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Market Review & Update

The New Year began on a positive streak that we can trace back to the month of March in the year 2008.

Since that time we have witnessed eleven quarters of improving economic metrics, both here and even more aggressively abroad. Coincident, and the more true measure of global vigor, are these consecutive quarters of positive surprises in the revenues, margins and earnings for the corporations of the world. These are the factual manifestations of the global economic recovery of which we find ourselves in the midst. And yet, “we” are replete with doubt, trepidation and fear…

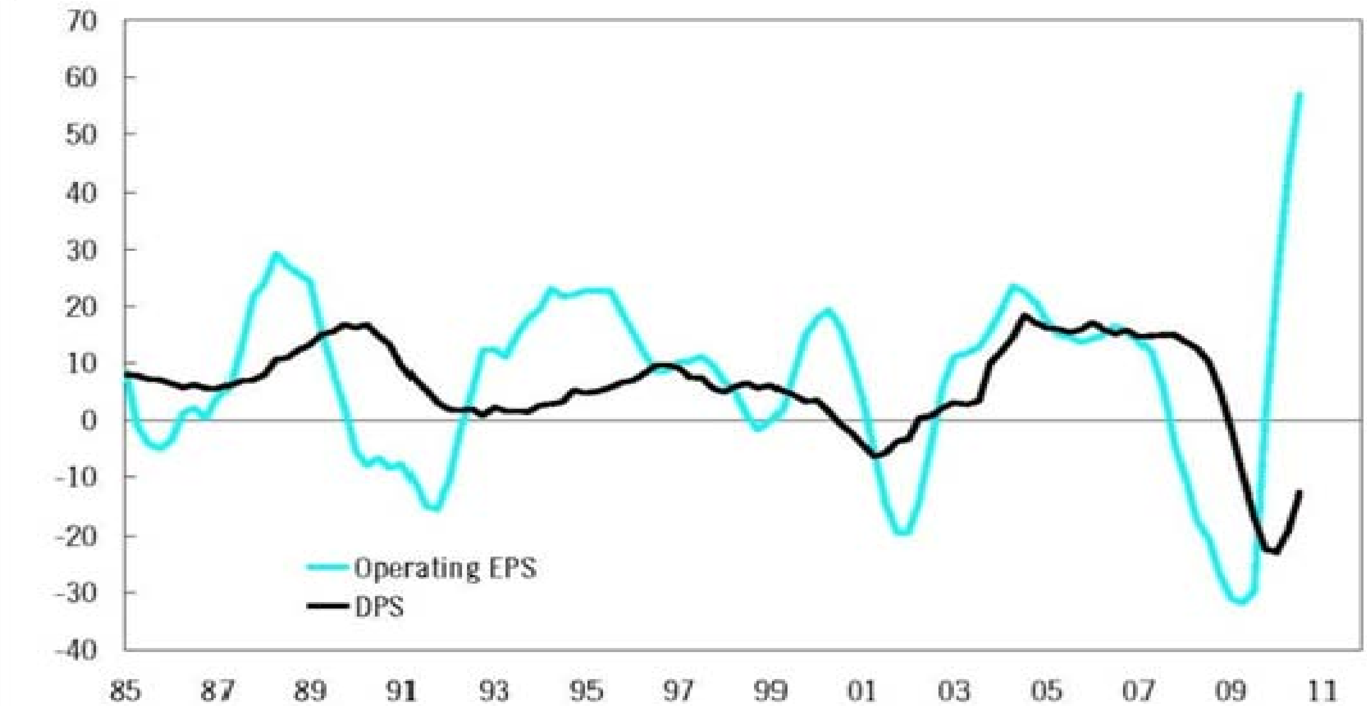
You are, by now, tiring of me asserting that all markets, and pretty much everything else in our lives, operate on two basic catalysts, fear and greed. If the price/earnings ratio, which is basically what we are willing to pay for tomorrow’s growth, was simply a clinical extrapolation of some lengthy algorithm then we could just push a button and go home. But, today’s price and the P/E of tomorrow are the manifestations of all our internal demons, terror and avarice alike. And, what we will pay for tomorrow is precisely where doubt has taken up very notable residence (see Fig. 1). Given the aforementioned recovery facts, the markets’ have priced in dramatic levels of doubt, all of them. Gold and US Treasuries have a fear component that has driven them to potential bubble levels, while equities and other growth based assets, including real estate continue to display compelling valuations. That is both a symptom of the problem and the key to future opportunity. If the populace is gloomy about tomorrow, and who would blame them as they see a continuous barrage of unemployment and foreclosure headlines, they will inevitably underbid risk and overpay for safety. Effusively optimistic? Remember standing in the year 2000 when the Oxford dictionary nearly removed the word “risk”? Ok, so they didn’t really do that, but you get my point. At that juncture the P/E mood ring of the S&P 500 stood at twice current levels. Twice…

Figure 1: The price of growth-the PEG ratio-for the S&P 500 is at a 20-year low, while long-run EPS growth expectations are moving back up

At the aforementioned juncture, the earnings per share of the S&P 500 stood at an historic high near $96 per share. It may be worth noting that S&P 500 earnings may, in 2011, surpass this historic high in corporate production (yes, I deliberately understated that…). Hmmm…what's the difference in an environment when the same level of earnings in one decade can produce all time high valuation metrics, whilst in another manifests in a multi-decade trough?(see Fig. 1, again…) Could it be fear and greed? Or, as Bert Lahr, in one of my favorite moments in moviedom, speaks on behalf of the S&P 500 "what's he got that I ain't got?!?! Courage…"

When metrics are manifesting morosity, it's a pretty safe prediction that 2011 will see another surprise boost to corporate earnings while finally displaying an increase in that missing element, confidence. The historic levels of corporate cash will be the primary focus of this evolution as it was hoarded by the timid. CEO's with an improving outlook, nudged along by a committed Fed and numerous and sundry stimulus additions will begin to spend. And, while buybacks and dividends (which have also been historically lagging as Fig. 2 indicates) are nice, and will increase, the real good spending will be of the capital expenditure variety.

Figure 2: S&P 500 Operating EPS vs. Dividends per Share (4-Quarter Averages) Y/Y%



Sources: Standards and Poor's and Citi Investment Research and Analysis.

This is the key driver to that "velocity of money" thing which is the very essence future economic expansion. You can easily personalize this economic reality via a driving analogy. Feel more confident? You drive a little faster and you get further, quicker. Barring a major unforeseen event, the current momentums should deliver more, more quickly than current metrics anticipate. We must always remember that somewhere on the path 'twixt fear and greed, lies wisdom…

We'll talk to you soon…