



Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

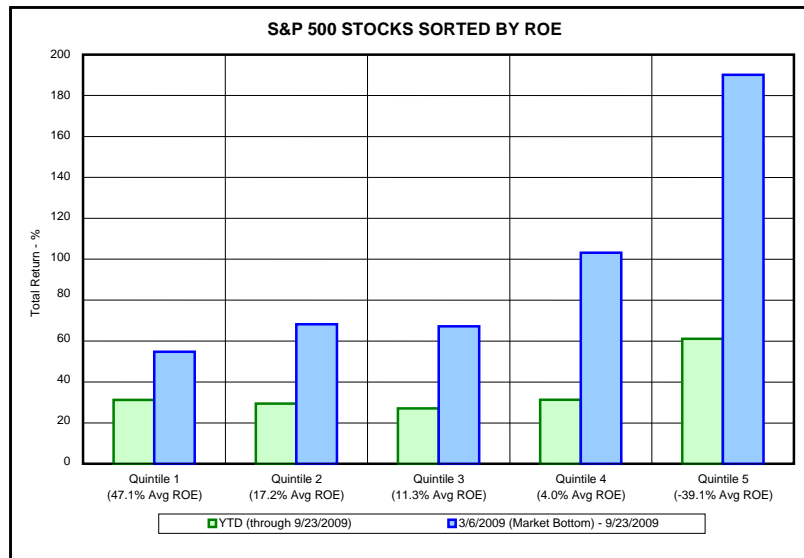
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The rally in the Standard & Poor's (S&P) 500 of nearly 50% since its bottom in early March 2009, and the even bigger rally in emerging markets stocks of over 100% since their bottom in November 2008, has led to some consternation about the sustainability of current market conditions. Investors are asking if the indiscriminate nature of the rally (in many instances, the lowest quality assets have rallied the farthest) discredits the result, thereby concluding that stocks have come too far, too fast. There is also concern that valuations must be extended based on the rapid price appreciation various equity markets have realized. We do think the rally is justified by the substantial improvement in the financial system (with continued governmental backstop, but more on that later) and the evidence of global economic recovery. We also don't find that valuation levels are unreasonable at this point, and we think they still reflect some discount for the continued dependence of the financial markets and economic recovery on global central banks and governments. So let's "peel the onion" on recent market performance, see which stocks have performed best, and look at where valuations sit after accounting for recent market gains.

One of the most eye-popping statistics available to market bears is the run in bank stocks – the KBW Bank Index bottomed at \$17.75 on March 6, 2009, and recently traded at \$46 – a whopping gain of 160%. Additional perspective, though, shows that this is less impressive than it appears, as the index is only up 5% year-to-date and is still 64% below its peak set in February 2007. Looking at the valuation of the financial sector as a whole, the group is trading at 1.1-times book value, compared with the average of 2.3-times book value in the period since 1995. This reflects the significant reduction in dividends, as the sector is currently only yielding 1.4%. So the reduction in valuation is justified, but with a price-to-book ratio of 1.1-times, valuations may be stretched if the sector has significantly disappointing earnings – which we don't anticipate.

The gains in bank stocks are emblematic of another feature of this market rally – the significant outperformance of low-quality stocks. The chart below, produced by Northern Trust's equity research department, breaks down the performance of the S&P 500 by quality ranking, using return-on-equity as a proxy for quality. For example, quintile 5 (the lowest quality stocks) had an average return on equity of -39%, meaning they had losses equal to 39% of their equity over the last year. Do that for a couple of years and you might just run into some trouble!





Since the bottom in the U.S. markets on March 6, 2009, the lowest quality stocks have appreciated in value over 180% – more than three times the return of the highest quality stocks. Even using the beginning of the calendar year as our starting point generates a return by the lowest quality stocks which is double that of the highest quality names. Note that these return numbers are much higher than the overall return for the S&P 500 – a capitalization-weighted index with a return most heavily influenced by the largest (and usually higher quality) companies. As the market rally matures and valuation measures become more normalized, we expect this “low quality” bias to disappear and high quality stocks to become better relative performers.

The strength of the rally in emerging markets stocks should also lead to a fresh examination of their outlook. As mentioned earlier, these stocks bottomed in November 2008, over three months ahead of the bottom in developed markets, and since then are up over 100%. Compared to their prior peak in October 2007, they are 30% below that high-water mark – comparable to the 33% drawdown realized by the S&P 500 since its peak in the same month. Even after these advances, global equity markets are trading at reasonable multiples of forward earnings – earnings we think should be achieved given the current profit cycle and business recovery. World stock markets are trading at 14 times forward earnings, with the U.S. at a 14 price per earnings ratio, Europe at 12 times, Japan at 25 times, and emerging markets at only 13 times. Notable valuations within the emerging markets group include China at 13 times, Brazil at 12 times, Korea at 13 times and India at 17 times. The current inflation environment and early cyclical position of the global economy could arguably support higher equity multiples, but the market seems to be extracting a risk premium for the continued dependence on governmental support. This seems sensible given the challenges central bankers will face in removing their liquidity support programs while attempting to minimize market disruption.

Equity markets are entering a volatile part of the quarterly earnings season – the “confession period” – where investors worry about earnings warnings from the companies that aren’t going to meet market expectations when they report earnings starting the second week of October. During this confession period last quarter, the market fell 7% from mid-June through mid-July, and then

rallied as earnings exceeded expectations. It wouldn't be a surprise to see a similar pattern emerge this quarter after the recent market gains, but investor confidence in the earnings picture is clearly stronger than last quarter. Setting aside short-term market fluctuations, the strength of the global recovery and the successful policy maneuvers by global central banks will be the key determinants of asset prices over the intermediate- to longer-term. We continue to think that the environment for increased risk-taking has improved in recent months, but remain focused, importantly, on the looming central bank exit strategies as the element most likely to provide a surprise.

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