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Monthly Market Commentary

Selling The Good News

Recently, a prominent strategic consultant, Leo Tilman, likened the current financial order to a “rickety bridge over a volcano” while offering the opinion that short-term risk will continue to overwhelm investor attention, thus disabling the willingness to assume longer-term investment perspective. Mr. Tilman’s observation is the best explanation I can find for the January 20, 2010, market swoon in which institutional traders pared 6% off the Dow Industrials in only eight trading days. Individual investors who have long avoided stocks were polled by *USA Today/Gallup*. Two-thirds think the economic recovery won’t happen for more two years, while 28% say it won’t begin for five years. The vapors of the public malaise are so strong that the current consensus economic opinion that the recovery likely began six months ago has not registered with the polled individual investors.

Surprisingly, the corporate news running coincident with the recent decline has been unquestionably good, while headlines from Washington (financial regulatory change), Greece (fiscal stability), and Beijing (credit tightening) served to fuel selling pressure. Business media scripted focus now is honed to calibrate the likelihood of a full 10% correction as a precursor to a larger market decline. After a 64% rally with only minor (under 10%) trading dips from March 2009 lows, it seems only natural for the market to pause and enable those who sold to evaluate future opportunity. Recent positive economic reports and more robust fourth-quarter earnings and revenue readings may be an indication of compelling valuation and a telltale sign that selling as a precaution was premature.

The economic and corporate profit “bridge” certainly appeared less “rickety” at January’s month end. The preliminary report of fourth-quarter 2009 Gross Domestic Product grew at a 5.7% rate, besting a 4.5% consensus expectation. With 221 of the S&P 500 companies reporting, revenue growth for the fourth quarter was 8.8%, which was 0.7% better than analyst expectations. In fourth-quarter 2009, 77.8% reported positive earnings surprises versus 60.1% in the fourth quarter of 2008. Since mid-December, according to Thomson Financial, the 2010 S&P 500 earnings estimate has increased \$1.30 to \$78.78, representing an expected growth rate of 26.5% compared to the current 2009 estimate. At January’s close, the forward twelve-month S&P 500 P/E ratio stood at 13.6 times, indicating a valuation discount to the historic average of 16.3 times earnings.

A recent *Wall Street Journal* article citing a Birinyi Research study of the nine bull markets since 1962 found the average bull market duration at four years and concluded that while the “rampaging gains” of the past 10 months are unlikely to repeat, that does not mean the bull market is over. The study found that an initial 5% market decline normally continued to a total of 9%, on average. In fewer than 10% of the cases a 5% decline led to a drop of 20%, signaling the end of the bull market. Only one-fourth of the time did it lead to a drop of more than 10%. The bull market of 1982 began with a sizable gain similar to our experience in 2009. The 1982 gain was followed by a twelve-month decline of 9%, after which blossomed a multi-year bull market extension.

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