based on expected 2010 profits. Historically, based on the trailing 12-months earnings, the long-term average P/E ratio of the S&P 500 was 18.3, according to data from Barclays Capital, as reported by *The Wall Street Journal* on March 14, 2010. Therefore, if 2010 profits do arrive as projected, then the current market may be *undervalued* based on the historical P/E ratio.

But, here's where it gets interesting.

In 1998, S&P 500 earnings were $44.27 while the index closed that year at 1229, according to Standard and Poor's March 14, 2010 article, and data from Yahoo! Finance on March 20, 2010. Yet, last week, the S&P 500 closed at 1160--about 6% *below* the level of year-end 1998--despite the fact that S&P 500 earnings in 2009 came in at about $57--more than 28% *above* the level in 1998, according to Standard and Poor's March 18, 2010 article. Even more remarkable, S&P earnings in 1999 were $51.68 (still below 2009's earnings) and the S&P 500 closed that year at 1469, which leaves our current market 21% below 1999 even though last year's earnings were about 10% higher than 1999's.

Are you dizzy, yet?

In short, earnings are significantly higher today than they were in 1998 and 1999, yet stock prices are still lower. This seeming paradox occurred because investors are placing a lower P/E multiple on today's earnings than they did on 1998's or 1999's earnings. That's the good news.

The bad news is an alternative measure of the P/E ratio, which uses 10-year average corporate earnings instead of just the past year, shows the S&P 500 at a P/E ratio of 20.6. Yale economist Robert J. Shiller popularized this measure and the P/E of 20.6 is currently higher than the historical average of 16 using this methodology, according to *The New York Times* on March 19, 2010. So, by this calculation, the current market may be *overvalued.*

So which is it? Whether undervalued, overvalued, or just right, you can find data to support any opinion.

Data as of 3/19/10	**1-Week**	**Y-T-D**	**1-Year**	**3-Year**	**5-Year**	**10-Year**
Standard & Poor's 500 (Domestic Stocks)	0.9%	4.0%	50.9%	-6.1%	-0.4%	-2.3%
DJ Global ex US (Foreign Stocks)	0.1	0.7	57.1	-6.0	3.2	0.6
10-year Treasury Note (Yield Only)	3.7	N/A	2.6	4.6	4.5	6.2
Gold (per ounce)	-0.1	0.1	15.6	19.1	20.6	14.5
DJ-UBS Commodity Index	-0.1	-4.9	17.7	-7.4	-4.0	3.0
DJ Equity All REIT TR Index	2.0	9.7	103.8	-10.6	3.7	11.9

Notes: S&P 500, DJ Global ex US, Gold, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods.
Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association.
Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable or not available.

THE YEAR 2012 has significance for some people as a year of either cataclysmic devastation or spiritual transformation. For the people on Wall Street, it means something entirely different--*big bills are coming due.*

During the heady days of the pre-2008 credit crisis, private equity firms and other companies racked up more than $700 billion of risky, high-yield corporate debt to finance buyouts and other transactions. Those loans start coming due beginning in 2012 and there is some concern about the debt market's ability to absorb them, according to a *New York Times* article on March 15, 2010.

On top of the corporate debt, the U.S. government is projected to borrow about $2 trillion in 2012 to fund its deficit. When you combine the financing needs of the private sector with the government's needs, 2012 may turn out to be a pivotal year.

Weekly Focus – Think About It

"Valuation matters. Over periods of decades, the average rarely happens; above-average returns occur when P/E ratios start low and rise; below-average returns occur when P/E ratios start high and decline."
--Ed Easterling, author of *Unexpected Returns: Understanding Secular Stock Market Cycles,* published in 2005 by Cypress House.

Best regards,
Jim

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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.

* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.

*Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

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