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1st QUARTER MARKET COMMENTARY AND OUTLOOK

Since we wrote our last outlook on October 12th, the market has barely budged. As we write this on January 13th, the return on the S&P 500 has been down 2% since then. At the time, we thought the market had become undervalued but due to overshooting in the correction we would see maybe another 10% decline. In fact, to the low that occurred in November we saw a loss of about 17% before a good recovery of what is now a rebound of 18%

So with the market at similar levels as we had at back in mid-October, many might think we view the market as undervalued here and poised for more gains. Unfortunately, this is no longer our view. While the market barely moved over the time, the fundamentals declined in a big way with reported earnings coming in way below forecasts that were in place three months ago. And to pile on, the forecasts for 2009 have fallen dramatically as well.

There are a lot of valuations thrown around these days but our view is that the correct forward p/e of the S&P 500 is 14. This uses the top-down estimates which tend to be more accurate, particularly if things are changing as quickly as they are. At a p/e of 14, this is pretty much in line with historical valuations. Using reported earnings, the p/e is about 16. This also is in line with historical levels. Some might argue that with treasury bond yields so low at about 2%, this makes the stock market more appealing and thus undervalued. But we prefer to look at the bonds of the companies that make up the S&P 500. Investment-grade corporate bonds yield about 6-7%. If you were to take the inverse of the p/e of 14, you would get an earnings yield of 7%. This suggests stocks are fairly valued, but for one catch. The problems and the risks that exist today are unprecedented since the Great Depression and this would suggest that we should demand a more attractive earnings yield from stocks in comparison to bonds. This would need to come from a stock market decline. Given that it appears the economy will not begin to grow again until early next year at best, stocks (which typically lead the economy by 6-9 months) are not likely to begin moving up until the third or fourth quarter. Throw in a 20% decline in wealth, as well as the worst economic and market decline since the Depression and investors are going to be more risk averse than normal. This would suggest we should look for the earnings yield to move well above the corporate bond yield. A 2% premium earnings yield above bonds would suggest a yield of 8-9% or a p/e of about 12. So barring an unexpected recovery in earnings we should see a market decline of 15-20% from today's levels in the first half of the year before the market recovers somewhat, probably sometime in Q4. That recovery will depend on the outlook for corporate earnings as we approach year-end. For this reason, we are expecting a market decline of 10-15% from here for the remainder of 2009.

That said, more than normal, forecasting is a tough game these days. Changes are happening quickly and in dramatic fashion. And it's important to realize that having had lousy returns for the last ten years actually makes the case more appealing for long-term investors, even though most investors tend to act otherwise. To support this view, consider this: At the end of November, we just moved to the first negative return over a 10-year period since 1941. Over the next ten years from that point in 1941, the stock market provided a return of 300%! Reasons to be optimistic long-term are that companies are shedding costs by huge amounts and in general becoming leaner. Add in the fact that year over year comparisons keep getting easier to grow from when things do recover and we should get a strong rebound in earnings a year or so from now. It is for this reason that we continue to have our clients owning stocks in moderate amounts. Because although we expect a short-term decline in the market, we are more confident in our long-term view that investors who own stocks over the next 3-5 years will be well rewarded, especially compared to what are perceived as the current "safe" alternatives of treasuries, money market funds or CD's.