



From: Heydon Traub  
Traub Capital Management  
97 Chapel Street-2nd Floor  
Needham, MA 02492  
Fax: 781-898-7647  
Phone: (781) 453-3929  
Cell: 781-405-4410

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## **2<sup>nd</sup> QUARTER MARKET COMMENTARY AND OUTLOOK**

“2 Fast 2 Furious” was the name of a movie in 2003 and seems an apt title for what we have seen over the last month or so in the stock market. In fact, the four week gain from the March 9<sup>th</sup> close of more than 20% was the largest gain over a four week period since 1933! We had called for a 10-15% decline in the short-term as part of our last outlook and in fact got even more than that by the market bottom in early March. However, as discussed above, the market finished down 11%. As we write this, the market has now risen another 8% in April already, bringing us to just under a 30% gain for the S&P 500 from its market low only about a month ago. That qualifies as a great year by most standards, let alone over a month. Yes, the market was cheap a month ago even with all the problems we face in the economy as this had brought the market’s overall p/e down to just 11.

But now we have the interesting dilemma that the market is no longer clearly “cheap” with the market p/e back up to 14 times 2009 earnings estimates. That is using the bottom-up numbers for individual companies. Using the slightly more conservative “top-down” forecasts and we are at a p/e of 15. Why isn’t the market cheap given that it has fallen 45% from its peak in October 2007? Well, there are two main reasons. First, valuations were expensive back then while earnings estimates turned out to be too high. Secondly, earnings fell off a cliff. On operating earnings, the numbers used in the discussion above, estimates call for about a 25% decline from the peak year of 2007. However, operating earnings typically exclude those often huge one-time write-offs. If we used those to calculate the p/e we would have a significantly higher (and expensive) valuation on the market. Given the wealth destruction in the real estate and stock market and the higher than normal risk aversion that investors have these days, we think the market will trade cheaper than normal over the next cycle. Hence our view that this market rally has been “2 Fast” and “2 Furious” and we expect a pullback over the next few months. We may not go back below the lows we saw in early March, but even if we stop about 5% above there (about 700 on the S&P), we’d get a staggering 19% decline, big even in this new world of wild market gyrations.

Outside of large-caps in the U.S. stock market there is an interesting mix of cheap and dear assets. On the dear side, we have small-caps, which “everyone” agrees will lead the way as stocks continue to rally (by the way when everyone agrees on something to do with stocks, be skeptical). In fact, small-caps are one of the most expensive asset classes trading at about a 75% premium to large-caps on a forward p/e basis. International stocks and Emerging Market stocks trade at lower valuations on a p/e basis than the U.S.,

but each have their own worries. International is dominated by Europe, which is behind the U.S. in its cycle and thus is likely to come out of its recession later than the U.S. This was due to a lag in government action in response to the economy's slowdown so the rate cuts came later and to a lesser degree, as did the stimulus packages. For this reason, earnings forecasts are likely still too high. Emerging Markets have been dancing to their own beat in 2009 as they are up about 12% year-to-date. Despite this, the valuations are still at modest discounts to the U.S. However, if we do have a prolonged recession from here this is likely to hurt the emerging markets most as they are highly dependent on exports and commodities.

An area that continues to look appealing is most bond investments except for Treasuries, which yield only 0% to 3.7% depending on the maturity. On the other hand, we have investment-grade corporate bonds which have yields to maturity of 6-7%. It seems likely that if the economy recovers later this year that the credit risk on these types of bonds goes down and prices go up leading to capital gains along with the noted yield. This will likely rival the returns in the stock market. If the economic recovery is nowhere to be found for another year or longer, then the credit risk priced into these bonds is appropriate and you likely earn the yield (or at worst small losses), far outpacing stock returns. High yield bonds have a similar story. The yield to maturity remains in the high teens. If things improve soon, spreads will tighten leading to capital gains along with the high yield. If things don't improve soon, prices may fall, but they have to fall a lot to offset the high yields and so they'll likely hold up much better than stocks in another stock sell-off. Lastly, municipal bonds should perform well as they yield in the 4-6% range depending on the maturity, but they are also tax-free (federal and possibly state). So they yield nearly double that of Treasuries, yet have the tax advantages as well. So over the next 3-6 months the risk/return trade-off seems best for riskier bonds as compared to most asset classes of stocks. Long-term (at least three years) investors will probably still do well owning stocks here, but we think it will be a bumpy ride.