

Quarterly Update

Fourth Quarter 2009

January 5, 2010

The quarter and year ended on a positive note which is spilling over to the new year. Growth outperformed value by more than 1,700 basis points, an enormous variance rarely seen over the past 30 years. If the financial sector and energy do better in 2010, this disparity between growth and value should narrow markedly.

We sense that the present consensus that the economy is bound to operate in an average mode next year is too cautious, even pessimistic.

We expect positive employment numbers in coming months. This is an enormous confidence builder touching off consumer spending, home buying and automobile demand. Detroit has already announced a sizable increase in car production for the opening quarter of 2010. This after a surprisingly strong selling rate in November and December. Let's not forget, automobile sales at the peak of the business cycle in early 2007 reached 16 million units. China is now selling more cars than the U.S.



So, a strong first quarter for GDP is all but in the bag, whittling down the unemployment rate. We're seeing too many negative head-lines and think pieces in the financial press. There remains a reservoir of pessimism that permeates financial markets. The present market consensus is approximately 1150 for the S&P 500 – in June of 2010. Expectations are unemployment doesn't peak below 10.9 percent. Fed Funds are put at 0.5 percent and the market ranging as low as mid-900s.

We reached for 1100 on the market months ago and expect 1200 within a few months. The level of Fed Funds is not relevant even at 2 percent, possibly even bullish, as it reduces excessive speculation in gold, oil and other commodities tied to futures markets. For these operators we wish burnt fingers for destabilizing financial markets. Our easiest prediction is equities outperform gold, which is the residual of fear extent in the world that the dollar has a shot at a free fall. As our country begins to post 4 percent or more GDP quarters the gold bugs must lose traction as the dollar strengthens.

Oil remains problematic. If we're right and the world reaches normalized growth by mid-2010, oil ranges between \$80 and \$100 a barrel, but in a very choppy trajectory. Inventories currently are very high in the western world. There are dozens of tankers filled with oil but nowhere to deliver it. Inventories in emerging markets are not counted in published weekly reports, but are substantial.

We remain underweighted in the energy sector. Additionally, electric power demand is down sharply, maybe for the next couple of years. Coal inventories pile up everywhere. Refineries are pad-locking old facilities and crack spreads remain narrow with gasoline consumption flattish at best. Sadly, the outlook for oil production in the U.S. is dismal. Old reservoirs have peaked and no major new discoveries are on the horizon.

Imponderables related to GDP forecasting are the personal savings rate, personal consumption spending and capital goods outlays. Currently, the personal savings rate stands at 4 percent but we expect it to work lower. If it hangs in there, personal consumption hardly budges on the upside. All the surveys on capital spending we see suggest some recovery next year, particularly for information technology. We remain overweighted in technology which we construe mostly as high class industrials tied directly to consumer spending.

Housing remains a tough call. Existing home transfers have picked up but new home buyers aren't stepping up to the plate as yet. The good news is both housing and capital goods spending are so depressed currently that even a modest surge bolsters GDP, more than 1 percent and possibly as much as 2 percent. The corporate sector handled itself conservatively with the exception of the financials. American industry cut overhead and smothered cap ex. Obviously, you can do this only once, but the fear is dissipating.

If we're right that the economy recovers, profit margins work higher. We're at \$80 a share in earnings for the S&P 500 in 2010. This is above consensus but could be low, especially if we prove too conservative on bank earnings and the price of oil. Market technicians pontificate that stocks rise as payrolls rise, consistent with late expansion of a market cycle.

With scare headlines still hogging the financial press we're not so sure the late expansion phase of this market's cycle has arrived. Actually, we're nowhere near end-of-cycle buoyancy, just the end of the beginning. We haven't even reached the end of inventory destocking, but it's coming soon, another upside surprise for GDP next year worth incrementally at least 1

percent of GDP.

Within the context of rising corporate earnings, low inflation and low interest rates, the stock market historically values earnings at a 15 multiplier. We expect normalized GDP momentum next year and a market at 1250 or higher. Equities should outperform 10-Year Treasuries, investment grade corporate debentures, gold and oil.

Our talking points for 2010:

- The dollar strengthens versus the Euro. There are too many Euro – denominated countries like Greece and Spain, even England that have troublesome economies. We grow faster.
- Dollar strength creates a headwind for oil and gold. Nobody gets any richer long these two commodities relative to equities.
- Our interest rates ratchet up slowly and don't impact the valuation structure on the Big Board. Fed Funds at 2 percent and 10-year Treasuries at 4.5 percent by yearend is a livable construct. The working multiple for the market remains mid-teens.
- Employment turns positive month after month and the country experiences normalized growth, at least 4 percent the next four quarters.
- Growth stocks continue to outperform value properties because the financial sector and energy are discounting too much recovery over a foreshortened time span. The variance may close to no more than 500 basis points this year.
- The S&P 500 ends the year at 1250 as corporate earning power doesn't disappoint and the market is busy discounting more growth in 2011.
- The pivotal macro variables for the market by mid-2010 are the savings rate and personal consumption expenditures. We could argue both sides but viscerally come out bullish. The savings rate declines because there's no real yield available unless you buy below investment grade paper with 10-year maturities.
- The biggest surprise will be how fast the market reaches 1200. Why? Because most economists fear a midyear relapse in GDP. Hedge fund operators coming off a mediocre year remain ambivalent and Wall Street's pundits fear inflation, surging interest rates and a stall out in major corporations' profit margins. What are they missing? Synchronous worldwide growth.

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