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ASSET MANAGEMENT

MARKET INSIGHT

February 2009

The U.S. stock market (as measured by the S&P 500) began January on an encouraging note, initially rising 4.5 percent from its year-end closing level. However, weak economic statistics, further bank losses and confusion over the U.S. government's financial rescue and economic stimulus plans surfaced later in the month and caused the index to decline 8.4 percent for the full month. The negative January performance marked the worst January on record and caused some observers to predict a down year for the stock market in 2009 based on the "January Effect" premise. Our review of the January Effect since 1901 suggests that, while far from perfect, it tends to be more predictive of positive years after positive January performances (80 percent of full years are positive when January is positive) than it does of negative years following negative January performances (63 percent of full years are negative when January is negative). Moreover, there are several examples of strong positive full-year performances that followed negative January returns, most notably 1982 and 2003 – two years that marked the end of deep bear markets.

The economic data released in January showed that the U.S. economy slowed significantly during the fourth quarter of 2008, as U.S. GDP contracted at an annual rate of 3.8 percent (its worst quarterly decline since 1982). The headline fourth quarter GDP figure was somewhat misleading since it contained a positive 1.3 percent contribution from an inventory increase that is unlikely to repeat itself over the next several quarters. Therefore, with the lack of any positive inventory contribution, the U.S. economy is expected to show a greater contraction on the order of 5-6 percent in first quarter of 2009. Consensus forecasts predict another contraction in the second quarter of 2009 of between 1-3 percent, before expansion begins in the second half of the year. If consensus forecasts prove accurate, the U.S. recession would last 19 months in duration, the longest U.S. recession since 1918, aside from the 43-month contraction of the Great Depression. Positively, as we have pointed out in previous newsletters, the stock market tends to bottom 3-5 months prior to the end of a recession, suggesting the bottoming process may be completed by February to April.

The timing and magnitude of a recovery is partially dependent on the final form of the U.S. government's financial rescue and economic stimulus plans. The Obama administration indicated a financial rescue plan will be announced by the second week of February, and many observers expect this plan to take the form of a government-sponsored aggregator bank that buys bad assets from the financial system in a fashion similar to how the Resolution Trust Corporation handled the savings and loan crisis of the early-1990s. Additionally, the rescue plan may include direct common equity injections from the U.S. government, perhaps with a matching feature or some other incentive to attract private capital. Senator Charles Schumer (D-N.Y.) stated recently that the bad assets of the U.S. financial system could approximate $3-4 trillion. Thus, the market will be looking at both the structure of the rescue plan including dilution, as well as the implied magnitude of the assets that need to be purchased. The size of the problem will be viewed in relation to the size of U.S. economy -- a $14 trillion economy with great recuperative powers, but one that is now forecast to endure annual deficits of 10-12 percent of GDP and amass total debt exceeding 90 percent of GDP. As Pete Peterson points out in his book *Running on Empty*, most economists that have studied the data agree that countries often experience adverse effects when their annual deficits exceed 5 percent of GDP and their debt exceeds 40 percent of GDP. Thus, the US will need to undergo a drastic restructuring of its fiscal situation once the crisis has passed.

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An increasing awareness and sensitivity toward the country's escalating fiscal imbalance likely contributed to the stock market's January decline, as the initial $819 billion stimulus plan was perceived by some observers to contain insufficient stimulus and excessive entitlement/welfare spending. *The Wall Street Journal* estimated that "only 12 cents of every dollar of the current bill is for something that could plausibly be called stimulus." A further concern is that much of the spending could become part of the baseline budget and thus difficult to cut once the economy recovers. One final criticism of the current bill is that only 20-25 percent of the money will be spent in the first year of passage, while most economists believe the effectiveness of a stimulus package is linked to its timeliness (i.e., tax credits can be implemented quickly while infrastructure projects take longer). So, the details of this stimulus bill will be watched closely by the markets as it works its way through the legislative process. Items that might be viewed favorably by the market should they become part of the final bill include incentives for home purchases, a tax holiday for repatriation of foreign cash holdings of U.S. companies (estimated at over $540 billion) and clear timetables and rules to cut spending programs once the economy recovers.

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While most economic indicators released during the month were weak, a few showed some improvement. Most notably, existing home sales increased 6.5 percent in December vs. the prior month, as housing affordability reached its best level since 1973. Total housing inventory at the end of December fell to a 9.3 month supply from an 11.2 month supply in November. While a 5-6 month supply is considered normal and U.S. home price futures continue to predict another 10 percent decline in prices thru 2010, the data suggests the U.S. housing market continues on a corrective path. Commenting on the latest housing data, Karl Case, co-creator of the widely-followed Case-Shiller home price index, said "It's not going to be a terrible year for the housing market … over the next year you'll see the housing market come back into equilibrium." Several other encouraging signs were the continued narrowing in credit spreads, as inter-bank lending rates, corporate debt, preferred and commercial paper spreads all narrowed further during the month suggesting credit conditions continued to thaw. Another positive sign is that the Baltic Dry Freight index, a measure of international shipping prices, appears to have bottomed two months ago in early-December and is up over 65 percent since then.

Our general sense remains that a bottoming process for equities began last October and that most of the price damage of this bear market has occurred. However, the average time duration of a severe bear market is 18 months, which suggests the bottoming process may continue through early 2009. Technically, the S&P 500 is currently attempting to hold key support at 800 which it tested and held four times in January. At this point, if S&P 500 support at 800 fails, a full retest of the November 2008 lows at 741 is possible. We will be watching many indicators at that point to see if a loss of downside momentum is present which would lend support to our bottoming thesis. The main indicators we will be watching upon further weakness are:

Stock issue and volume breadth – Are fewer stocks hitting new 52-wk lows? Is there less selling volume vs. prior price lows?
Volatility – Is the VIX or "fear index" lower than it was in October and November 2008 when the stock market hit previous price lows?
Credit Spreads - Are key credit spreads continuing to improve and thus diverging from the equity weakness?
Commodities - Are key commodities (oil, copper) failing to make new lows?
Economic Indicators - Are economic metrics becoming less negative?

We will close with a few thoughts on long-term stock market valuation. As shown below, the four valuation metrics we track for the S&P 500 all indicate that the index is significantly undervalued. Clearly, valuation is only one of many analysis tools, but we are encouraged by the similar conclusions drawn from each of these valuation metrics.

INDEX VALUATION

While still above the extremes reached during the Great Depression and 1980-82 secular bear markets, our analysis indicates that current valuations are now below the average bear market trough levels of the post-WW II era. So, while not "dirt cheap", valuations are at levels that have historically been supportive of above average intermediate and long-term returns.

As shown on the chart on the following page, the long-term returns of stocks have been inversely correlated to entry valuations with higher returns corresponding to lower entry valuations. This chart shows that S&P 500 is currently valued between its second and third cheapest quintiles. Though past performance is not an indicator of future results, the real returns (ie, inflation-adjusted) have been above average from these valuation levels.

S&P 500 Valuation Metrics (as of 1/31/09)	**Current Value**	**Historical Average Value**	**Percentage from Historical Average**	**Index Value at Historical Average**
P/E 10	14.5	16.3	-11.0 percent	925
Price-to-Book	1.5	1.9	-21.2 percent	1055
Median P/E	12.5	16.5	-24.2 percent	1205
Price-to-Trend Earnings	13.1	16	-18.1 percent	1005
			Fair Value Estimate	**1050**

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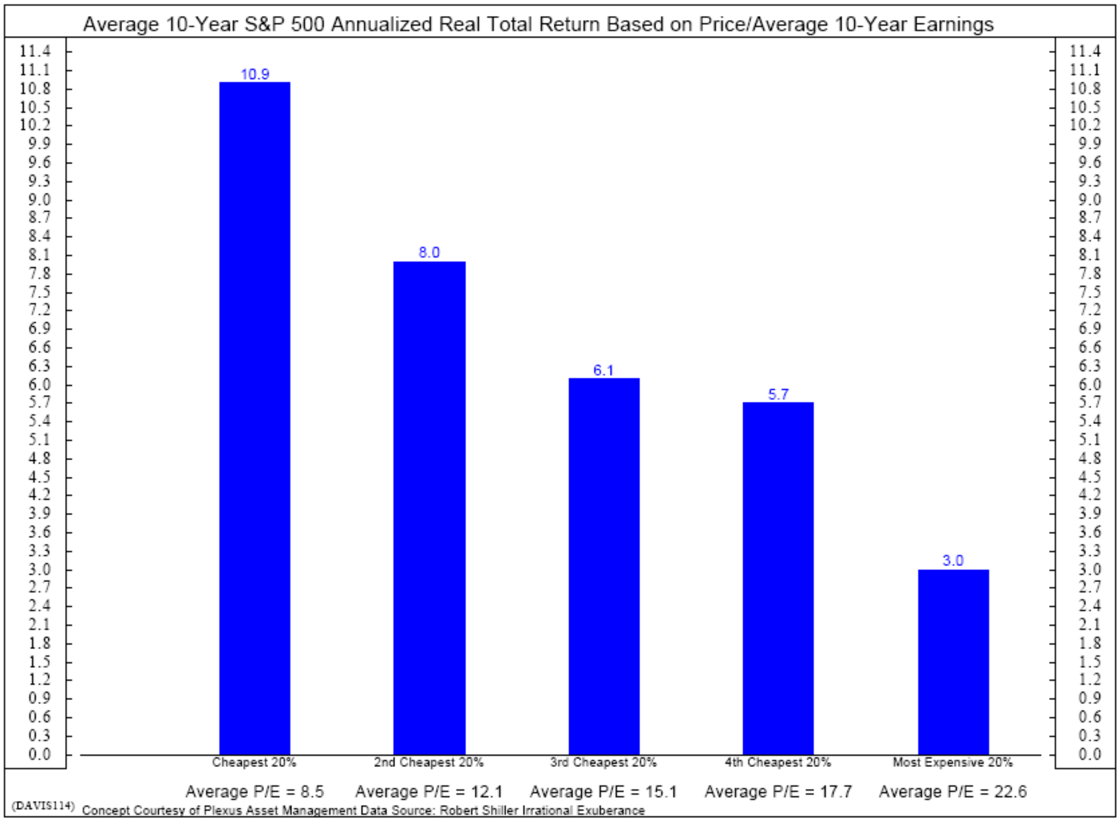

Source: Ned Davis Research

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