



Perspective on the Latest Market Events

Commentary from Jim McDonald, Chief Investment Strategist

March 30, 2009

Does the latest rally have legs? While we recently cut our significant cash overweight in half by increasing our recommended exposure to high yield, emerging market stocks and commodities, we don't think we are out of the woods yet. History backs that expectation.

The Standard & Poor's 500 (S&P) has rallied 25% from the intraday low set March 6, 2009. Financial stocks led the gainers and jumped more than 50%, while the defensive health care and consumer staples stocks rose 12% and 13%, respectively. Looking back at the worst bear markets of the last century, both the 1929 – 1932 and the 1937 – 1942 bear markets produced four rallies greater than 25% during their duration.¹ The most recent severe bear markets (1973 – 1974 and 2000 – 2002) had two and four rallies, respectively, of more than 10%. But only the 2000 – 2002 bear market had rallies (two, in fact) that exceeded 20%. So the magnitude of the recent rally does have precedent in prior bear markets.

What sparked this rally? First, we simply may have hit a selling climax in the first week of March. With the markets down 18% during the first two months this year, some investors psychologically threw in the towel and liquidated their stock holdings. This led to the March 6 intra-day low of 666 in the S&P 500. This point of maximum bearishness set the stage for a stock rally that was kindled by a combination of factors: positive commentary from key bank executives about their company profitability thus far this year; more detail about the Obama administration's financial stability plans; signs the economy's pace of decline is moderating; and the Federal Reserve's bold move to quantitative easing. The market decline also had slashed valuations so that stocks were trading at a price/earnings (P/E) ratio of 10,² using market capitalization-based earnings, and the median P/E stood at 11.³ That compares to a median P/E of 16.5 over the last 37 years.

So what is the current outlook for the market? We are entering a period of significant news flow, featuring the Group of 20 (G-20) nations meeting this week in London, the expected completion of bank stress tests, further implementation of the Term Asset-Backed Securities Loan Facility (TALF) program, plus first-quarter corporate earnings.

The G-20 is expected to act on IMF funding and regulatory change but produce little movement on substantial coordinated fiscal stimulus. Information about the Obama administration's bank stress tests, structured to determine which banks may need additional capital in a more-stressed economic environment, likely will show some banks need substantial assistance. The TALF's successful operation will be critical to restoring lending in several important consumer markets, including



automobiles, credit cards and student loans.

Finally, companies will report first-quarter earnings reports over the next month – and we do not expect the news will be good. Our contacts with industrial companies indicate that demand continued to deteriorate as the quarter progressed, and the much-discussed improved performance from leading banks early in the quarter appeared to soften in March. Management outlooks also are unlikely to prove uplifting. Regardless, this won't be the leading indicator of an upturn in the economy. If the stock market acts anything like it has in prior recessions, it may start to anticipate a recovery well before the evidence shows up in the economic data or company management outlooks.

We continue to view a couple of items as central to a sustained recovery in the stock market. First, we need to see the improvement in the credit markets extend beyond the direct sale of debt by issuers (the primary market). It helps that corporations are seeing increased access to the issuance of new debt to willing buyers; however, the market for trading existing debt – the secondary market – remains dysfunctional. This secondary market strain, which prompted creation of the government liquidity programs intended to unfreeze this trading, continues to hamstring many financial firms. Second, housing prices must stabilize and establish a floor for collateral values for much of the troubled debt outstanding. While recent housing data have improved somewhat, including new and existing home sales in February, these come in a seasonally slow period and thus are hard to extrapolate. Housing affordability has reached a record high due to the decline in home prices, and conforming 30-year mortgage rates have dropped to 4.63%. But buyers won't return in full force without increased confidence that prices have stabilized.

We want to see not only improvement in credit markets but also signs of a bottom in housing, both of which could create an environment in which to put some additional cash to work in risk assets.

¹ – Data source: Brown Brothers Harriman & Co.

² – Russell 1000 index

³ – S&P 500 index

Important Information

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. This material is for information purposes only. The views expressed are those of the author(s) as of the date noted and not necessarily of the Corporation and are subject to change based on market or other conditions without notice. The information should not be construed as investment advice or a recommendation to buy or sell any security or investment product. It does not take into account an investor's particular objectives, risk tolerance, tax status, investment horizon, or other potential limitations. All material has been obtained from sources believed to be reliable, but the accuracy cannot be guaranteed.

