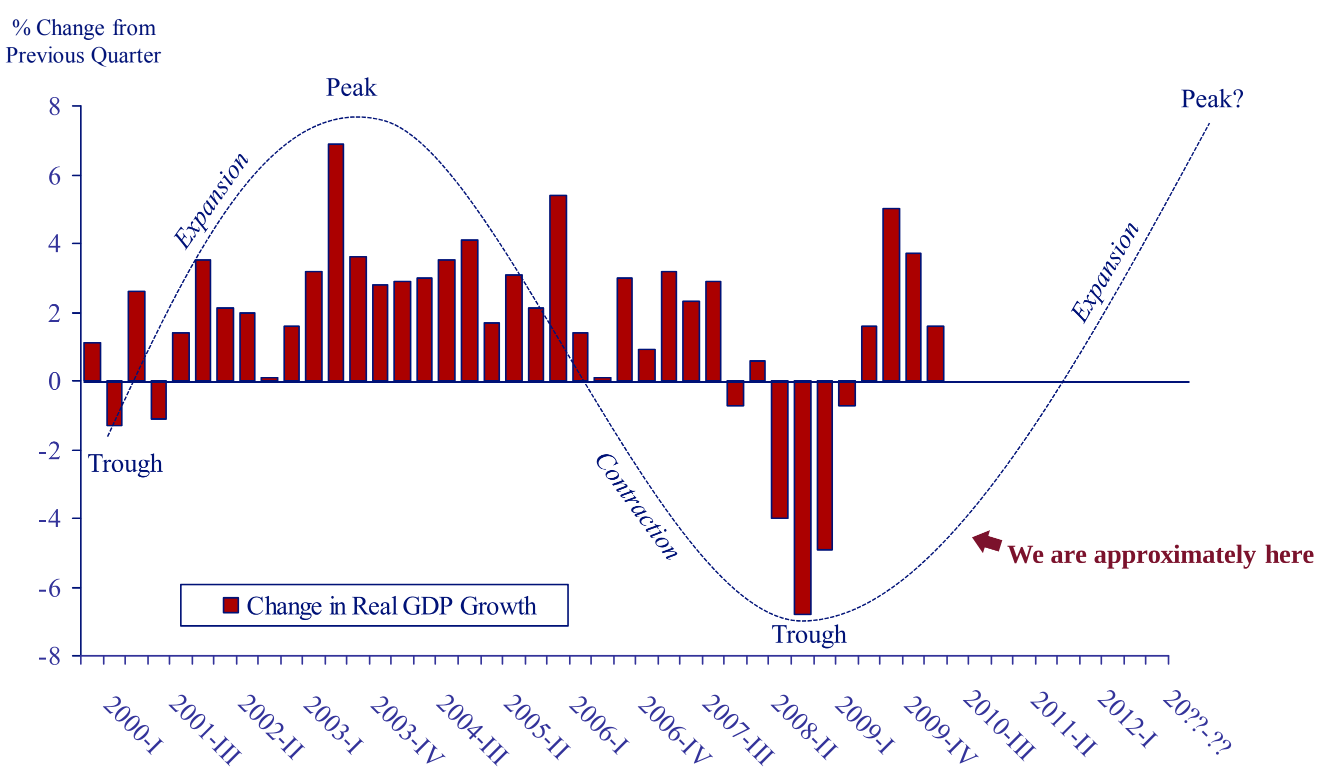
Looking Ahead: The Economy & Equity Market

Over the last few quarters, investors have been faced with seemingly contradictory economic data coupled with a volatile equity market. One day the global economy appears to be on an upswing and the next it is headed for the dreaded "double dip." The chart below illustrates where we are currently in the economic cycle.

The Classic Economic Cycle



Source: Bureau of Economic Analysis

The red bars represent the change in real GDP growth from the previous quarter (at seasonally adjusted annual rates). After the 2001 recession, GDP expanded robustly before beginning a period of contraction in 2008. Positive growth resumed in late 2009 and should continue. The blue sine wave overlay shows the basic economic cycle model and provides a reference point to decipher the raw data.

As illustrated by the red arrow, we believe the economy is still in the early stages of an upswing. Although the global economy is on the mend, it faces the headwinds of high federal debt, slow growth, significant unemployment and a struggling housing market. We are likely facing a period of relatively slow growth as the recovery resumes and eventually peaks at some point in the future. While still possible, we assign a low probability of a "double dip" recession. Following are a number of positive developments we are watching carefully:

Sovereign Governments – Among developed nations, increasing debt to GDP ratios are becoming objectionable both economically and politically. This is a positive development. While increased sovereign debt was necessary to battle the "Great Recession", debt levels will likely decline and/or stabilize - assuaging fears and leading to increased global stability. Historically, debt ratios have been reduced through a combination of economic growth, inflation and taxes. With a new Republican majority in the House, the focus will shift away from the Democratic agenda of higher taxes and government spending to lower spending and the potential extension of the Bush-era tax cuts. With the Democratic Party retaining a majority in the Senate grid-lock in Washington is likely. Historically, grid-lock has been good for the stock market as major legislation is unlikely and government interference is lessened.

Consumers – After years of easy credit, consumers are rebuilding their personal balance sheets. The personal savings rate is up to 5.8% after being nearly non-existent at times over the last decade. Improved financial health should lead to increased consumer confidence and economic improvement. Additionally, more and more homeowners are refinancing mortgages at historically low interest rates. This activity frees up cash to be spent elsewhere or saved.

Corporations – The corporate sector is leading the economic recovery. Balance sheets are the strongest they have been in decades and corporate profits are up. Coffers are flush with cash and interest rates are low. This provides companies with an opportunity to make acquisitions at depressed valuation levels. For example, Intel has announced a $1.4 billion deal to acquire Infineon's wireless solutions business, which comes on the heels of the $7.7 billion acquisition of McAfee (their largest acquisition ever). 3M has made two acquisitions in the last month with a combined value of almost $1.2 billion, and HP's $2.35 billion tender offer for 3Par outmatched Dell's offer. Furthermore, the Obama administration is supporting a number of business incentives to help spur growth.

A Cautious Note on the Bond Market

Before exploring the state of the equity market, we feel it is important to address one of the biggest stories of the last two and half years - the flow of capital into bonds. After a decade marred by two bear markets in stocks, the perceived safety of bonds has lured investors into fixed income. According to the Investment Company Institute, from January 2008 through July 2010 $559 billion has flowed into taxable and municipal bond funds with $243 billion flowing out of equity funds. The massive flow of capital into bond funds suggests that investors are trying to get conservative after recent sub-par equity returns. Unfortunately, bonds are unlikely to be the safe haven the average investor thinks they are given that interest rates are at historic lows. As rates increase, bond values will fall and those with weak resolve will sell at losses. Although bonds have done well as of late, shifting into a bond-heavy strategy now could prove costly. Unfortunately, the average investor has a track record of changing investment strategies at the most inopportune times. During 1999 and 2000 investors poured $497 billion into equity funds just in time to catch the bear market that followed. A similar situation could be brewing in the bond market.

For our clients with fixed income allocations, we are focusing primarily on Treasury Inflation Protected Securities (TIPS). We think this is the most attractive area of the bond market and are currently maintaining these allocations.

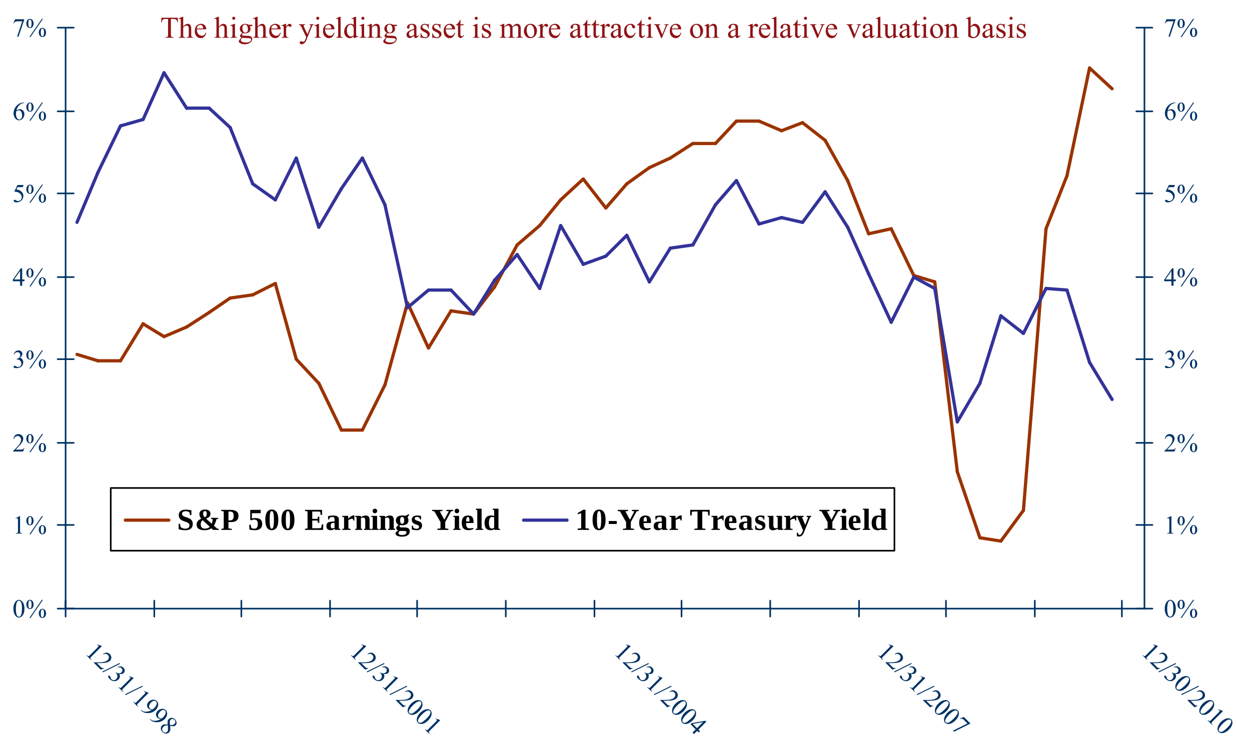
The Equity Market is Undervalued

From an historical perspective and on a relative basis, the equity market looks quite attractive compared to bonds. Following are a number of metrics indicating that the equity market is undervalued:

Normalized P/E Ratio – Using normalized earnings, the long run average P/E ratio for the S&P 500 is about 15. We estimate the current normalized P/E ratio to be around 11 indicating the market could be as much as 30% below its fair value. In this calculation, we prefer to use normalized earnings instead of highly cyclical reported earnings. Normalized earnings produce a more stable measurement that is indicative of mid-cycle conditions and gives a better indication of long term value. The financial media typically focuses on reported earnings which produce highly volatile results.

Earnings Yield vs. 10-Year Treasury Yield – When measuring the relative value of stocks to bonds, it is useful to use the earnings yield (E/P), which is the inverse of the P/E ratio (we prefer to use forward looking earnings here). This technique allows both stocks and bonds to be compared in terms of yield. Theoretically, capital should flow into the highest yielding asset class creating an ebb and flow of capital between stocks and bonds over time.

S&P 500 Forward Earnings Yield vs. US 10-Year Treasury Yield

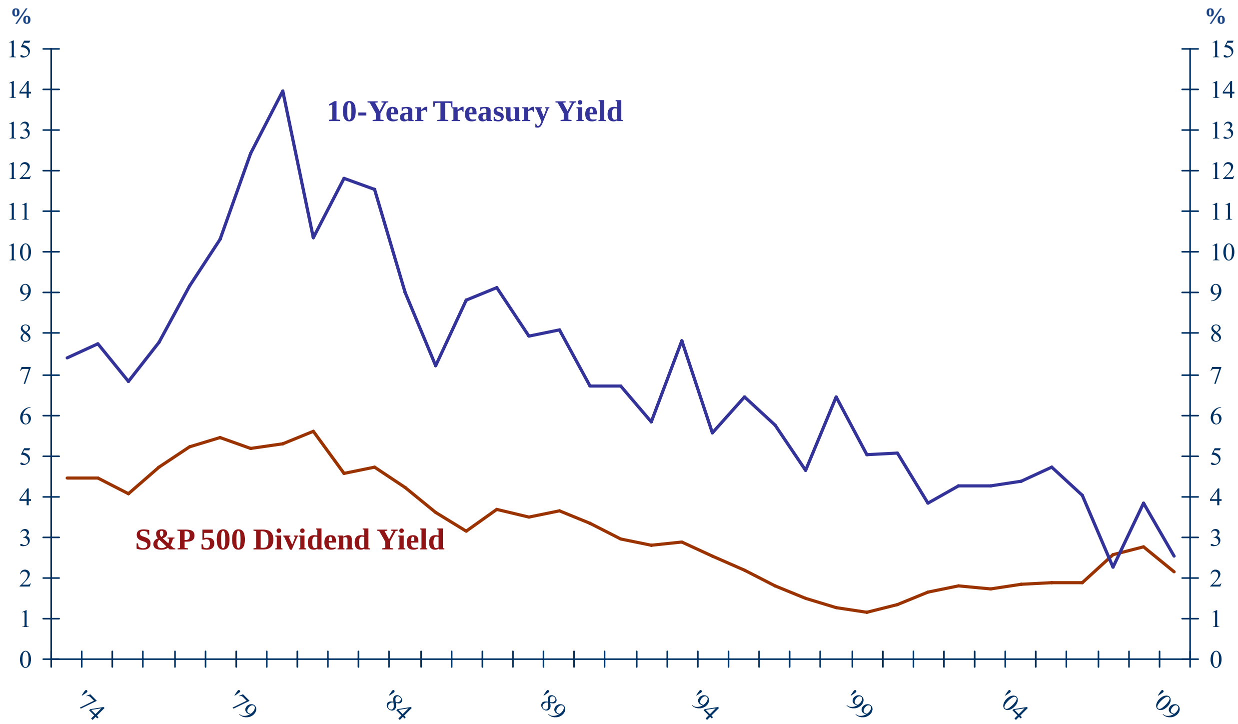


Source: Standard Poor's & Federal Reserve

For instance, in 1999, this metric indicated that stocks were overvalued in relation to bonds (red line was below the blue line). This reality became evident during the technology/large cap bubble and the bear market that unfolded shortly thereafter. By the end of 2003, stocks were once again attractive (red line was above the blue line) and remained so until 2007. Now the earnings yield has been pushed above the 10-year Treasury yield once again (the red line is above the blue line). This development indicates that stocks are yielding more than bonds and are attractive on a relative basis.

Dividend Yield vs. 10-Year Treasury Yield – Another technique for measuring the attractiveness of stocks versus bonds is to compare the dividend yield of the S&P 500 to the 10-year Treasury yield. For more than a quarter century, bonds have yielded more than stocks by a comfortable margin. As interest rates have trended downward over this time period so have dividend yields. Now, as illustrated in the chart below, the 10-year Treasury yield and S&P 500 dividend yield are nearly equal.

S&P 500 Average Dividend Yield vs. US 10-Year Treasury Yield



Source: Standard Poor's & Federal Reserve

From an income perspective, these two asset classes are yielding similar amounts. The primary difference is that stockholders retain far more potential on the upside than bondholders. As growth and profits continue to improve, stock prices should rise and companies may even increase dividend payouts. With competitive income and the possibility of significant price gains, the attractiveness of stocks is clear.

We anticipate equities to trend higher as the global economic recovery continues and capital flows back into stocks. While the timing of these developments remains uncertain, we are encouraged as we look ahead and maintain that stock selection will be key for future success.

DARRELL & KING
INVESTMENT COUNSEL, LLC

410 White Gables Lane • Charlottesville, Virginia 22903
434-977-7010 PHONE • 434-977-6313 FAX • www.darrellandking.com