



HEYDON TRAUB  
Traub Capital Management, LLC  
97 Chapel Street  
Needham, MA 02492

(781) 453-3929  
Cell: 781-405-4410

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## **1ST QUARTER 2010 MARKET OUTLOOK AND COMMENTARY**

After posting back-to-back 16% quarters the market “cooled off” with just a 6% gain in the fourth quarter. Of course, all of this sounds downright silly to many people out there as the market has returned 75% since its March low. In the meantime, only very recently has the unemployment rate just stabilized, not improved. But this stabilization is a bit misleading. There were a large number of people who dropped out of the labor force, essentially giving up looking for a job. Without this drop-off, the unemployment rate would have jumped to 10.4%. Again this shows a mixed economic picture and a soaring market. However, this is typical of how markets move- they anticipate activity about 6-9 months ahead. So now the question we face is how things will look in the second half of 2010 and this is far from clear. Investment managers like me get paid to worry, to attempt to foresee issues that are not clearly expected. So let’s discuss these many concerns. It is likely by then that the government will begin scaling back its stimulus programs. If so, how will that affect the economy and ultimately earnings? I think it’s fair to say as the government backs off, the economy will cool if not shrink. Nearly all of Q3’s growth was driven by government programs such as “cash for clunkers”. If the economy does slow in the second half, earnings are not likely to grow at the breakneck pace that is expected for 2010.

Ultimately, the big question we face is whether the market is overvalued or undervalued. Many pundits point out that the market is trading at a forward p/e of just 15, roughly in line with its historical averages. However, the reality is that the market’s historical average that is referred to is based on the trailing p/e (meaning we use earnings that are already reported) which has been around 15 over history and that is the better comparison. On this measure, the market is trading at a p/e of about 19 (and even this is generous on the earnings since it uses estimated earnings for Q4, which are just starting to come in). This is higher than normal. One could argue that this is justified given the low level of inflation and interest rates. With fewer good alternatives on the bond or money market side investors have charged into stocks pushing up the valuations. And of course the way we are to get from a p/e of 19, which uses 2009 earnings to 15, which uses 2010 earnings estimates is based on high levels of expected earnings growth. Analysts in aggregate are forecasting earnings growth of 29%. That is a very large number to live up to and if we fail to come close to that growth, the market will fall. And while on the p/e comparisons another measure which has been a pretty good indicator (it showed the market as very undervalued in March), is a p/e based on average earnings over the last ten years, in order to normalize the volatile earnings numbers. On this measure the market’s valuation is now well above its norm.

In addition, interest rates have nowhere to go but up and have already begun to climb for example on 10-year treasury bonds. These have gone from a trough of just over 2% about a year ago to 3.8% today. If interest rates begin to climb on short-term rates or riskier bonds, this will certainly take some steam out of the market and more likely also lead to a fall.

Other concerns include the fact that a broader measure of unemployment and underemployment, the "U6", began to climb again last month with a rate of 17.3%. The measure includes those who have given up looking for work in the short-term (this still excludes those who have given up looking long-term), those who are no longer collecting unemployment benefits, and those working part-time who would like to work full-time.

Lastly, one of the things that provide the fuel for the economy's expansion is money supply growth. The broadest measure of this is called M3 and the government recently stopped reporting this. However, there is a newsletter called Shadow Government Statistics that estimates this along with other modifications of government statistics. The worrying thing currently about M3 is that it recently began shrinking in nominal and real (after adjusting for inflation) terms. This is occurring despite the government running the printing presses at historic levels but the drop in M3 comes because the banks are not lending nearly as much as usual- as has been well discussed. The previous four times this measure went negative in real terms (1970, 1974, 1981, and 1991) the unemployment rate rose each time in the near future (on average about six months later). This provides fuel for those looking for a double dip recession.

Now before you go out and sell all your investments (or tell your adviser to do so) and put it under your mattress, keep in mind that I have pointed out all the major concerns I could come up with while conveniently leaving out the positives. And in fact, things currently are looking pretty good, but the key is to look at second half 2010. The takeaway here is that despite the rosy picture and markets we are seeing now, there's a lot to worry about. And with a market trading at a historical p/e of 19, this is no time to be too aggressive. So what I suggest investors do (and I am doing so for my investors), is to upgrade the quality of your portfolio. Scale back on the riskier lower quality stocks that did so well in 2009 and buy the blue-chip quality stocks. These stocks have three big advantages: 1) the valuations on them are typically less than the market, 2) they are consistent (albeit usually modest) earnings growers, and 3) they typically have dividend yields above the market, typically ranging from 2-4% (the market is just above 2% today and the small-cap index is closer to just 1%).

These quality stocks include companies such as Wal-mart, McDonalds, Exxon Mobil, Pfizer, Microsoft, J&J, Nokia, Eli Lilly, CVS, Google and Ebay (we own many of these in each of our clients' portfolios, but not every stock for every client). All have strong balance sheets and in general have been consistent earners and growers of earnings and rarely, have earnings declines. All have dividend yields of between 1.7% and 4% except the latter 3 stocks. Investors generally pay a premium to own stocks with the consistency of earnings and strong balance sheets these stocks possess. However, due to the dramatic decline in risk aversion we have just experienced, these stocks have generally

been left behind relative to lower quality peers giving them relatively reasonable valuations compared to the broader stock market. This is where we suggest investors concentrate their investments going forward. Given their reasonable valuations they should keep pace in a rising market. However, if we do face a double dip recession or even an economy with little growth, these stocks are likely to hold up much better in a corresponding market sell-off.