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3rd QUARTER MARKET COMMENTARY AND OUTLOOK

Interestingly, as we write this (at the close of July 9th) we are almost back to where we were at our last market outlook where we felt we had come rapidly too far, back in mid-April. Still, the S&P 500 returned about 4% since then. Of course, we had moved a lot higher up to about a month ago but since that high the market has given back about 8%. Importantly, we were right that the best opportunity resided in bonds that involved some risk, i.e. not government bonds. Over the same timeframe, using the appropriate ETF (exchange-traded fund) as a proxy for the asset class, investment-grade corporate bonds returned about 7% and high yield bonds did even better at 10%.

The more recent market declines relate to the fact that prices had moved up when things began to look less bad. In other words, it appeared we were not going into a depression, but the market can only rise so long based on declining sales and earnings which aren't as bad as some feared. One of the recent data points that has thrown the market back was non-farm payrolls report last week, as the "less bad" story didn't hold. The recent numbers were worse than the previous month after the report we saw last month was an improvement. Overall, the unemployment data paints an ugly picture. One of the concerns is that the unemployment rate understates the problem as it leaves out the "underemployed" and those who have given up looking for work. Including that group, the rate is at 16.5%, an all-time high, although the number certainly would have been much worse in the 1930's if the data went back that far. With so many people's incomes down as well as many others who fear that their income will go down, this will likely keep consumer spending from improving and thus real GDP growth will be hard to come by, especially when the government spending programs begin to wane.

Of course, as we have discussed in the past, often the unemployment rate is a lagging indicator. This is because companies don't necessarily ramp up hiring when the recovery seems to be upon us as they try and get by with who they have for a period of time before committing to new hires. Thus, the unemployment picture often doesn't improve until the recovery is well underway. And this is the challenge for those of us making market forecasts: markets typically move before the "all-clear" signs are showing.

In our mind, earnings are the key determinant over the next year, even more than normal, as to where the market goes. We say this because the stock market has priced in a sizeable recovery in earnings. And although most agree that there will be a good recovery in earnings, the key is how good. Forecasts right now look for earnings growth for the S&P 500 of low 20's. Using forecasts for 2009, we are looking at a p/e of 15-16. This is just slightly above normal suggesting that the market is modestly overvalued. But if the 20+% growth forecasts hold into next year this would bring the forward p/e down to the 12-13 range, making the market attractive based on that measure.

Our view is to take the more conservative view and not count on the sizeable growth that many are forecasting. Given the many problems out there we think we might see a continued market decline of 5-10% from here over the next few months. At that point it will likely be clearer whether we can actually realize the large earnings gains in 2010. Even if the expectations fall to just half the expected level, if we do get a modest market decline, we would view that as an appealing time to buy stocks or increase exposure.

As for other asset classes, our view hasn't changed much since last quarter. The least attractive area is small-caps whose index shows a loss in terms of reported earnings over the last twelve months. Even looking at expected earnings we are looking at a p/e over 30. International stocks and emerging market stocks have modestly better valuations than the U.S. (using the S&P 500), making them a bit more attractive as well.

Bonds, other than treasuries, continue to look appealing. Although given their large gains last quarter they are not quite as attractive anymore. We view investment-grade corporate bonds as still appealing as a defensive asset to own where gains should continue to be pretty good (expect to earn over the next year at least their yield to maturity of 6%+). And high yield bonds look similar to us as they have a bit more risk, but still less risk than stocks, although you may get nearly as good returns from them in a stock market rally.